IFRS AT A GLANCE

IAS 39 *Financial Instruments: Recognition and Measurement*

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Also refer:

IFRIC 9 *Reassessment of Embedded Derivatives*

IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

Effective Date
Periods beginning on or after 1 January 2005

INITIAL RECOGNITION

Financial instruments are recognised on the statement of financial position when the entity becomes party to the contractual provisions of the instrument.

INITIAL MEASUREMENT

All financial instruments are measured initially at fair value, directly attributable transaction costs are added to or deducted from the carrying value of those financial instruments that are not subsequently measured at fair value through profit or loss.

- Fair value - is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (see IFRS 13 *Fair Value Measurement)*
- Directly attributable transaction costs - incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

SUBSEQUENT MEASUREMENT

Subsequent measurement depends on the category into which the financial instrument is classified.

FINANCIAL ASSETS

Fair value through profit or loss

Includes financial assets held for trading; derivatives, unless accounted for as hedges, and other financial assets designated to this category under the fair value option (strict rules apply).

- e.g. shares held for trading, options, interest rate swaps.

Measured at:

- Fair value with all gains and losses being recognised in profit or loss.

Held-to-maturity

Non-derivative financial assets with fixed or determinable payments and fixed maturity that the entity has the positive intent and ability to hold to maturity.

- e.g. bonds, redeemable preference shares, redeemable debentures.

Measured at:

- Amortised cost using the effective interest method, less impairment losses.

Loans and receivables

Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

- e.g. trade receivables, long-term bank depositsintercompany loans receivable.

Measured at:

- Amortised cost using the effective interest method, less impairment losses.

Available-for-sale

Includes all financial assets that are not classified in another category and any financial asset designated to this category on initial recognition.

- e.g. shares held for investment purposes.

Measured at:

- Fair value with gains and losses recognised in other comprehensive income
- Impairment losses and foreign exchange differences are recognised in profit or loss.

FINANCIAL LIABILITIES

Fair value through profit or loss

Includes financial liabilities held for trading; derivatives; and financial liabilities designated as at fair value through profit or loss on initial recognition (strict rules apply).

Measured at:

- Fair value with all gains and losses being recognised in profit or loss.

Amortised cost

All financial liabilities that are not classified at fair value through profit or loss.

Measured at:

- Amortised cost using the effective interest method.

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FINANCIAL GUARANTEE CONTRACTS

Financial guarantee contract – 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.

MEASUREMENT

- Initially measured at fair value plus directly attributable transaction costs
- Subsequently measured at the higher of:
  - The amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
  - The amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

IMPAIRMENT

Assess at each reporting date whether there is objective evidence that a financial asset (group of financial assets) is impaired. If there is evidence of impairment:

Financial assets at amortised cost
- Amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted using the asset's original effective interest rate. Future credit losses that have not been incurred are excluded
- The carrying amount of the asset is reduced either directly or through the use of an allowance account
- The impairment loss is recognised in profit or loss
- Reversals of impairment are recognised in profit or loss. Reversals cannot result in a carrying amount that exceeds what the amortised cost would have been had no impairment been recognised.

Financial assets at cost
- Amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

Available for sale financial assets
- When a decline in the fair value of the asset has been recognised directly in OCI and there is objective evidence that the asset is impaired, the cumulative loss recognised directly in OCI is removed from OCI and recognised in profit or loss
- Subsequent reversals of impairment losses recognised in profit or loss on equity instruments are recognised in OCI, not profit or loss
- Subsequent reversals of impairment losses recognised in profit or loss on debt instruments are recognised in profit or loss.

RECLASSIFICATION

Financial instruments at fair value through profit or loss
- Derivative financial instruments may not be reclassified out of this category while it is held or issued
- Any financial instrument designated into this category on initial recognition may not be reclassified out of this category
- May reclassify instruments that would have met the definition of loans and receivables out of this category to loans and receivables if the entity has the intention and ability to hold for the foreseeable future or until maturity. Any gain or loss already recognised in profit or loss is not reversed. The fair value on date of reclassification becomes the new cost or amortised cost
- May reclassify instruments to held to maturity or available for sale in rare circumstances
- May not reclassify a financial instrument into the fair value through profit or loss category after initial recognition.

Held to maturity instruments
- If no longer appropriate to classify investment as held to maturity, reclassify as available for sale and remeasure to fair value
- Difference between carrying amount and fair value recognised in equity
- Prohibited from classifying any instruments as HTM in the current and following two financial years.

Available for sale instruments
- May reclassify instruments that would have met the definition of loans and receivables out of this category to loans and receivables if the entity has the intention and ability to hold for the foreseeable future or until maturity.

Financial instruments measured at cost as unable to reliably measure fair value
- If a reliable fair value measure becomes available for which a fair value measure was previously not available, the instrument is required to be measured at fair value
- Difference between carrying amount and fair value recognised in equity for available for sale instruments
- Difference between carrying amount and fair value recognised in profit or loss for financial instruments measured at fair value through profit or loss.

Fair value measurement is no longer reliably measureable
- If a financial instrument currently carried at fair value subsequently has to be carried at cost or amortised cost because fair value is no longer reliably measurable, the fair value carrying amount at that date becomes the new cost or deemed cost
- Prior gain/loss on financial asset with no fixed maturity recognised in equity remains in equity until the financial asset is derecognised at which time it is released to profit or loss.

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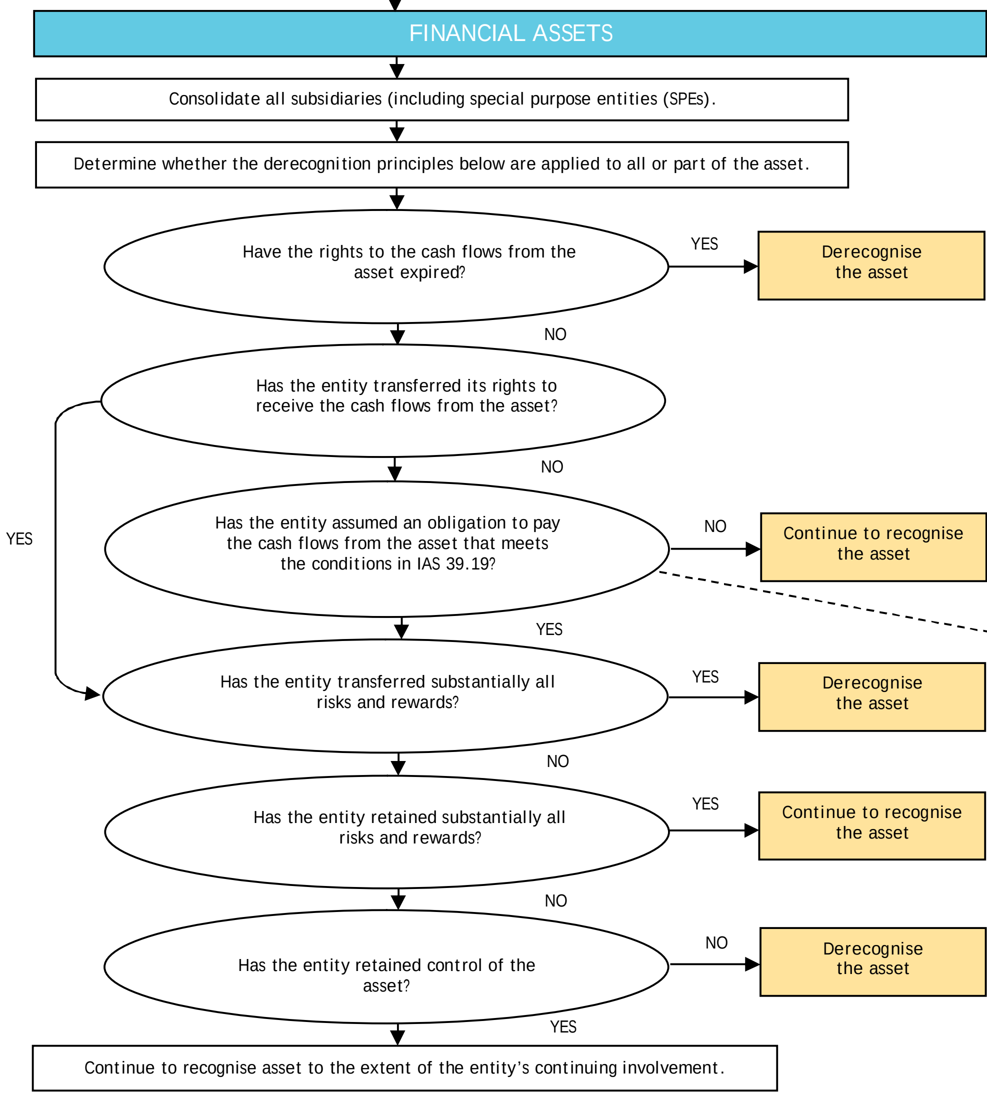
DERECOGNITION



FINANCIAL LIABILITIES

- A financial liability is derecognised only when extinguished i.e., when the obligation specified in the contract is discharged, cancelled or it expires
- An exchange between an existing borrower and lender of debt instruments with substantially different terms or substantial modification of the terms of an existing financial liability of part thereof is accounted for as an extinguishment
- The difference between the carrying amount of a financial liability extinguished or transferred to a 3rd party and the consideration paid is recognised in profit or loss.

- If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it recognises either a servicing asset or liability for that servicing contract
- If, as a result of a transfer, a financial asset is derecognised, but the entity obtains a new financial asset or assumes a new financial liability or servicing liability, the entity recognises the new financial asset, financial liability or servicing liability at fair value
- On derecognition of a financial asset, the difference between the carrying amount and the sum of (i) the consideration received and (ii) any cumulative gain or loss that was recognised directly in equity is recognised in profit or loss.

IAS 39.19 – where an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay those cash flows to one or more entities, three conditions need to be met before an entity can consider the additional derecognition criteria:

- The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset
- The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients
- The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. The entity is not entitled to reinvest the cash flows except for the short period between collection and remittance to the eventual recipients. Any interest earned thereon is remitted to the eventual recipients.

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Also refer:
IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*

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HEDGE ACCOUNTING

Hedge accounting may be applied if, and only if, all the following criteria are met:
- At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge
- The hedge is expected to be highly effective (80 – 125 % effective) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship
- For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss
- The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured
- The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

CASH FLOW HEDGE

- Definition - a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss
- The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in OCI; and the ineffective portion of the gain or loss on the hedging instrument is recognised in profit or loss
- If the hedge results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised in OCI are reclassified from equity to profit or loss as a reclassification adjustment in the same period(s) during which the asset acquired or liability assumed affects profit or loss
- If the hedge results in the recognition of a non-financial asset or a non-financial liability, then the entity has an accounting policy election of either:
  - Reclassifying the associated gains and losses that were recognised in OCI to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised
  - Removing the associated gains and losses that were recognised in OCI and including them in the initial cost or other carrying amount of the asset or liability.
- Cash flow hedge accounting is discontinued prospectively if:
  - The hedging instrument expires or is sold, terminated or exercised (net amount recognised in OCI remains in equity until forecast transaction occurs and is then treated as described above)
  - The hedge no longer meets the criteria set out in the above block (net amount recognised in OCI remains in equity until forecast transaction occurs and is then treated as described above)
  - The forecast transaction is no longer expected to occur (net amount recognised in OCI is transferred immediately to profit and loss as a reclassification adjustment)
  - The entity revokes the designation (net amount recognised in OCI remains in equity until forecast transaction occurs and is then treated as described above).

FAIR VALUE HEDGE

- Definition - a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss
- Gain/loss from remeasuring the hedging instrument at fair value or the foreign currency component of its carrying amount is recognised in profit or loss
- Gain/loss on the hedged item attributable to the hedged risk adjusts the carrying amount of the hedged item and is recognised in profit or loss
- Fair value hedge accounting is discontinued prospectively if:
  - The hedging instrument expires or is sold, terminated or exercised
  - The hedge no longer meets the criteria set out above
  - The entity revokes the designation.
- Where hedge accounting is discontinued, adjustments to the carrying amount of a hedged financial asset for which the effective interest rate is used are amortised to profit or loss. The adjustment is based on a recalculated effective interest rate at the date amortisation begins.

HEDGE OF A NET INVESTMENT IN A FOREIGN OPERATION

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, are accounted for similarly to cash flow hedges:
- The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised in equity; and
- The ineffective portion is recognised in profit or loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in OCI is reclassified from equity to profit or loss as a reclassification adjustment on the disposal of the foreign operation.

NOVATION OF DERIVATIVES

Hedge accounting continues for novated derivatives so long as:
- The novation is a consequence of laws or regulations (or the introduction of laws or regulations)
- The parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty of each party.
- Any changes to the hedging instrument are limited only to those that are necessary to effect such a replacement of the counterparty (including changes in the collateral requirements, rights to offset receivable and payable balances, charges levied.)

DESIGNATION OF NON-FINANCIAL ITEMS AS HEDGED ITEMS

If the hedged item is a non-financial asset or non-financial liability, it is designated as a hedged item, either:
- For foreign currency risks
- In its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below. Alternatively, please visit www.bdointernational.com/Services/Audit/IFRS/IFRS Country Leaders where you can find full lists of regional and country contacts.

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