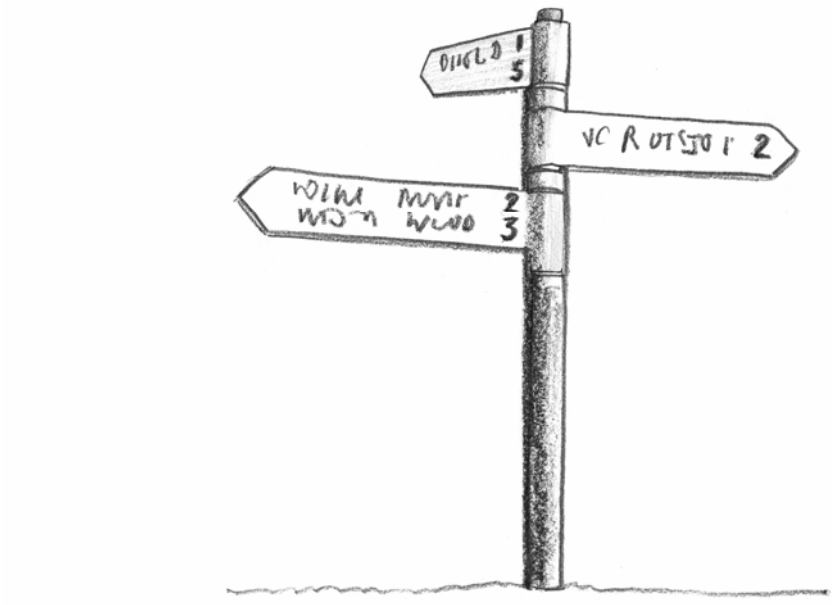
Financial Instruments – A Chief Financial Officer's guide to avoiding the traps

An introduction to IAS 39 Financial Instruments: Recognition and Measurement

April 2009



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1 Introduction

1.1 Who should read this?

This guide is intended for Chief Financial Officers (CFOs) of businesses that prepare financial statements under IFRS. It summarises the impact of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) together with relevant parts of IAS 32 *Financial Instruments: Presentation* (IAS 32). It is not intended to explain every aspect of the standards in detail. Rather, it summarises the main challenges that businesses typically encounter in order to help CFOs to prioritise and identify key issues. The guide will help a CFO to understand potential problem areas in order to know when to consult further.

Every business is involved in financial instruments in some way. The required accounting can be challenging even for seemingly straightforward arrangements. IAS 39 and IAS 32 are two of the most complex IFRS standards - they are lengthy, use technical language and often take a rule-based approach. Detailed examination of the standards, and specialist advice, may be needed to determine the required accounting. The specific challenges will of course vary between businesses - this guide is aimed at typical commercial businesses rather than financial institutions or sophisticated treasury operations. A CFO of such a business may not need to understand all the complexities of IAS 39 and IAS 32 but he or she should know what to look out for and when to drill down further.

The member firms within Grant Thornton International Ltd (Grant Thornton International) – one of the world's leading organisations of independently owned and managed accounting and consulting firms – have gained extensive insights into the more problematic aspects of IAS 39. Grant Thornton International, through its IFRS team, develops general guidance that supports its member firms' commitment to high quality consistent application of IFRS and is therefore pleased to share these insights by publishing this guide *Financial Instruments – A Chief Financial Officer's guide to avoiding the traps*. The guide reflects the collective experience of Grant Thornton International's IFRS team and member firm IFRS experts.

1.2 What are the key challenges?

This document summarises the key challenges in the following areas:

Which transactions give rise to financial instruments?

Normally, this is straightforward but there are some important exceptions. For example businesses that buy or sell commodities will often have to be very mindful of the IAS 39 scope rules and the 'own use exemption'. To put this into context, if a purchase or sales order in respect of a commodity is outside the so-called 'own use exemption' in IAS 39, it would typically give rise to a derivative financial instrument accounted for at fair value through profit or loss. (See Section 2)

What is within the scope of IAS 39?

Some types of transaction give rise to an item meeting the definition of a financial instrument but which is outside IAS 39's scope. It is important to understand those areas, as being within the scope of IAS 39 normally brings specific recognition and valuation consequences.

For instance, a business can often enter into contracts which might result in a potential obligation to pay out cash in the future. This meets the basic definition of a financial liability, once the contract is no longer executory (eg when goods or services have been delivered). However if, for example, the contract meets the definition of an insurance contract then it would be scoped out of IAS 39. (See Section 2)

What distinguishes debt from equity?

Distinguishing between financial liabilities (debt) and equity in respect of instruments that an entity issues, for example where it issues share capital, can be a particular challenge. For instance, there are many instruments with contractual obligations to pay cash under circumstances which are contingent on future events. These typically meet the definition of a financial liability and pose considerable challenges in terms of measurement. Further, businesses often issue instruments which they will settle in their own equity, for example, where a business issues warrants. Whether or not such warrants are classed as debt or equity requires careful consideration, and the impact is considerable. For instance, if warrants are classified as debt, then they would typically be carried at fair value through profit or loss and so have a volatile impact on earnings. (See Section 3)

How does IAS 39 categorise financial instruments and why does this matter?

It is important to identify how each financial instrument is categorised under IAS 39 and how the instrument is then measured. 'Fair value' is always relevant on initial recognition. Depending on the categorisation, subsequent measurement might either be at fair value or at amortised cost. Also, any derivatives within the scope of IAS 39 must be carried at fair value through profit or loss, other than those relating to cash flow hedges or net investment hedges where the optional (and onerous) hedge accounting rules are applied. (See Section 4)

How are financial instruments measured?

Measurement of instruments may involve having to employ the services of valuations specialists. Management may also need to carry out a detailed assessment of expectations of future cash flows, potentially including situations where there is significant inherent uncertainty. For instance, consider a loan where future payments are dependent on uncertain events such as future revenues. The measurement of the instrument will involve management having to assess at each reporting date its best estimate of the future cash flows. It is important to identify such issues at as early a stage as possible in order to allow management to address those challenges and to manage the expectations of the users of its financial statements. (See Section 4)

How might IAS 39 impact on seeking or renegotiating finance?

Whenever a business is seeking new financing or modifying existing finance deals, it is important to understand the impact of IAS 39. The standard could have important implications both in terms of the carrying value and classification of the new funding and in terms of whether there is any gain or loss to be recognised on any modifications. There may also be an impact on balance sheet ratios and covenants. (See Section 5)

What are embedded derivatives and why are they important?

Identifying if any separable embedded derivatives exist is crucial. Embedded derivatives are derivatives which reside within a larger contract. For many businesses, these will not provide any particular complications, but for some they will pose a significant challenge.

For instance, say an entity takes out a loan where finance costs vary in accordance with the price of a commodity. This would require the instrument to be separated into a host debt contract with an embedded derivative. The embedded derivative would then be valued at each reporting date with the fair value movements included in profit or loss for the period.

Embedded derivatives can also exist in common business transactions such as sales or purchase orders denominated in foreign currencies or in early repayment options in loans. However, in many such cases, the nature of the embedded derivative is such that it is deemed to be 'closely related' to the host contract and so is not separated. (See Section 6)

What about bad and doubtful debtors?

The impairment rules in IAS 39 can pose a challenge for businesses that have receivables where there are doubts as to repayment or if repayment is expected but delayed. For commercial businesses, IAS 39 is relevant to normal receivables due from customers, and requires a 'scientific' assessment of the net present value of the expected future cash inflows. Achieving compliance with IAS 39 may necessitate changes to internal procedures for assessment of bad debt provisions. (See Section 7)

How might IAS 39 impact on results and can this impact be mitigated?

IAS 39 can sometimes lead to more volatile earnings, particularly when the business has entered into derivatives. Sometimes, those derivatives will have been taken out as part of an economic hedge. The default IAS 39 position is that the derivative should be carried at fair value through profit or loss, even if this results in the statement of comprehensive income reflecting the fair value impact of the hedging instrument (usually a derivative) in profit or loss in different accounting periods to those in which the hedged item impacts on profit. Hedge accounting in IAS 39 is purely optional but can be used to mitigate those timing differences. However, hedge accounting comes with significant conditions and is far from a free choice, and one which requires action at the outset. (See Section 8)

What if my company prepares its separate financial statements under IFRS?

IFRS has some unique challenges for 'separate financial statements' such as the individual financial statements of the parent entity, in particular for intra-group balances and guarantees over other group entity borrowings. (See Section 9)

1.3 Additional material in this guide

In addition, we include the following:

- a glossary – a description of the meaning of some terms used by IAS 39 (Appendix A)
- a summary of the type of financial instruments which a typical non-financial services business may enter into and the consequences of IAS 39 (Appendix B).

This guide does not cover the disclosure challenges posed by IFRS in respect of financial instruments. The financial instruments disclosure standard IFRS 7 *Financial Instruments: Disclosures* includes extensive requirements. A key message is that IFRS 7's disclosures will make it more apparent as to whether or not IAS 39 has been applied correctly.

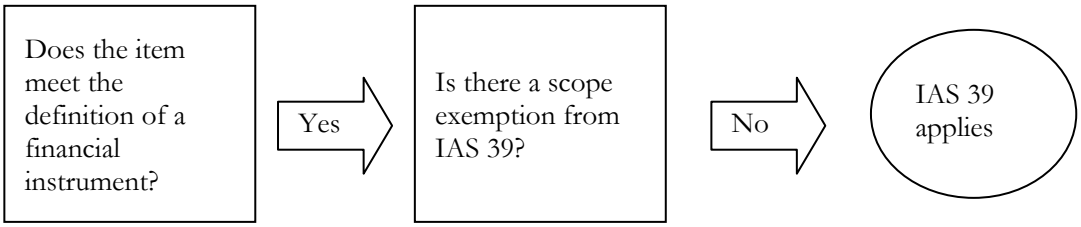
1.4 Terminology used in this guide

The terminology used in this guide is consistent with that in IAS 1 *Presentation of Financial Statements* (Revised 2007). This standard is mandatory for annual periods commencing on or after 1 January 2009. Key terminology changes include replacing the term 'balance sheet' with 'statement of financial position' and introducing the statement of comprehensive income. The latter may be presented as one statement or as two, an income statement and a separate statement of comprehensive income, broadly equivalent to the statement of recognised income and expense under the previous version of IAS 1.

Income and expenses recognised outside profit or loss (ie outside the income statement) are now referred to as being recognised in other comprehensive income.

2 Scope of IAS 39

2.1 When does IAS 39 apply?



When considering whether IAS 39 applies, the key point to address is whether or not the transaction entered into gives rise to a financial instrument. To do that, we need to look to IAS 32, which defines a financial instrument as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity". The scope of IAS 39 also covers some contracts for non-financial items, such as certain commodity contracts (see below.) The terms financial asset, financial liability and equity, are themselves defined in IAS 32.

The definitions are detailed and technical. In addition, some types of financial instrument are specifically excluded from IAS 39's scope. These issues are discussed below.

2.2 What is a financial instrument?

Common examples of financial instruments include cash, equity investments, accounts receivables, accounts payable, loans receivable, loans payable and derivatives (such as forward contracts or interest swaps). However, financial instruments can also arise in less obvious ways, such as through contracts for non-financial items (see below).

Key definitions

Detailed definitions are set out in the Glossary at Appendix A and summarised definitions of the key terms are provided below.

A 'financial instrument' is defined by IAS 32.11 as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity."

A 'financial asset' is any asset that is:

- cash
- an equity instrument of another entity
- a contractual right to receive cash or another financial asset or to exchange financial assets or financial liabilities on potentially favourable terms
- certain types of contract which will or may be settled in the entity's own equity instruments (discussed further in Section 3.3).

A 'financial liability' is any liability that is:

- a contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity
- certain types of contracts which will or may be settled in the entity's own equity instruments (discussed further in Section 3.3).

An 'equity instrument' is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities, eg ordinary shares.

In summary, a 'derivative' is a financial instrument or other contract within the scope of IAS 39 with all three of the following characteristics:

- Its value changes in response to an 'underlying' such as a specified interest rate, financial instrument price, commodity price foreign exchange rate, index or other variable (provided in the case of a non-financial variable that the variable is not specific to a party to the contract)
- It requires no initial net investment or an initial net investment smaller than would be required for other types of contract expected to have a similar response to changes in market factors
- It is settled at a future date.

Throughout this document, we refer to the 'issuer' and 'holder' of instruments. The holder is the 'asset holder' and the issuer is the party that either issues an equity instrument or has a liability. For instance, if Entity A issues ordinary shares to an investor, then the investor is the holder and Entity A is the issuer. Similarly if Entity A borrows from a bank, the bank is the holder and Entity A is the issuer.

The definition of financial liability as opposed to equity is one which is often crucial from an issuer's perspective and is covered in Section 3.

Does the arrangement arise from a contract?

The definition of a financial instrument involves an arrangement formed within a contract. Therefore common exclusions from the financial instrument definition are liabilities or assets arising from statute (as opposed to contracts) such as income taxes or sales taxes.

What if ultimate payment is contingent or uncertain?

IAS 39 and IAS 32 do not have any exclusion on the basis of payments being contingent or uncertain in nature. Hence, a contract where an amount of cash is payable dependent on a future contingent event still meets the definition of a financial asset in the hands of one party and a financial liability in the hands of the other party. Therefore, that instrument would be accounted for under IAS 39, unless the financial instrument definition was failed for some other reason or there was a specific IAS 39 scope exclusion.

Whilst in most cases, it will be apparent whether or not a contract gives rise to a financial instrument, there are many cases where careful analysis will be required. A common example is a contract that gives rise to future obligations to pay cash to a third party where those cash outflows are based on a percentage of the entity's own sales or profits. Such contracts are commonplace in financing arrangements, such as entities issuing share capital to venture capitalists, and in certain industries such as the extractive industries, technology sector and pharmaceuticals.

IAS 32.25 clarifies that obligations contingent on events outside an entity's control, such as its future sales or profits, meet the definition of a financial liability. If such obligations give rise to a financial liability within the scope of IAS 39, the entity is normally required to recognise a liability based on the expected future cash outflows.

Note that the recognition criteria in IAS 39 differ significantly from those in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. For instance, consider an arrangement where an entity has a potential obligation to pay out cash in the future dependent on a contingent event where occurrence of that event is not considered probable. If that arrangement were contractual such that it met the definition of a financial instrument, then it would be within the scope of IAS 39, and IAS 39 would require a financial liability to be recognised. However if the arrangement had for some reason not met the definition of a financial instrument, then IAS 37 would probably be applied instead. IAS 37 would not require any liability to be recognised on the basis that ultimate payment was not considered probable.

Thus, it is important to consider carefully any arrangements entered into by contract where settlement is contingent on future events, as these may require recognition of a financial instrument at the time the contract is entered into. A common misunderstanding is that contingent assets or liabilities do not result in recognition of assets or liabilities (by application of IAS 37). However, if the particular arrangement is contractual then this may give rise to a financial instrument. IAS 39 may require recognition of a financial asset or financial liability.

What about contracts for non-financial items?

Non-financial items (eg normal purchase and sales orders) do not create financial instruments unless they are considered to be capable of net cash settlement and fall outside the 'own use exemption' in IAS 39. However a financial instrument arises once the related services or goods are delivered. For example, when a purchase order is entered into there is no financial liability. However once the goods or services are received, the associated creditor is a financial liability.

Some contracts for non-financial items (eg commodities) are caught by IAS 39 if they do not meet the 'own use exemption' in IAS 39. This exemption means, for example, that in general purchase orders are not accounted for as financial instruments where they are for non-financial things the entity will use in its business.

Factors to consider in determining whether such contracts are covered by IAS 39 are set out below:

- If the contract can be settled net or the entity's practice is to take delivery for short-term profit (eg a dealer's margin) then the contract is covered by IAS 39. An example is contracts to buy grain where the entity either has a practice of settling these to cancel delivery (and settling the net difference in value) or of taking delivery and selling on for short-term gain
- A written option is covered by IAS 39 (see Appendix A for definition of a written option). For example, Entity A enters into a sales contract with Entity B at a stated price per tonne, but Entity B has a choice under the contract as to how much volume to take at that price. From Entity A's perspective, this is a written option
- If contracts are not settled net in practice and are for the entity's own use then they are outside IAS 39, eg contracts to purchase grain where an entity uses it as raw material and does not in practice settle the contracts net.

For entities such as commodity suppliers or utility companies, the own use exemption will require very careful analysis and the technical considerations are likely to be more extensive than described in this document. For those entities, the own use exemption analysis will be of crucial importance. For example, in the context of an aluminium supplier, this is important because:

- sales contracts which were 'own use' would normally not result in any accounting entries until delivery (at which time revenue would be recognised)
- sales contracts which were not 'own use' would be accounted for as financial instruments. This means that accounting recognition would commence at time of entering into the contract (ie pre-delivery). It is likely such contracts would meet the definition of a derivative and so would be carried at fair value through profit or loss.

2.3 What instruments are excluded from IAS 39's scope?

Having identified an entity's financial instruments, it is important to understand that various types of financial instruments are scoped out of IAS 39 and so are typically dealt with by other standards. The basic approach is that, if an entity has entered into a contract which meets the definition of a financial instrument, it must account for it under IAS 39 unless there is a scope exclusion.

The main financial instruments excluded from IAS 39 are:

- investments in subsidiaries, associates and joint ventures (as dealt with by IASs 27, 28 and 31) although derivatives relating to these investments remain within the scope of IAS 39
- an issuer's own equity instruments, as defined by IAS 32, hence adding further importance to the distinction between debt (financial liability) and equity
- leases (accounted for under IAS 17) although IAS 39 applies to derecognition, impairment of lease receivables and embedded derivatives, eg prepayment options within leases
- employee benefit plans (covered by IAS 19)
- share-based payments (dealt with under IFRS 2) unless they fall within the criteria noted below for certain contracts to buy or sell non-financial items
- rights and obligations under insurance contracts. This is relevant where insurance risk is involved. Insurance contracts are defined in IFRS 4. Distinguishing between insurance contracts and financial instruments can require careful analysis based on the specific fact pattern
- contingent consideration in business acquisitions in respect of the acquirer (dealt with by IFRS 3) although this scope exclusion is removed after adoption of the revised IFRS 3 (Revised 2008) which applies for periods commencing on or after 1 July 2009
- loan commitments, although IAS 39 includes rules for provisions in respect of commitments to issue loans at less than market value. This exclusion does not apply where the commitment can be settled net, such as where loan assets are sold shortly after origination, or where the entity designates commitments as at fair value through profit or loss.

Therefore, the assessment of whether or not the arrangement gives rise to a financial liability in the scope of IAS 39 has major consequences. We set out below some brief examples to illustrate the attention to detail which may be required.

Example 1 – financing arrangement
On 1 January 20X0, Entity A issues shares to Investor. Investor pays CU1 million to Entity A. The share capital agreement involves Entity A agreeing to pay an annual dividend to Investor based on 20% of its annual profits. This meets the definition of a financial liability from Entity A's perspective and there is no scope exemption from IAS 39. Entity A therefore must account for the financial liability arising. This will involve at each reporting date Entity A assessing the net present value of the future cash flows (based on its best estimate of future profits).

Note there are potentially two views as to whether in Entity A's financial statements the financial liability would meet the definition of a derivative or whether it would be an 'other financial liability' at amortised cost. However on either basis, the carrying value would still need to reflect the expected future cash flows. This would typically mean that the liability would give rise to volatility in profit or loss.

Example 2 – technology licence
On 1 January 20X0, Entity B signs an agreement with Entity C to use patented technology in a specified product for a period of 10 years. The licence is non-exclusive. Entity B is required to make payments to Entity C based on 10% of product sales. Entity C has retained control over the technology as evidenced by the following:

1 Entity B is not permitted to sell or sub-licence the technology
2 The uses to which Entity B could put the technology are restricted

From Entity B's perspective, the arrangement does not give rise to a financial liability because Entity B has entered into the arrangement for a non-financial item (being the access to Entity C's technology) and a financial instrument does not arise at the outset. In other words, a financial instrument arises only after the non-financial services or products have been delivered. Entity B would then reflect only a financial liability as sales occur based on 10% of actual sales made to date (as opposed to being based on future sales).

Note that the analysis may be different if it were concluded that, on 1 January 20X0, Entity B obtained control of an intangible asset (eg if it has unrestricted use). Under that scenario, the non-financial item (the purchase of the intangible) would have been delivered at the outset on 1 January 20X0, and thus a financial liability would arise under IAS 39, based on the net present value of future expected cash outflows.

2.4 Are financial guarantees covered by IAS 39?

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a debtor fails to make payment when due. IAS 39 specifies the accounting in respect of the issuer of that financial guarantee:

- A contract which meets the definition of a financial guarantee contract may be accounted for under IAS 39. Under IAS 39, such contracts are generally recognised initially at fair value, and subsequently at the higher of the amount determined under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less cumulative amortisation under IAS 18 *Revenue*
- If the entity has previously asserted that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts then the issuer may elect to apply the insurance standard IFRS 4 instead. This election can be made on a contract by contract basis

If separate financial statements (such as parent entity individual financial statements) are prepared under IFRS, then depending on their terms, guarantees provided by one entity over borrowings of another group entity may meet the definition of a financial guarantee contract. The accounting may cause practical difficulties as there is no exemption for guarantees in respect of related party borrowings. In such cases, it may be a challenge to assess the fair value of the guarantee at inception. This issue is discussed further in Section 9.4.

It is incorrect to assume that all guarantees are financial guarantee contracts. An examination of the contract terms will often indicate that the particular terms do not meet the definition of a financial guarantee contract. For example, performance guarantees where one party provides a guarantee (to make a payment to an entity) should a third party fail to perform an obligation such as delivering plant and machinery does not meet the definition of a financial guarantee contract. This is because it is not dependent on failure by a debtor to pay and therefore does not relate to credit risk; such contracts would normally be insurance contracts.

3 Distinction between debt and equity

3.1 Debt versus equity – why so important?

The debt (financial liability) versus equity distinction is important from an issuer's (ie borrower's) perspective. Put simply:

- If an instrument is debt:
  - it will be presented as a liability in the financial statements
  - it will be subject to IAS 39's recognition and measurement rules
  - the accounting will impact on the profits for the period.

- If an instrument is equity:
  - the proceeds received are credited directly to equity and are not remeasured
  - it is not subject to IAS 39 accounting by the issuer
  - there will be no impact on profit or loss for the period.

3.2 Debt and equity

In summary, a financial liability (debt) is any instrument that is:

- a contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (with the exception of certain 'puttable instruments' and obligations that arise only on liquidation)
- a certain type of contract which will or may be settled in the entity's own equity instruments (see Section 3.3).

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Most ordinary shares are equity instruments.

3.3 Contracts for settlement in own equity – the fixed-for-fixed test

An entity may enter into contracts which will or may be settled via the issue of the entity's own equity instruments. For example an entity may issue warrants or options to its investors. From the investors' perspective the instruments are clearly financial assets. However the accounting by the issuer depends crucially on what is often termed the 'fixed-for-fixed test.'

The fixed-for-fixed test is included in IAS 32.16, which states that an instrument is an equity instrument if, and only if, specific conditions are met. In this context, the key condition that an instrument must meet in order to be equity is that in IAS 32.16(b):

"(b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D."

The references to paragraphs 16A and 16B and 16C and 16D are to exceptions for puttable financial instruments and obligations arising on liquidation. Where these exceptions are relevant, reference should be made to the full text of IAS 32.

Why is the fixed-for-fixed test important?

The fixed-for-fixed test is important because it can have a significant impact on an issuing entity's statement of financial position and results:

- If the contract passes the fixed-for-fixed test, it is accounted for as equity. That means the initial proceeds are credited to equity and are not re-measured
- If the contract fails the fixed-for-fixed test, it is a financial liability. It will often be a derivative, which means it will be accounted for at fair value through profit or loss. Thus, at each reporting date the entity will have a significant challenge in assessing the reporting date fair value. Also, the movement in fair value will affect profits

The fixed-for-fixed test is particularly important in the context of debt instruments, such as convertible bonds, that include contractual terms which may involve conversion to the issuer's own equity. From the issuer's perspective, if the conversion option fails the fixed-for-fixed test, it is accounted for as an embedded derivative liability. This usually means the conversion right is remeasured at each reporting date and the fair value movements impact on results.

Whenever an entity issues financial instruments which may be settled via the issue of its own equity (such as warrants, options or convertible bonds) it is crucial that the fixed-for-fixed test is considered. It determines whether these instruments are debt or equity.

Note that the fixed-for-fixed test is not relevant in the case of options or warrants issued in exchange for goods or services (such as share options issued to employees). That is because such options would fall within IFRS 2 *Share-based Payment* and would be scoped out of IAS 39.

The following examples illustrate how the fixed-for-fixed test operates:

Fixed-for-fixed test illustrations

Example 1

Entity A issues 100 share warrants to investors. Each warrant gives the holder (investor) the right to buy one of Entity A's equity shares at CU1.20 per share. There are no variations to the exercise price or numbers of shares. Entity A's functional currency is Sterling. As exercise of each warrant always involves the holder paying a fixed amount of cash for a fixed number of shares, Entity A accounts for the warrant as equity.

Example 2

On 1 September 20X6, Entity A enters into a contract with Entity B to issue 100 equity shares on 31 December 20X6 for such an amount of cash as is equal to 100 ounces of gold. This contract does not meet the fixed-for-fixed test because the price of gold is variable, so this is a financial liability in Entity A's financial statements (IAS 32.24). The financial instrument would be likely to meet the IAS 39 definition of a derivative.

Example 3

Entity A issues 100 share options to investors. Entity A's functional currency is Sterling. The exercise price for each option is 1 US dollar. As the exercise price is not fixed in terms of Entity A's functional currency, under IAS 32 and IAS 39, this option contract fails the fixed-for-fixed test and so is treated as a financial liability in Entity A's financial statements (most likely as a derivative liability).

In many cases, agreements will begin by specifying a fixed exercise price and number of shares, but then specify numerous conditions giving rise to variations in the number of shares to be issued. In performing the fixed-for-fixed test, it is important to consider carefully such variation clauses. A strict reading of the fixed-for-fixed test may indicate that any such variations cause the fixed-for-fixed test to fail. However, terms that give rise to changes in the exercise price and number of equity instruments issued on exercise that are purely anti-dilutive do not necessarily breach the fixed-for-fixed requirement. For example, a pro-rata change in the event of a future bonus issue is an obvious anti-dilutive clause. Nevertheless, there are many ways in which the fixed-for-fixed test might fail. This publication does not address this issue in detail but it is critical to take care regarding terms in the conversion rights that have the effect of varying the number of shares to be issued or varying the conversion price to be paid. Professional advice should be sought in such circumstances.

3.4 Compound instruments

Compound instruments are non-derivative financial instruments (from an issuer's perspective) which contain both a financial liability and an equity component. IAS 32 sets out how to account for such instruments. Broadly, this involves splitting the fair value of the instrument at time of initial issue between a debt component (based on the fair value of the cash flows of the debt) and an equity component (which is the residual). IAS 32 includes illustrative examples on how to perform this split. A common example of a compound instrument is a convertible bond where the conversion right passes the fixed-for-fixed test. The issuer would account for this as a compound instrument. However, there is no accounting parallel treatment from a holder's perspective.

4 Categorisation and measurement of financial instruments

4.1 Categorisation and measurement summary

The measurement basis is dependent on categorisation of the financial asset or liability, which may be summarised as follows:

	Category	Initial measurement	Subsequent measurement	Gains and losses
Assets	Fair value through profit or loss	Fair value	Fair value	Recognised in profit or loss
	Loans and receivables	Fair value *	Amortised cost	Recognised in profit or loss
	Held to maturity	Fair value *	Amortised cost	Recognised in profit or loss
	Available for sale	Fair value *	Fair value	Fair value movements initially taken to other comprehensive income and then recycled to profit or loss on impairment or derecognition
Liabilities	Fair value through profit or loss	Fair value	Fair value	Recognised in profit or loss
	Other financial liability	Fair value *	Amortised cost	Recognised in profit or loss
* The value at inception is also adjusted for transaction costs, other than for assets or liabilities at fair value through profit or loss (see Section 4.2).				

Financial assets and financial liabilities at fair value through profit or loss

Financial assets in this category are carried at fair value, with fair value changes recognised in arriving at profit or loss for the period.

This category covers:

- financial assets and financial liabilities held for trading – these include all derivatives (apart from those designated as hedging instruments) and other financial assets and financial liabilities held principally for sale in the short term (ie relating to short term-trading of financial instruments)
- financial assets and financial liabilities designated as being at fair value through profit or loss. An entity may opt to designate a financial asset or liability into this category but this option is available only on initial recognition. IAS 39 limits such designation to the following cases where:
  - it eliminates or reduces an accounting mismatch
  - it relates to a group of assets/liabilities which are managed and their performance evaluated on a fair value basis
  - the instrument is a hybrid contract containing an embedded derivative.

Loans and receivables

These are non-derivative financial assets with fixed or determinable payments. They are measured at amortised cost, less impairment where applicable.

'Amortised cost' means the amount recognised initially less principal repayments plus or minus cumulative amortisation, using the effective interest method, of the difference between initial amount and maturity amount. Reductions for impairment or uncollectibility are made where necessary.

To be included in this category, the loan or receivable asset must not be quoted on an active market and the entity must not have elected to classify it as being at fair value through profit or loss or as an available for sale asset. In addition, there must be no intention to sell in the short term (otherwise the asset would be categorised as held for trading instead).

Held-to-maturity investments

These are assets that have fixed or determinable payments and that the entity has a positive intention and ability to hold to maturity. Assets are included in this category only by specific designation as such. They are measured at amortised cost, less impairment where applicable. Financial assets generally may not be included in this category where a previous asset was so categorised in the last two years but was sold before its redemption date. (This is an anti-abuse provision known as the 'tainting rules'.)

This is a category rarely used by non-financial services businesses. This is because it would normally only be relevant to loan assets traded on an active market and non-convertible traded bonds (such as listed corporate bonds). An entity would only have an incentive to use this category where it wished to account for such an instrument at amortised cost. Where a financial asset with fixed or determinable payments is not traded on an active market, it will normally be classified as a loan and receivable and carried at amortised cost making designation as held to maturity unnecessary.

Available-for-sale financial assets

This category includes those financial assets not included in any of the previous three categories. In addition, an entity may designate any asset other than a trading one as being available for sale. The most common type of financial asset to be included in this category is likely to be an equity instrument held as a non-trading investment.

Available-for-sale financial assets are measured at fair value with the gains or losses being recognised in other comprehensive income rather than through profit or loss, then recycled through profit or loss later, usually when the asset is sold or impaired. Rarely, where fair value cannot be measured reliably, they are measured at cost.

Other financial liabilities

These are basically all financial liabilities other than those carried at fair value through profit or loss (most commonly this will mean all financial liabilities other than derivatives). These are carried at amortised cost.

4.2 Initial measurement

Whether carried subsequent to initial recognition at fair value or amortised cost, all financial assets and financial liabilities are measured on initial recognition at fair value plus, except in the case of financial assets or financial liabilities at fair value through profit or loss, transaction costs that are directly attributable to their acquisition or issue (IAS 39.43).

Normally the amount of the transaction proceeds is strong evidence of the initial fair value and should be taken as the best evidence of opening fair value. However there are situations where the initial transaction value may not be a reliable evidence of fair value. For example this may be the case with related party loans.

Where the opening fair value is different to the transaction proceeds, IAS 39 requires the difference to be included in profit or loss unless it relates to another asset (IAS 39.AG64).

4.3 Amortised cost where there are uncertain future cash flows

There may be cases where the future cash flows for loans and receivables, or for other financial liabilities, are uncertain. One such situation would be a financial liability where the contractual outflows are based on uncertain factors such as future profits, for example share capital where there is a contractual obligation to pay dividends as a fixed percentage of profits earned. Despite being accounted for at amortised cost under the effective interest method, IAS 39.AG8 includes a principle which will result in the carrying value being restated at each reporting date to the net present value of the future discounted cash flows, discounted using the original effective rate. The restatement is included in profit or loss.

If the future cash flows of an instrument are uncertain, the impact of IAS 39.AG8 may create significant profit volatility and will require an entity to continually reassess expected future outflows. The impact on profit or loss in many cases will not be dissimilar to fair value through profit or loss accounting.

4.4 Derecognition of financial assets

IAS 39 contains detailed steps to consider when deciding whether a financial asset should be derecognised. There are five key steps summarised in the table on the following page.

Step 1	Determine whether to apply derecognition criteria to specific assets or to a group of assets.
Step 2	Derecognise when contractual rights to asset expire or an asset has been 'transferred' (Step 3) and transfer qualifies for derecognition (Steps 4 and 5).
Step 3	Consider whether a 'transfer' has occurred. This is the case where either the rights to cash flows have been transferred or where the entity retains the contractual rights but assumes obligations to pay the proceeds onto a third party without delay once received.
Step 4	If a transfer has taken place, consider the extent to which risk and rewards have been retained or transferred. If substantially all risks and rewards have been transferred then the asset should be derecognised. If substantially all risks and rewards have been retained then the asset should continue to be recognised. Risks and rewards are reviewed in the context of exposure to cash flows pre and post the deal, eg if an asset is sold with the option to buy back at fair value at the time of purchase, the asset is derecognised as substantially all risks and rewards will have been transferred.
Step 5	If the entity has neither transferred nor retained substantially all risks and rewards (ie some significant risks and rewards transferred but others retained) the entity needs to assess whether it retains 'control' over the asset (referring to the practical ability of the transferee to sell the asset). If control is not retained then the asset is derecognised and the assets or liabilities retained are separately recognised. If control is retained, the asset continues to be recognised to the extent of the entity's continued involvement.

On derecognition, the sales value less carrying value of sold assets is taken to profit or loss together with any gains or losses previously recognised in other comprehensive income (eg on assets previously designated as available for sale). When proceeds are received but the asset is not derecognised, the proceeds received are reflected as a liability.

Examples of transactions where assets qualify for derecognition are unconditional sales, a sale with an option to repurchase at fair value at time of purchase, a sale with a put or call option which is deeply out of the money such that the option is unlikely to be exercised, and a sale of a readily obtainable asset (eg a quoted investment) with a call option that is neither deeply in nor deeply out of the money. Examples of transactions where assets do not qualify for derecognition are a sale and repurchase agreement where the purchase price is fixed or is sales price plus a lender's return, a security lending arrangement, a sale with a put or call option that is so far in the money that it is unlikely to be out of the money before expiry and a sale of receivables where the transferor guarantees to compensate credit losses.

In our experience, non-financial services entities are not normally affected by the complex de-recognition rules. This is because they normally either retain the risks and rewards relating to the financial asset until they receive counterparty payment (eg a loan asset) or sell the asset (eg an equity investment). One important exception to this is a factoring arrangement. Careful analysis is required in such cases.

4.5 Derecognition of financial liabilities

Financial liabilities are derecognised when and only when they are extinguished, ie the obligation is discharged, cancelled or expires.

5 Raising new finance and modifications to existing borrowings

5.1 Raising new finance

When raising new finance, companies should always consider carefully the IAS 32 classification of, and IAS 39 accounting for, all instruments to be issued. This will often involve specialist consultation. In our experience, many companies have had unpleasant surprises when they have not considered the accounting carefully at the outset. Some recurring themes are outlined below.

Warrants and options

If the raising of finance involves the issue of warrants or options, the fixed-for-fixed test should be considered carefully as this will determine whether the instruments are accounted for as equity or as derivative liabilities (see Section 3.3). Derivative liabilities will be accounted for at fair value through profit or loss. Hence, the entity would then often need to use sophisticated valuation techniques to determine the fair value at each reporting date.

Convertible loans

If the entity issues convertible loans, the conversion terms should be considered very carefully to see if the fixed-for-fixed test is met (see Section 3.3). If the fixed-for-fixed test is passed, the issuer must account for the instrument as a compound instrument, where there is both a debt component (representing the obligation to pay interest and potentially redeem in cash assuming no conversion) and an equity component (representing the conversion right). If the fixed-for-fixed test fails then the accounting involves a host debt and a separable embedded derivative. The embedded derivative would then need to be accounted for at fair value through profit or loss. The embedded derivative treatment (for the conversion right) would normally involve valuation techniques being used at each reporting date to calculate the fair value. Embedded derivatives are considered further in Section 6.

Share capital – IAS 32 classification

If the entity issues share capital, any non-standard terms should be examined carefully against the IAS 32 debt/equity classification. The following are examples of non-standard terms attaching to shares which give rise to financial liabilities:

- Any dividend rights which are outside the control of the entity, even if on a contingent basis, create a financial liability at the outset, for example if there is a contractual obligation to pay dividends based on future profits (IAS 32.25)
- Redemption rights requiring the entity to pay cash in the event of change of control create a financial liability as the entity cannot prevent its shareholders from selling their shares

In summary, if there are any terms that involve the entity making payments due to events that are not within the complete discretion of the entity, this may create a financial liability.

Instruments issued in combination

If more than one instrument is issued at the same time to the same holders, then this may present complications. Whilst the overall transaction proceeds would normally be a reliable basis for the combined fair value of all instruments issued, the amounts contractually allocated to each individual instrument may not be a reliable basis for the fair value at inception of those individual instruments.

Example

Consider a case where Entity A issues to holder B, a CU1 million five-year loan at 6% per annum and 1,000 share warrants. The issue proceeds are an overall CU1 million (paid by B to Entity A). The legal documentation ascribes the proceeds of CU1 million all to the loan. In this case, the opening accounting carrying values of the loan and warrants would require a split of the CU1 million so that they reflect properly the opening fair values of the two instruments.

Transaction costs

The treatment of transaction costs and other payments connected with the issue of an instrument should be considered carefully. Transaction costs in relation to debt instruments are included within the finance cost relating to the debt, through the amortised cost method, whereas transaction costs in connection with equity instruments are debited direct to equity (IAS 32.35).

5.2 Modifications and restructuring of finance

The accounting requirements (and the reflection of any gain or loss) will depend on the particular circumstances and we would strongly advise consultation with specialists in respect of the accounting implications. The accounting treatment would typically depend on:

- the IAS 32 classification of the instruments affected (debt, equity or compound) prior to the modification
- the IAS 32 classifications of any new issued instruments
- whether any debt instruments are modified and, if so, whether those modifications are significant
- whether modification of instruments alters the IAS 32 classification or creates embedded derivatives.

The table below illustrates some possibilities for modifications and why careful analysis will be required on a case-by-case basis.

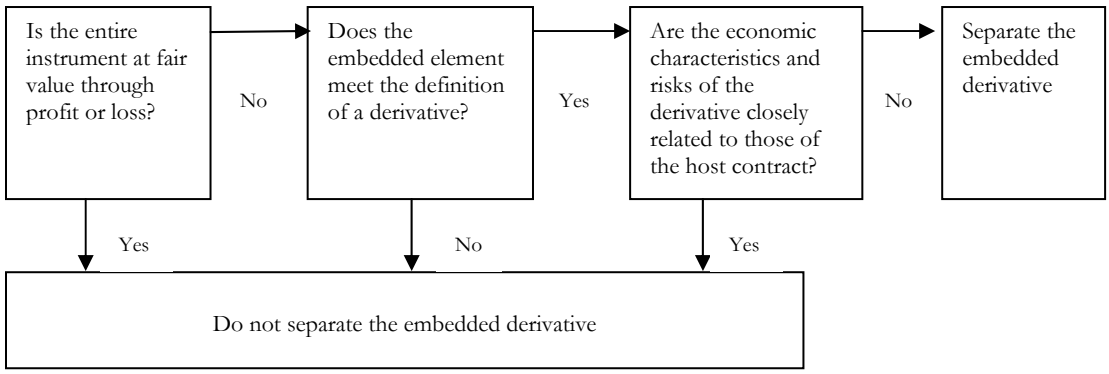
Instrument before modification or restructuring	**Nature of modification and resulting instrument**	**Accounting implications**
Debt (non-convertible)	Debt but significantly modified	IAS 39.40-41 require the new instrument to be carried at fair value on inception (and the old instrument extinguished). A gain or loss is reflected in profit or loss (including the impact of transaction costs per IAS 39.AG62).
Convertible debt (compound)	Equity (conversion under original terms)	There has been no modification here but rather the conversion has occurred within the original terms. Per IAS 32.AG32, the conversion results in no gain or loss.
Convertible debt (compound)	Repaid but on terms different to that in instrument	IAS 32.AG33 and AG34 contain specific rules on variations in contractual terms in order to repay a convertible bond early, where the instrument is currently a compound instrument. This involves splitting the repayment proceeds between debt and equity. The effect of this can be seen where a payment made by the issuer reflects a large premium to entice the bond holders to accept payment rather than use their conversion option (usually when the share price has increased such that the option exercise price is significantly in the money). If there has been no significant change in market rates of the debt component, there may often be negligible impact on profit or loss.
Convertible debt (compound)	Equity, but conversion was on different terms to original instrument	IAS 32.AG35 deals with a scenario in which an entity amends the conversion terms in order to induce early conversion. The difference at the date of amendment between the fair value of the consideration the holder receives on conversion under the revised terms, and the fair value of the consideration the holder would have received under the original terms, is recognised as a loss in profit or loss. This charge can be significant. IAS 32's illustrative examples include a worked example of this.
Convertible debt (host debt with embedded derivative liability)	Equity via conversion	The full fair value movement of the conversion rights (up to point of conversion) is reflected in profit or loss as this is the fair value movement of the embedded derivative.

Instrument before modification or restructuring	Nature of modification and resulting instrument	Accounting implications
Non-convertible debt	Equity (via deal agreed to convert to equity)	Treatment depends on the overall substance. If in substance the transaction was a waiver of debt then IAS 32.35 would require recognition of a gain in profit or loss. However, as long as the conversion to equity is genuine (as opposed to being clearly a waiver), this is an area in which IAS 39 is not specific and so an accounting policy choice is available. Possibilities may include reflecting the transaction on a no gain/no loss basis or reflecting a gain/loss based on the difference between the fair value of the shares issued in comparison to the pre-conversion carrying value of the debt (based on IAS 39.41).
Convertible debt (compound)	Convertible debt (host debt with embedded derivative)	This is where the change has involved modification such that the conversion no longer meets fixed-for-fixed. The standards are not prescriptive on this. A gain or loss arises, but there may be a choice of methods as to the underlying calculations, as the modification involves two things, being a debt modification which will give a gain or loss but also an equity distribution.

6 Embedded derivatives – what are these and what should I look out for?

6.1 What is an embedded derivative?

In some cases, derivatives are embedded into a host contract. Where this is the case, the derivative may need to be separated from the host contract and accounted for as a derivative, unless the entire instrument is carried at fair value through profit or loss. If an embedded derivative is required to be separated out but this is not possible, the entire instrument is accounted for at fair value through profit or loss. IAS 39 contains detailed provisions as to when an embedded derivative exists and should be separated, which are summarised by the following diagram:



Embedded derivatives may arise in many types of contract, including some that may not be financial instruments. The most common types of host contract to contain embedded derivatives are sales contracts, purchase contracts, lease contracts and debt contracts.

Many entities will have some embedded derivatives, although the more common ones are often deemed closely related to the host contract and hence not separated. For example, the following are all embedded derivatives, although separation would then depend on the closely-related test:

- foreign currency denominated sales and purchase contracts
- early repayment options within debt instruments
- options to extend a debt instrument
- clauses in leases causing changes in lease costs dependent on changes in an index
- a collar within a loan agreement (note this is not the same as a collar which is a separate contract to the loan – an embedded collar refers to a collar arrangement which is directly embedded and not contractually separate from a loan).

6.2 Closely-related test

This test examines whether the economic characteristics and risks of the derivative are closely related to those of the host contract. The detailed requirements for determining whether or not an embedded derivative is closely related to the host contract are set out in IAS 39.AG27-AG33. IAS 39.AG30 and AG33 contain specific criteria for particular types of embedded derivative.

In our experience, one of the most common types of embedded derivative that is not closely related to the host contract is a convertible debt contract. In this case, the equity conversion option is the embedded derivative. The equity conversion option is not generally closely related to the host debt. Thus, from the holder's perspective, the instrument will usually comprise a loan asset and a separable embedded derivative asset for the conversion option.

From an issuer's perspective the equity conversion option may meet the IAS 32 definition of equity and thus give rise to a compound instrument, provided the fixed-for-fixed test is met (see Section 3.3). If this test is not met, the conversion option will give rise to an embedded derivative liability from the issuer's perspective.

6.3 What if an embedded derivative is closely related?

As noted above, an embedded derivative that is closely related to the host contract should not be separated. Instead, it would be taken account of within the host contract.

For example, if an early repayment (or prepayment) option existed within a loan agreement, it would be considered closely related if the amount to be paid on repayment was always approximately equal to the amortised cost of the host loan. If this were the case, the prepayment option would not be separated. However, the effective interest cost calculations would take into account the expected impact of the prepayment option.

6.4 Embedded derivative versus stand alone derivative

The closely-related test is relevant only for an embedded derivative. IAS 39.10 notes that if a derivative is contractually transferable from a host contract then that derivative is a stand-alone derivative. A derivative contract (ie a stand-alone contract) is always carried at fair value through profit or loss unless hedge accounting applies.

The importance of this can be seen clearly in, for example, an interest collar. Interest collars will usually be taken out (in an economic sense) in relation to, say, a borrowing agreement. Contracts should be examined carefully to see whether the collar is a stand-alone contract or is embedded directly in, and not contractually transferable from, the underlying loan.

If the collar is a stand-alone contract, it would always be carried at fair value through profit or loss, unless hedge accounting applied. However, for detailed reasons not covered in this publication, avoiding profit or loss volatility of a collar by using hedge accounting is difficult.

If the collar arrangement is embedded directly in the loan agreement, the collar would instead be an embedded derivative (eg the loan agreement contains a clause stating that the interest rate on the loan will not be higher than 8% or lower than 4% and this clause is not contractually transferable from the loan). In the case of an embedded collar, the IAS 39.AG33(b) test is such that the closely-related condition would be met if at inception the market rate was neither below the floor nor above the cap of the collar (ie providing in this example that at time of inception the market rate was between 4% and 8%).

7 Impairment of financial assets

7.1 Overview

Impairment tests are required where there is evidence that financial assets are impaired. Such tests are required on assets carried at cost or amortised cost and also on assets designated as available for sale, because previous gains or losses on those will have been recognised in other comprehensive income rather than through profit or loss. Impairment losses are recognised in profit or loss.

Where assets are carried at amortised cost, subsequent reversal of impairment write-downs is required in certain circumstances. However, where assets are carried at cost, because a reliable fair value was not available, subsequent reversal is not permitted. For available-for-sale financial assets, subsequent reversal through profit or loss may be required for debt instruments but is not permitted for equity instruments, although at time of writing the IASB have been under some pressure to reconsider this point.

7.2 Impairment of trade receivables

In the context of non-financial services businesses, the IAS 39 impairment rules are important for consideration of bad debt provisions against trade receivables. Such receivables technically have an impairment event if the debtor has not paid within its due date. Therefore an impairment charge could apply even if the nature of the impairment event is one of delay as opposed to ultimate non-payment.

IAS 39 has specific principles for calculating impairment of financial assets. For assets carried at amortised cost (eg including loans and receivables such as trade receivables) the impairment calculation involves a comparison between the carrying value (pre-impairment) and the net present value of the expected cash flows discounted by the original effective rate.

A significant issue for a non-financial services business to monitor is whether their impairment provisions on trade and other receivables have a material impact as a result not only of non-payment by debtors but also slow payment. In other words, in trade receivables slow payment can give rise to an impairment charge due to the time value of money impact even if ultimately payment is expected in full.

7.3 IAS 39 impairment model

Most businesses incur credit losses (bad debts) from time to time. The extent of credit losses varies widely depending on the credit standing of customers and entity-specific credit control practices.

IAS 39 deals with credit losses through its requirements on impairment. Its approach is often referred to as an 'incurred loss' model. Under this approach, impairments are recognised only on the basis of one or more 'loss events' that have occurred after initial recognition. Loss events are also referred to as objective evidence of impairment. An event is a loss event if there is a correlation between the event and a deterioration in the expected cash flows (amount and/or timing) from the receivables.

At each reporting date, receivables should be reviewed for any objective evidence of impairment. Objective evidence of impairment might include:

- information indicating that the debtor is in significant financial difficulty (IAS 39.59(a))
- breach of contract, eg a debtor not paying by the due date (IAS 39.59(b))
- information indicating that it is probable the debtor will become insolvent or similar (IAS 39.59(c))
- downgrade in credit rating (in conjunction with other information) (IAS 39.60).

In practice, failure to pay by the due date is the most common and easily identified indicator.

When evidence of impairment is identified, the amount of impairment is the difference between (i) the carrying value of the receivables; and (ii) the present value of the expected future cash flows discounted at the original effective interest rate (IAS 39.63).

IAS 39.64 always requires a collective or portfolio approach to impairment assessment. Further:

- An initial, individual review is required for items that are individually significant (IAS 39.64)
- In the collective assessment, items are grouped on the basis of common credit risk characteristics (IAS 39.AG87)
- Items are removed from the collective assessment once information becomes available that specifically identifies losses on individual items (IAS 39.AG88)
- Any individual items that are reviewed and found not to be impaired are then also included in the collective assessment (IAS 39.64)

Some entities reporting under previous GAAP have previously adopted accounting policies that are not necessarily supported by objective evidence such as:

- establishing general bad debt reserves to cover the risk of possible future bad debts, and
- alternatively, or in addition, determining bad debt reserves using a provision matrix that specifies provision percentages based on the length of time receivables are overdue.

These practices may be inconsistent with IAS 39.

Although IAS 39's impairment model can appear complex, the degree of sophistication required in practice should reflect the significance of credit losses to an entity's business. For most commercial businesses, implementing procedures to comply with the impairment requirements should not prove unduly burdensome. However, some analysis might be required to compile and maintain the necessary data on credit loss experience.

8 Hedge accounting – when might it be relevant?

8.1 Introduction

This section provides an overview and a brief illustration of the hedge accounting aspects of IAS 39. Hedge accounting is specified in much more detail in IAS 39 and reference to the standard is necessary in order to confirm compliance with the detailed requirements.

The key messages on hedge accounting are as follows:

- It is optional
- Particular risks are hedged
- It is intended to mitigate or avoid volatility in profit or loss
- It requires forward planning and cannot be done retrospectively
- The detailed requirements in IAS 39 present significant challenges for entities intending to apply hedge accounting

8.2 Is hedge accounting mandatory?

Hedge accounting is purely optional. It is, however, a useful tool in mitigating the profit or loss volatility that would otherwise arise, for example the potential for substantial profit fluctuations as a result of fair value movements. However, as set out below, if the hedge accounting option is taken then it is subject to significant rules within IAS 39. The rules-based approach of IAS 39 arises because hedge accounting involves a departure from the general IAS 39 principles in respect of derivatives (ie the IAS 39 default position is that derivatives are carried at fair value through profit or loss). It would be incorrect to assume that, because a hedge appears to be a sound economic hedge, it necessarily qualifies for hedge accounting and also incorrect to assume that hedge accounting will avoid all related volatility in profit or loss.

As hedge accounting is optional, not all entities will need to consider the detailed hedge accounting rules (ie the rules are only relevant if hedge accounting is opted for). However, if an entity wishes to apply hedge accounting, the hedge accounting rules are likely to provide a significant challenge. This section does not provide extensive hedge accounting guidance but seeks to:

- help a CFO understand when hedge accounting might be useful
- provide an overview of the rules and challenges faced
- illustrate simple examples of how hedge accounting impacts on the accounting entries.

An example of where hedge accounting might be useful is a foreign currency forward contract which may be used to hedge the foreign exchange risks relating to future sales or purchases. Forward contracts are normally derivatives and, as such, IAS 39 requires them to be included in the statement of financial position at fair value. In the absence of hedge accounting, changes in fair value would be recognised immediately in profit or loss. Cash flow hedge accounting allows gains or losses on the forward contract to be included in other comprehensive income until the time of the related sales or purchase transactions. In this illustration, the forward contract is the 'hedging instrument' and the forecast transaction is the 'hedged item'. In practice, particular risks may be hedged, rather than an entire transaction.

8.3 When can I choose to use hedge accounting?

As described below, there are detailed rules to consider in determining when hedge accounting is available. However, even where a hedging transaction meets the detailed conditions, the choice to use hedge accounting must be made at the inception of the hedge and this must be evidenced by formal documentation.

Hedge accounting cannot be decided upon as a matter of convenience during the year-end process. A CFO who has not previously been involved with hedge accounting needs to keep this in mind and plan ahead. Hedge accounting requires detailed analysis and documentation to be drawn up at the time of the transaction in order to justify the accounting treatment. A key challenge is that the documentation must specify the methods to be used for effectiveness tests. It is highly likely that, a CFO who has had no previous involvement with hedge accounting will need to seek specialist help before initiation of the hedging transaction.

8.4 What types of hedges exist and how are they accounted for?

There are three types of hedge that may qualify for hedge accounting under IAS 39:

- Cash flow hedges
- Fair value hedges
- Hedges of a net investment in a foreign operation.

Cash flow hedges

Cash flow hedges are those where a hedging instrument is designed to hedge future cash flow effects of a hedged item. Examples are:

- forward currency contract hedging future committed or highly probable foreign sales or purchases in respect of foreign exchange risk
- commodity contract hedging highly probable future sales or purchases in respect of commodity price risk
- variable-to-fixed interest rate swap hedging interest rate risk on a variable rate debt instrument.

Under cash flow hedge accounting, gains and losses on remeasurement of the hedging instrument to fair value are taken direct to other comprehensive income, to the extent that the hedge is effective, then subsequently released to profit or loss to match the related hedged item. Any ineffective element is charged or credited immediately to profit or loss.

Fair value hedges

Fair value hedges are hedges of the exposure to changes in the fair value of a recognised asset or liability or an unrecognised firm commitment or an identified portion of any of these.

Examples of where fair value hedge accounting may be used are:

- an entity has a loan asset at a fixed interest rate, which is carried at amortised cost. It uses an interest rate swap (pay fixed, receive variable) to cover the fair value risk
- an entity has a commodity asset (eg silver) or firm purchase commitment. It purchases a put option to sell the commodity at a fixed price to offset the risk of price changes
- a forward currency contract hedging a firm sale or purchase commitment in a foreign currency, although this could alternatively be accounted for as a cash flow hedge.

Fair value hedge accounting is designed primarily for use where (under other IAS 39 requirements) the hedged item is an asset or liability carried at cost or amortised cost whilst the hedging instrument is carried at fair value through profit or loss. The accounting for a fair value hedge involves an additional entry in profit or loss for the amount of the effective hedge (with the other side of the entry being to adjust the hedged item) offsetting the profit or loss effect of the movement in fair value of the hedging instrument.

Under IAS 39, entities may, in some cases, opt to designate financial assets or financial liabilities on initial recognition as being at fair value through profit or loss. Though IAS 39's 'fair value option' restricts the voluntary designation at fair value through profit or loss, one permitted case is where it eliminates or significantly reduces an accounting mismatch. For example, a loan asset that would otherwise be carried at amortised cost but is related to a derivative liability carried at fair value may itself be designated on initial recognition as being at fair value through profit or loss. This may be an alternative way to achieve a similar impact on profit or loss to fair value hedge accounting, without needing to meet IAS 39's more stringent and detailed hedging conditions.

Hedges of a net investment in a foreign operation

Under IAS 21, exchange gains and losses on retranslation of a foreign operation with a functional currency different to the currency in which the parent presents its group financial statements are taken to other comprehensive income. However, if a derivative, or a non-derivative instrument such as a foreign currency loan in the same currency as the foreign operation, is used to hedge the foreign exchange risk, then, in the absence of hedge accounting, the gains or losses on the hedging instrument would be taken to profit or loss. This would be inconsistent with the treatment of the foreign exchange movement on the foreign operation, with potential for significant profit fluctuation.

By applying hedge accounting, the gain or loss on the hedging instrument is taken to other comprehensive income to the extent that the hedge is effective. However, note the following:

- For hedge accounting to be used, formal documentation must be in place prior to hedge accounting being implemented
- Under IAS 39, gains or losses on the foreign currency loan or other hedging instrument can only be taken direct to other comprehensive income to the extent that the hedge is effective
- The IAS 39 hedge of a net investment covers only the consolidated financial statements (ie does not apply to the parent's individual or separate financial statements)

8.5 What qualifies as a hedged item?

A hedged item may be a single item or group of items that is:

- a recognised asset or liability (see below for exceptions)
- an unrecognised firm commitment
- a highly probable forecast transaction, such as highly likely sales or purchases
- a net investment in a foreign operation.

The following are not allowed as hedged items:

- assets designated as held to maturity in respect of interest rate or prepayment risk
- transactions that do not affect profit or loss
- derivatives, apart from a purchased option hedged by a written option, as these are already carried at fair value through profit or loss
- equity investments that do not have a quoted price or where fair value cannot be estimated reliably
- equity method investments, in respect of fair value hedges
- an investment in a consolidated subsidiary, in respect of a fair value hedge
- the entity's own equity instruments issued
- groups of items with dissimilar risks
- unrecognised assets or liabilities such as intangibles which do not qualify for asset recognition
- hedging of net positions (eg the net between sales and purchases) although the same effect can be achieved by designating part of the underlying item (eg rather than designating the hedged item as the net exposure on Euro sales less purchases, the hedged item would be the first X Euro sales)
- forecast transactions that are not highly probable.

A portion, rather than the whole amount, of a financial asset or liability may be designated as a hedged item. For a non-financial asset or liability, the entity can only hedge either foreign exchange risk or the entire change in fair value from all risks.

In a group, added complications arise. For the purposes of the consolidated financial statements, intra-group transactions do not normally qualify as hedged items. This is because they do not involve any external exposure for the group. However important exceptions to this are

- foreign currency risk on an intra-group monetary item (as the profit impact may not be removed fully on consolidation)
- foreign currency risk of a highly probable intra-group transaction provided that the transaction is denominated in a currency other than the functional currency of the entity entering into the transaction and the foreign currency risk will affect consolidated profit (ie where the intra-group transaction is related to an external transaction). This has important consequences where different group entities are involved in a series of transactions.

The above issue is best explained by an example.

Example
Parent entity A (Sterling functional and presentational currency) has a French subsidiary B (Euro functional currency) and a US subsidiary C (US dollars functional currency). B manufactures a product and sells those products to C in US dollars. C then sells the products to external customers in US dollars. B enters into a buy Euro/sell USD forward contract. In the group financial statements, A could designate the forward contract as a hedging instrument over the intra-group sales from B to C, due to the following:

- The intra-group sales are highly probable
- The intra-group sales are denominated in US dollars (ie a currency other than B's Euro functional currency)
- The expected onward sale of the inventory in US dollars to external customers results in a foreign currency exposure in the consolidated financial statements. In this case, the onward sale creates a foreign currency exposure arising from USD/Euro movement. This arises because, from a group perspective prior to the US dollar sale to customer, on consolidation the inventory held by the US entity has a cost denominated in Euros, as the intra-group profit is cancelled on consolidation. Therefore, the ultimate external US dollar sale creates a foreign currency exposure in the consolidated financial statements

8.6 What qualifies as a hedging instrument?

A hedging instrument may be:

- any derivative or a proportion thereof, except written options as these generally increase risk. A written option can be used as a hedge against a purchased option however
- a non-derivative financial asset or liability, but only for foreign currency risk (eg a foreign currency loan used to hedge foreign currency risk).

Sales or purchase commitments cannot be hedging instruments, as these are not assets or liabilities. Only instruments that involve a party external to the reporting entity may be designated as hedging instruments.

Generally, a hedging relationship is designated for a hedging instrument in its entirety, with limited exceptions for options and foreign currency contracts where fair value changes may be split into components and only one component designated as the hedging instrument. A portion of an instrument, for example 50% of the notional amount, may be designated as a hedging instrument but an instrument must be designated as such for its entire time period (eg a ten-year option must be a hedging instrument for that hedge for ten years; not just, say, five years).

8.7 Hedge effectiveness

To qualify for hedge accounting, a hedge must be 'highly effective' and effectiveness must be reliably measurable. Effectiveness must be tested both prospectively and retrospectively. Where a hedge fails the effectiveness test, hedge accounting should be discontinued. For the retrospective test, hedge accounting is discontinued from the date effectiveness was last demonstrated.

IAS 39 does not prescribe particular methods of assessing effectiveness. However, as noted below, the testing methods to be used must be set out in the formal documentation supporting the hedge accounting designation. The actual results of the hedge need to be that the gain or loss on the hedging instrument is within a range of 80% to 125% of the corresponding loss or gain on the hedged item.

Even if the hedge is highly effective, the ineffective element must always be charged to profit or loss. It is not correct to assume that the hedge is always 100% effective just because critical terms match. There are many ways in which ineffectiveness arises. For example:

- If the hedged items are highly probable sales, then it is unrealistic to assert that the customer will always pay on exactly the same day as the related hedging instrument matures
- If the hedge relationship commenced after the derivative hedging instrument had been entered into, then this would create ineffectiveness
- At inception of a cash flow hedge, an interest swap (pay fixed/received variable) will often have exactly matching terms to a variable rate loan (the hedged item). However, if at any time in the future the terms no longer match (eg through loan repayment) this may create ineffectiveness

8.8 When does hedge accounting commence?

Hedge accounting commences at the time that the hedge relationship is established on meeting the conditions of IAS 39.88. Amongst other things, this means that the hedge accounting documentation has been set up and that the first prospective effectiveness test has been carried out (ie to look forward to demonstrate that the hedge is expected to be highly effective).

The hedge inception date is not necessarily the same date as that on which the hedging instrument is entered into. For example, say on 1 January 20X0 Entity A enters into an interest swap with a bank. On 1 June 20X0, Entity A establishes the hedge relationship by documenting the hedge and meeting other conditions in IAS 39.88. This has the following implications:

- From 1 January 20X0 to 1 June 20X0 the interest swap should be carried at fair value through profit or loss (ie all gains or losses are recognised in profit or loss for the period)
- From 1 June 20X0, cash flow hedge accounting commences. However, the fact that the interest swap does not have nil fair value at the hedge commencement date means that some ineffectiveness will arise going forward

8.9 Example: cash flow hedge

Cash flow hedge accounting for variable-to-fixed interest rate swap hedging variable interest borrowings

Entity A borrows CU5 million on 1 July 20X0. Interest is paid semi-annually and no principal is repaid during the period considered in this example. The loan carries variable rate interest, which, for illustration, is assumed to be at LIBOR. The swap is assumed to be a fully effective hedge of the loan, being for the same principal amount, same payment date and paying variable rate interest at LIBOR to Entity A in exchange for Entity A paying 7.5% annual rate (which is also the LIBOR rate on date of entering the swap). Therefore, on each loan interest payment date, the swap acts to pay to or receive from Entity A so that its overall cash outlay is 7.5%. This swap receipt or payment is the 'settlement' referred to at each date in the table below.

The interest rates in place, settlement and swap fair values are:

Date	LIBOR	Swap fair value pre-settlement (CU)	Settlement paid/ (received) (CU)	Swap fair value post-settlement (CU)
1 July X0	7.5%	0	0	0
31 Dec X0	6.0%	(100,000)	37,500	(62,500)
30 June X1	7.0%	(40,000)	12,500	(27,500)

Under IAS 39, the swap is a derivative carried in the statement of financial position at fair value. In the absence of hedge accounting, the charge/(credit) through profit or loss would be:

	6 months to 31 Dec X0 (CU)	6 months to 30 June X1 (CU)
Interest on variable rate loan	150,000	175,000
Fair value movement on swap	100,000	(22,500)
Total profit charge	250,000	152,500

The fair value movement on the swap in the six months to 30 June 20X1 represents the difference between its fair value, pre-settlement, at 30 June (CU40,000 liability) and its opening fair value, post-settlement, on 1 January (CU62,500 liability). For the six months to 31 December 20X0, the movement is simply the difference between the fair value at inception of CUnil and the pre-settlement fair value at 31 December of CU100,000 (liability).

Therefore in the absence of hedge accounting, the profit or loss impact is volatile.

Under hedge accounting, the fair value movement on the swap would instead be taken to a hedging reserve and recognised in other comprehensive income, rather than through profit or loss. The hedging reserve is then reclassified to profit or loss as the related costs are incurred.

In the period to 31 December 20X0, the entries relating to the swap using hedge accounting would be:

	CU	CU
Dr Hedging reserve (other comprehensive income)	100,000	
Cr Swap liability (100,000 – 37,500)		62,500
Cr Bank		37,500
Recognition of fair value movements and payments on interest swap.		
Dr Finance costs (profit or loss)	37,500	
Cr Hedging reserve (other comprehensive income)		37,500
Release of hedging reserve to match with interest costs incurred (ie reclassification to profit or loss).		

In the period to 30 June 20X1, the entries relating to the swap using hedge accounting would be:

	CU	CU
Dr Swap liability (12,500 + 22,500)	35,000	
Cr Hedging reserve (other comprehensive income)		22,500
Cr Bank		12,500
Recognition of fair value movements and payments on interest swap.		
Dr Finance costs (profit or loss)	12,500	
Cr Hedging reserve (other comprehensive income)		12,500
Release of hedging reserve to match with interest costs incurred (ie reclassification to profit or loss).		

Therefore under hedge accounting in both six-month periods, the profit or loss charge will be CU187,500, equivalent to fixed rate of 7.5% of loan, and fair value movements on the swap will go through other comprehensive income. For the six months to 31 December 20X0 the CU187,500 comprises the interest on the loan of CU150,000 together with a reclassified hedge amount of CU37,500. For the six months to 30 June 20X1, the CU187,500 comprises interest on the loan of CU175,000 and a reclassified hedge amount of CU12,500.

At 30 June 20X1, the swap liability post-settlement is CU27,500, which is matched by a debit balance on the hedging reserve of CU27,500 (100,000 – 37,500 – 22,500 – 12,500).

The fair value gains (losses) on the swap and the reclassification adjustments in each period may be presented separately on the face of the statement of comprehensive income as illustrated below (IAS 1.92). Alternatively, the reclassification adjustments may be presented in the notes, in which case the net amounts are shown in other comprehensive income (IAS 1.94).

Statement of comprehensive income - extract	**6 months to 31 Dec X0 (CU)**	**6 months to 30 June X1 (CU)**
Other comprehensive income		
Cash flow hedging		
-current period gains (losses)	(100,000)	22,500
-reclassification to profit or loss	37,500	12,500

Statement of changes in equity- cash flow hedges reserve	**6 months to 31 Dec X0 (CU)**	**6 months to 30 June X1 (CU)**
Opening balance	-	(62,500)
Other comprehensive income		
Cash flow hedging		
-current period gains (losses)	(100,000)	22,500
-reclassification to profit or loss	37,500	12,500
Closing balance	(62,500)	(27,500)

Cash flow hedge accounting unwinds as the cash flows occur. At the end of the hedging instrument's life, all related cash flows will have occurred and its fair value will be nil. All gains and losses recognised in other comprehensive income will ultimately be released through profit or loss. In this example, the overall profit or loss impact will equal the total cash paid, which will be equivalent to 7.5% fixed interest on the loan.

However this simple example has assumed 100% effectiveness and is therefore prior to any ineffectiveness. 100% effectiveness will not always be achieved. For example, if the principal amounts or the payment dates did not always match exactly between the swap and the related loan, then this would create ineffectiveness. Also if the hedge relationship commenced after the interest swap was already in place, and hence the hedge relationship started when the interest swap did not have nil fair value, this would create ineffectiveness.

8.10 Example: fair value hedge of unrecognised firm commitment

On 30 June 20X0, Entity B (whose functional currency is CU) entered into a firm commitment to purchase a machine, which will be property, plant and equipment once delivered, for US$100,000. Delivery is due on 31 January 20X1. Payment is due immediately on delivery. At the same time, Entity B entered into a forward contract to buy US$100,000 on 31 January 20X1 at a rate of CU0.57142 for each $1 (in effect fixing the amount to pay for the machine at CU57,142). Entity B's year-end is December.

Under IAS 39, a foreign currency risk of an unrecognised firm commitment may be accounted for as either a fair value hedge or a cash flow hedge.

Entity B designates the forward contract as a fair value hedge of the currency risk within the commitment to purchase the machine. Exchange rates (expressed as amount of CU needed to buy US$1) and the fair values of the forward contract are:

	Spot rate	**Forward rate (for contract maturing 31 January 20X1)**	**Fair value of forward contract at 0.57142 for $100,000**
30 June X0	0.5500	0.57142	CUnil
31 December X0	0.5400	0.55000	(CU2,142)
31 January X1	0.5400	0.54000	(CU3,142)

On 31 January 20X1 the machine is delivered as planned. The accounting entries are as follows:

30 June 20X0

No entries. The firm commitment itself is not recognised. The hedging instrument is recognised but its fair value on initial recognition is assumed to be CUnil.

31 December 20X0:

	CU	CU
Dr Profit or loss	2,142	
Cr Derivative liability		2,142
Being recognition of change in fair value of forward contract derivative (compared to initial fair value of nil).		
Dr Firm commitment (asset)	2,142	
Cr Profit or loss		2,142
Being change in fair value of (previously unrecognised) firm commitment recognised under fair value hedge accounting.		

If hedge accounting had not been selected, only the first of the above entries would have been made.

31 January 20X1 (pre-delivery and settlement):

	CU	CU
Dr Profit or loss	1,000	
Cr Derivative liability		1,000
Change in fair value of forward contract.		
Dr Firm commitment (asset)	1,000	
Cr Profit or loss		1,000
Fair value accounting entry for change in fair value of firm commitment (pre-delivery).		

Post delivery on 31 January 20X1:

	CU	CU
Dr Plant asset (machinery)	57,142	
Cr Firm commitment (asset)		3,142
Cr Cash – supplier		54,000
Dr Derivative liability	3,142	
Cr Cash – pay off forward contract		3,142

In summary, fair value hedge accounting has allowed the net effect of the forward contract derivative to be deferred from profit or loss and recognised within the asset purchased once the commitment had been fulfilled.

If hedge accounting had not been used, the machine would have been recorded at CU54,000, being its purchase price of $100,000 translated at the spot rate on delivery, under IAS 21. The overall impact of the forward contract would have been an expense of CU3,142 charged to profit or loss.

What if the machine delivery was subsequently delayed?

If, in the above example, it became apparent during December 20X0 that delivery would be delayed until March 20X1, this would create ineffectiveness in the hedge, as the forward contract would expire on a date different from the date of delivery.

This would have two consequences:

- any ineffective movement in the unrecognised firm commitment would be charged immediately to profit or loss
- the retrospective and prospective tests of the highly-effective criteria would need to be checked to ensure that the 80%-125% limits are met (see Section 8.7). Failure of this test would mean hedge accounting would have to be discontinued on this transaction.

The method of assessing effectiveness must be documented. Effectiveness might be ascertained by, for example, comparing via ratio analysis the cumulative fair value movement of the hedged item, being the change in fair value of unrecognised firm commitment, taking into account the revised March 20X1 delivery date, with the hedging instrument (ie change in fair value of forward contract).

In this example, if at the end of December, when the delayed delivery became apparent, the forward rate for the revised expected delivery date of end March 20X1 was 0.5530, the fair value of the unrecognised firm commitment could be ascertained by comparing the 'contracted rate' of $100,000 at 0.57142 with the revised forward rate on expected date of delivery of 0.5530. On a $100,000 commitment, this means the change in fair value of the hedged item, the firm commitment, at the end of December of CU1,842 (CU57,142 less CU55,300) compares to a liability on the hedging instrument at that time of CU2,142. There is therefore ineffectiveness of CU300, which is charged to profit or loss. The effectiveness percentage at that time may, on cumulative basis, be assessed as 1,842/2,142 = 86% (or 2,142/1,842 = 116%), which is within the 'highly effective' retrospective test limit.

8.11 Hedging documentation

As noted above, formal documentation is required at the inception of the hedge. Hedge documentation cannot be 'backdated'. The documentation is required to set out the following:

- a clear description of the hedged item and hedging instrument
- the risk management objective for carrying out the hedge
- the nature of the risk being hedged
- the methods to be used in assessing effectiveness, including frequency of the tests.

9 Challenges for separate financial statements

9.1 Initial recognition challenge for intra-group balances

Where a parent entity prepares its individual financial statements, also referred to as separate financial statements, under IFRS, significant additional issues may arise in applying IAS 39.

IAS 39.43 requires that all financial assets and financial liabilities are carried initially at fair value. For loans and receivables, subsequent carrying amount will be at amortised cost. Whilst investments in subsidiaries are scoped out of IAS 39, there is no similar scope-out for intra-group payables or receivables. In arm's length negotiation situations, the transaction price is normally strong evidence of the opening fair value. However in related party situations this is not the case. Therefore, this could lead to accounting adjustments.

Example

On 1 January 20X0, parent P lends CU1 million to subsidiary S. Parent P applies IFRS in its individual financial statements. The terms of the loan are interest at 5% per annum payable annually, and the term of the loan is 3 years. However a market rate loan at that time for a similar loan is considered to be 10%. The fair value at initial recognition is not CU1 million, but is CU875,667 (based on a discounted cash flow using a 10% market rate). On initial recognition, the financial asset receivable would initially be recorded in P's accounts at CU875,667. An initial recognition difference of CU124,333 arises. This initial recognition difference normally results in an increase in the cost of investment in the subsidiary.

The accounting for the loan receivable in P's accounts is thereafter:

Year to	Opening CU	Finance income at 10% CU	Cash CU	Closing CU
X0	875,657	87,566	(50,000)	913,223
X1	913,223	91,322	(50,000)	954,545
X2	954,545	95,455	(1,050,000)	0

Note that a mirror image might not necessarily apply in the subsidiary's financial statements, depending on factors such as:

- what GAAP the subsidiary's separate financial statements are prepared in
- the potential future need for the lending entity to make some impairment provision if the borrower is unable to pay within the contractual date.

Whilst the inter-company balances cancel on consolidation, at individual entity level there can be an impact on taxation and distributable reserves.

9.2 How is fair value determined?

For a debt instrument, fair value is normally determined by a net present value calculation of the future cash flows. However a key input is the discount factor, which should reflect a market rate for a similar instrument. IAS 39.AG77 notes that the market rate would depend on the following factors:

- the remaining maturity, ie long-term borrowings typically carry higher rates than short-term borrowings
- cash flow pattern, ie loans where interest is paid regularly would have a lower market rate than those where interest is rolled up
- currency
- credit risk
- collateral

To put into context, there is a substantial difference between borrowings that have first ranking secured collateral over a low credit risk entity compared to an unsecured borrowing with a highly geared and high credit risk entity.

9.3 What about intra-group balances with no formal repayment terms?

It is common for intra-group loans to have no formal repayment terms. Each situation will need to be assessed on its own circumstances. However, a common analysis is that the lack of any repayment terms means the balance might be considered as repayable on demand. This could have important consequences:

- From the borrower's point of view, a demand feature is deemed to exist. Therefore, applying IAS 39.49, the borrower's liability should not be recorded at less than the net present value based on the earliest repayment date. If repayment is on demand, this effectively means there is no discounting
- The lender has a more difficult assessment. At initial recognition, the lender should consider whether in substance the borrower would be able to repay immediately if called upon, as this will affect the opening fair value
- Ongoing, the lender will have to consider the impairment rules and whether the borrower can realistically repay the loan within the timescale originally envisaged. Delayed payment would result in an impairment charge in the lender's financial statements

9.4 Financial guarantee contracts

In group situations, it is common for one group entity to provide a guarantee to a third party bank over borrowings due from another group entity to that bank. Depending on the terms, it may be that this guarantee meets the definition of a financial guarantee contract and, if so, IAS 39 mandates accounting entries for the guarantee provider unless that contract has been explicitly asserted as an insurance contract to be accounted for under insurance accounting.

In terms of the entity which provides the guarantee, IAS 39 prescribes the accounting as follows:

- At initial recognition, set up a liability based on the fair value of the guarantee, ie what fee would be charged in an arm's length transaction in exchange for providing the guarantee? Ascertaining this fair value can be a challenge

- Subsequently, the liability is amortised to income over the period of the guarantee. However the liability might be increased if required by IAS 37 (provisions)

For the group entity which is borrowing from the bank, it may be that as a result of the guarantee it has received a beneficial rate of interest. Therefore, if that group entity is also reporting under IFRS, this could lead to initial recognition differences in that entity. Entities may decide to charge an arm's length fee (ie guarantee provider charges a fee to the borrower) in order to keep the overall transaction on market terms.

These accounting entries could be important for taxation and distributable profits issues.

In our experience, the following are key points to keep in mind in respect of intra-group arrangements:

- Do not assume that, simply because interest is charged, intra-group balances are at market value
- Do not assume that entries in one group entity will be automatically mirrored in the other group entity, even if both group entities are under IFRS
- Carefully consider the market rate at time of initial advance in the context of the specific credit risk and collateral considerations
- Consider which GAAP each individual entity's financial statements are subject to and follow through on the anticipated accounting entries
- Think through the implications of financial guarantee contracts both in respect of the guarantee provider, who may have a financial guarantee to account for under IAS 39, and the borrowing group entity, who may have a below-market-rate loan
- Consider whether those accounting entries could have adverse consequences for taxation and distributable profits positions

A Glossary

Term	Description
Available-for-sale financial assets	Defined by IAS 39 as: "…those non-derivative 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" The reference can be misleading as a financial asset is classified as available for sale if it has not fallen into one of the other IAS 39 categories. Equity investments are common examples of investments which are often categorised as available-for-sale financial assets.
Cap (in context of interest)	The seller of a cap is obliged to reimburse the buyer should the market price/rate exceed the cap's strike price. The seller receives a premium for taking on this risk. For instance, an interest rate cap is an agreement by the cap seller (typically a bank) to pay the buyer the excess of the prevailing market rate (eg 3-month LIBOR) over a cap rate (eg 6%). For instance if an entity had a variable rate loan it may take out a cap to limit its maximum exposure to interest rate rises.
Call option	A call option gives the option holder the right to buy a pre-determined amount of an underlying (say currency) at a pre-determined exercise price. Where the call option exercise price is cheaper than the current spot price then the option is termed 'in the money'. When it is not, it is 'out of the money'. This refers to the option's intrinsic value. The fair value of the option however is the total value which includes time value plus the intrinsic value. The time value element encompasses the insurance cover the option provides and the time value of money.
Collar (in context of interest)	A collar is a combination of a cap and a floor. For example, if an entity has a variable rate loan liability, it may take out an interest rate collar, which would provide a minimum and a maximum rate (an entity may prefer a collar to a cap in this case as a collar would involve a lower premium).

Term	Description
Derivative	IAS 39.9 contains a detailed technical definition as follows: "A derivative is a financial instrument or other contract within the scope of [IAS 39] with all three of the following characteristics: (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (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." This will typically include forward contracts (eg foreign currency forward contracts), contracts for differences, interest swaps, currency swaps, interest caps, interest floors, interest collars and options (such as currency options).
Financial guarantee contract	Defined by IAS 39.9 as: "…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."
Floor	A floor operates where the floor seller agrees to compensate the buyer should the rate fall below an agreed strike price. The seller would also receive a premium. For example if an entity held, say, gold in its inventory, it may enter into a floor contract (for gold) where the counterparty would compensate the entity if the market price of gold fell below the floor price.
Foreign currency forward contract	A foreign currency forward contract is an agreement to buy or sell a specific amount of currency at a contracted rate at a maturity date. An example of this is a contract to buy US$100,000/sell GBP on 31 December 20X0 at a rate of 0.55. These are typically derivatives under IAS 39. At time of entering into the contract, the contracted rate will equate to the forward rate.
Forward points (in respect of foreign currency)	This is the difference between the forward rate and spot rate and usually reflects the interest differential between the respective currencies. For example if on 1 January 20X0, the spot rate to buy USD/sell GBP is 0.55, but the forward contract rate for a 3-month forward is 0.58, then the forward points are 0.03.

Term	Description
Forward rate (in foreign currency context)	The forward rate is the rate today which the market would offer (as the contracted rate) in a forward contract (between two currencies) where settlement occurs at a specified future maturity date. For example on 1 January 20X0, a forward contract to buy USD/sell GBP maturing 31 March 20X0 would reflect the forward 3-month rate between USD and GBP. The forward rate is normally based on the spot rate between the respective currencies as adjusted for differences in the interest rates on those two currencies.
Holder	The holder is the entity which holds the instrument (not the issuer). In the context of borrowings, the holder will be the lender (ie asset holder).
Interest swap	An interest rate swap can operate in one of two ways. It can either be a 'pay fixed, receive variable' or 'pay variable, receive fixed'. For example, a receive LIBOR, pay fixed 6% on CU1 million notional principal is an example of a 'receive variable pay fixed' swap. Such a contract would typically be used to effectively fix the interest cash flow outlay on a variable interest loan debt. Each interest swap will have settlement dates. For example, an entity may have a pay fixed 6%, receive LIBOR on CU1 million notional, with settlement dates of 30 June and 31 December each year until a specified date. On each settlement date, the 'interest differential' would be settled. Interest swaps are normally derivatives.
Issuer	The issuer is the entity which issues the instrument (not the holder). In the context of borrowings, the issuer will be the borrower.
Loans and receivables	IAS 39.9 defines loans and receivables as: "…non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (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. 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." These include many types of receivables including accounts receivable (trade debtors) and, typically, cash at bank and in hand.

Term	Description
Option	An option provides one party (the holder) the option to buy (a call option) or sell (a put option) an underlying at a specified exercise price at specified exercise dates. Options can also be of different styles. • 'European style' means that the option can only be exercised on the exercise date. • 'American style' means the option can be exercised at any time up until exercise date. This has a substantial effect on the type of valuation methods used. • 'Bermudan style' is when the holder can exercise on one or more possible dates prior to expiry (also known as a limited exercise, a mid-Atlantic or a semi-American option). The holder of the option will typically pay a premium at the outset (while the counterparty who 'writes' the option will receive that premium).
Put option	A put option gives the option holder the right to sell a predetermined amount of an underlying (say currency) at a predetermined price.
Warrants	Warrants are similar to options.
Written options	A 'written option' is where the entity is the option seller rather than the holder. For example, if a bank issues currency options to an entity A, then whilst A holds a currency option, the bank has written the option. However, many non-financial services companies also write options (often done by 'selling short', meaning the entity sells before it buys). In a written option, an entity would receive a premium on entering into the contract (but would then retain the obligation associated with writing the option).

B Summary of IAS 39's impact on various types of instruments and contracts

Type of arrangement	IAS 39 impact	Ref
Loan assets	These are normally measured at amortised cost, unless designated as at fair value through profit or loss or as available-for-sale financial assets. Designation at fair value through profit or loss will be subject to IAS 39's restrictions on use of the fair value option. Initial recognition is at fair value at the time of recognition, plus transaction costs. Normally, the transaction price is strong evidence of the initial fair value but in some cases (such as related party loans) alternative valuation techniques would need to be considered. If the future cash flows are to any extent uncertain then the IAS 39.AG8 impact should be considered carefully. In addition, care is needed to ascertain whether or not any embedded derivatives exist, and if so whether they are separable.	 4.2 4.3 6
Accounts receivable/ trade debtors	Trade debtors are financial assets falling under the IAS 39 category of loans and receivables. They are normally carried initially at fair value at the time of initial recognition (which may necessitate discounting to present value). Nominal value (ie amount invoiced) would typically be used where discounting is not material and there is no stated interest rate. However care is needed in cases of extended credit. If payment is delayed, this can lead to impairment charges even if full payment is still expected. The derecognition rules will normally be straightforward for a non-financial services business although careful assessment will be required for factored debtors. Embedded derivatives will also require careful consideration in respect of sales arrangements (similar to those mentioned within trade creditors below in the context of purchase arrangements).	 4.2 7 4.4 6

Type of arrangement	IAS 39 impact	Ref
Equity investments	Where investments are classed as held for trading, all gains or losses will be included in profit or loss. IAS 39 has detailed guidance on the definition of held for trading. Companies may also choose to include gains or losses on non-trading investments in profit or loss by designating those investments as financial assets at fair value through profit or loss (subject to restrictions on use of the fair value option). Such designation must be made on initial recognition and reclassification is not permitted until they are sold. Unless held for trading or designated as at fair value through profit or loss, equity investments are classified as available-for-sale financial assets, with gains or losses on remeasurement being taken direct to other comprehensive income then released to profit or loss on subsequent sale or impairment. Equity investments not traded in an active market will generally be classed as available-for-sale financial assets. Other methods of valuation will need to be considered to determine their fair value. In rare cases where fair value cannot be measured reliably, the investment should be held at cost.	4.1
Loan commitments	Commitments to issue loans at below market value are within the scope of IAS 39, as are commitments that can be settled net in cash (the latter being derivatives). Loan commitments are also within IAS 39 if they are designated as at fair value through profit or loss. Commitments to issue loans at below market rate of interest are initially included in the statement of financial position at the fair value of the commitment and then subsequently at the higher of any provision required under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or the amount initially recognised less amortisation under IAS 18 *Revenue*.	

Type of arrangement	IAS 39 impact	Ref
Investments in corporate bonds	Where corporate bonds are traded in an active market, they are accounted for by the holder in the same way as equity investments. The only exception (for active market bonds) is where there is an intention and ability to hold to maturity, in which case the investments could be classed as such and carried at amortised cost. This is subject to tainting provisions prohibiting such classification where, for example, similarly designated investments in the previous two years were sold before normal maturity date. Where bonds are not traded in an active market, there are several possibilities: • they could be classified as a loan asset and so carried at amortised cost • if fair value is reasonably assessable, they could be designated as at fair value through profit or loss (subject to restrictions on use of the fair value option) or as available-for-sale financial assets If there are any embedded derivatives, these must be assessed carefully. If the bond were convertible, then the conversion right would be a separable embedded derivative.	4.1 6
Interest swaps	Derivatives are always carried in the statement of financial position at fair value. Unless cash flow hedge accounting applies, the gains or losses are included in profit or loss. In the case of interest rate swaps that are part of an effective hedge, profit or loss account volatility can be reduced via the use of hedge accounting. However, hedge accounting must be opted for at the start of the hedging transaction (not as an afterthought) and must be evidenced by formal documentation. Hedge accounting is also subject to complex rules regarding what is considered an effective hedge.	4.1 8
Loan liabilities	These are measured at amortised cost using the effective interest method unless they are designated as being at fair value through profit or loss in cases where this is permitted under the fair value option provisions in IAS 39. Initial recognition is at fair value (net of transaction costs unless designated at fair value through profit or loss). Fair value is normally the transaction price but care is required where the transaction may not be on arm's length terms. If the cash flows relating to the liability are uncertain then this creates challenges under IAS 39.AG8. Modifications should be considered carefully. Loan terms should be monitored for embedded derivatives.	4.1 4.2 4.3 5 6

Type of arrangement	IAS 39 impact	Ref
Trade creditors / accounts payable (including accruals)	For normal purchases with no unusual features, trade creditors will be treated with simplicity, ie recorded at time of delivery at the amount invoiced. However initial recognition differences could arise if the supplier offers extended payment options. Some care is needed in the case of embedded derivatives, eg a purchase in Sterling, but with a clause such that an additional liability may arise at the option of the supplier should the exchange rate with the US dollar go beyond a particular limit. The embedded derivative, being a currency option, may need to be separated and accounted for at fair value.	4.1, 4.2 6
Share capital issued	The treatment depends on the IAS 32 classification and whether the instrument is debt, equity or compound. Equity instruments are not remeasured.	3, 5.1
Warrants or call options issued	If the warrants or call options were issued in exchange for goods or services IFRS 2 would apply (not IAS 39). However IAS 39 would apply in other cases (eg if issued as a means of raising finance). The IAS 39/32 treatment depends on whether the fixed-for-fixed test is met. The fixed-for-fixed test determines whether or not the instrument is a derivative liability or equity.	3, 5.1 3.3
Issue of convertible bonds	Convertible bonds where the conversion terms meet the fixed-for-fixed test are accounted for by the issuer (under IAS 32) as compound financial instruments comprising two components that are treated separately: a liability and a share option (the latter usually being an equity instrument). If the conversion right fails the fixed-for-fixed test then the instrument is a host debt with a separable embedded derivative. The embedded derivative should be separated and carried at fair value through profit or loss. This is likely to involve use of valuation models and that valuation would require to be carried out at each reporting date. As an alternative, the entity could at initial recognition use the fair value option to carry the entire instrument at fair value through profit or loss. From the holder's perspective, the instrument is a host debt with an embedded derivative regardless of the fixed-for-fixed test.	3.3 6 4.1

Type of arrangement	IAS 39 impact	Ref
Foreign currency forward contracts or options	Forward currency contracts and options are derivatives and so are carried at fair value at each reporting date. Unless designated as a cash flow or net investment hedging instrument (for an effective hedge) the gain or loss on remeasurement to fair value is recognised in profit or loss. This can lead to substantial profit volatility, for instance regarding contracts covering future purchases or sales transactions. Hedge accounting can also be considered but is subject to stringent rules on formal documentation at inception and effectiveness considerations. However hedge accounting is likely to be a key consideration for these instruments.	4.1 8
Intra-group balances	If within IAS 39, such balances require special consideration as to whether or not the terms at time of initial recognition are at fair value. In addition, the impairment provisions can have a significant impact.	9
Financial guarantee contracts	If an entity enters into a guarantee which meets the definition of a financial guarantee contract, these are in the scope of IAS 39 unless the entity has previously asserted that it regards the contract as an insurance contract and applied the insurance standard instead. If under IAS 39, the required accounting is to set up initially a liability based on the fair value of the guarantee. This liability is then amortised to income over the period of the guarantee. However the liability should be increased if required by the provisions standard, IAS 37. The most common situation where this will impact on a non-financial services entity is likely to be guarantees provided to a bank in respect of borrowings by another group entity.	2.4 9.4