



FINANCIAL INSTRUMENTS

MASTER NOTE

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Financial Instruments

This note discussed the basic principles for recognition of financial asset or financial liability in the statement of financial position and the classification and measurement of a financial asset or financial liability into different categories. It is intended to provide a better understanding to IFRS requirements for financial instruments.

Relevant IFRS

Current requirements for financial instruments are included in the following IFRS:

- IAS 32 - Financial Instruments: Presentation,
- IFRS 7 - Financial Instruments: Disclosures; and,
- IFRS 9 - Financial Instruments.

Definition

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. The definition is wide and includes cash, deposits in other entities, trade receivables, loans to other entities, investments in debt instruments, investments in shares and other equity instruments.

Financial Asset: is any asset that is:

- cash
- a contractual right:
 - to receive cash or another financial asset from another entity
 - to exchange financial asset/liabilities with another entity under conditions that are potentially favourable
- an equity instrument of another entity.
- a contract that will or may be settled in the entity's own equity instruments and is:
 - i. a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Examples of financial asset include trade receivables, options, investment in equity shares.

Financial Liability: is any liability that is: a contractual obligation:

- a contractual obligation:
 - to deliver cash or another financial asset to another entity
 - to exchange financial instrument with another entity under conditions that are potentially unfavourable.
- a contract that will or may be settled in the entity's own equity instruments and is:
 - i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Examples are trade payables, loans from other entities, and debt instruments issued by the entity e.g. debenture loans, redeemable preference shares.

Equity Instrument: any contract that evidences a residual interest in the asset of an entity after deducting all of its liabilities.

IAS 32 Financial Instrument – Presentation deals with requirements for the presentation of financial instruments as either financial liabilities or equity, including:

- when a financial instrument should be presented as a financial liability or equity instrument by the issuing entity
- how to separate and present the components of a compound financial instrument that contains both liability and equity elements.

According to the standard, entities that issue financial instruments should classify them (or their component parts) as either liabilities or equity. This classification should be made in accordance with the substance, not merely the legal form, of the instrument. The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation on one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the issuer.

A **compound instrument** is one which has both a liability and an equity component. For example, the value of a convertible bond consists of a liability component – the bond – and an equity component – the right to convert in due course to equity.

Illustration 1

Aron issued one million convertible bonds on 1 June 2006. The bonds had a term of three years and were issued with a total fair value of \$100 million which is also the par value. Interest is paid annually in arrears at a rate of 6% per annum and bonds, without the conversion option, attracted an interest rate of 9% per annum on 1 June 2006. The company incurred issue costs of \$1 million. If the investor did not convert to shares they would have been redeemed at par. At maturity all of the bonds were converted into 25 million ordinary shares of \$1 of Aron. No bonds could be converted before that date. The directors are uncertain how the bonds should have been accounted for up to the date of the conversion on 31 May 2009 and have been told that the impact of the issue costs is to increase the effective interest rate to 9.38%.

Required: Discuss, with relevant computations, how the above financial instruments should be accounted for in the financial statements for the year ended 31 May 2009.

Illustration 2

Pingway issued a \$10 million 3% convertible loan note at par on 1 April 2007 with interest payable annually in arrears. Three years later, on 31 March 2010, the loan note is convertible into equity shares on the basis of \$100 of loan note for 25 equity shares or it may be redeemed at par in cash at the option of the loan note holder. One of the company's financial assistants observed that the use of a convertible loan note was preferable to a non-convertible loan note as the latter would have required an interest rate of 8% in order to make it attractive to investors. The assistant has also commented that the use of a convertible loan note will improve the profit as a result of lower interest costs and, as it is

likely that the loan note holders will choose the equity option, the loan note can be classified as equity which will improve the company's high gearing position. The present value of \$1 receivable at the end of the year, based on discount rates of 3% and 8% can be taken as:

	3%	8%
	\$	\$
End of year 1	0.97	0.93
2	0.94	0.86
3	0.92	0.79

Required: Comment on the financial assistant's observations and show how the convertible loan note should be accounted for in Pingway's income statement for the year ended 31 March 2008 and statement of financial position as at that date.

Interest and Dividends

The accounting treatment of interest and dividends payable on a financial instrument follows the accounting treatment of the instrument itself. For example, dividends paid to holders of redeemable preference shares should be charged as interest (finance costs) in the income statement, while dividends paid to holders of ordinary shares are debited direct to equity in the statement of changes in equity. In addition to providing **specific** information about particular financial instrument balances and transactions, enterprises are required to provide a **discussion** of the extent to which financial instruments are used, the associated risks and the business purposes served.

IAS 32 also addressed the problems of accounting for derivatives

A derivative is a financial instrument:

- ♣ Whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the 'underlying')
- ♣ That requires no or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions
- ♣ That is settled at a future date.

Examples of derivatives include forward contracts, forward rate agreements, futures contracts, swaps, options. The standard also applies to more complex, derivative financial instruments such as call options, put options and swaptions. Derivatives are contracts that allow entities to speculate on future changes in the market at a relatively low or no initial cost.

IAS 32 and the disclosure of treasury management policies

Enterprises must describe enough information to enable readers to understand:

- ♣ Accounting policies for financial instruments
- ♣ Amount, timing and certainty of future cash flows
- ♣ The nature and extent of the use of financial instruments
- ♣ The business purpose of these instruments and the risks associated with these instruments.

Derivatives - Example

A company enters into a contract (call option) on 1 September 2006 that gives it the right to purchase 50,000 shares issued by another company on 1 February 2007 at a price of \$30 per share. The company pays \$1 per share option. The company's year-end is 31 December 2006 when the value of the share option is \$2.50.

The following entry is made on 1 September 2006:

Dr	Call option	\$50,000
Cr	Cash	\$50,000

The increase in the fair value of the options is recorded on 31 December 2006:

Dr	Call option	\$75,000
Cr	Income statement	\$75,000

The company purchases the shares on 1 February 2007 for \$30 per share when the fair value of the share is \$32.50. There has been no increase in the value of the options. The following entries will occur:

Dr	Investment in shares	\$1,625,000
Cr	Cash	\$1,500,000
Cr	Call option	\$125,000

(Exercise and de-recognition of call options and receipt of shares)

Amortised cost

Amortised cost is the cost of an asset or liability adjusted to achieve a constant effective interest rate over the life of the asset or liability. An entity must apply the effective interest rate method in the measurement of amortised cost. The effective interest rate method also determines how much interest income or interest expense should be reported in profit and loss.

Example - A debt security has a stated principal amount of \$50,000, which will be repaid in five years at an interest rate of 6% per year payable annually at the end of each year. The entity purchases the security on 1 January 2006 at a discount for \$46,700. The effective interest rate of the investment in the debt security is approximately 7.65%. This is the discount rate that will give a present value of the future cash flows that equals the purchase price. Based on the effective interest rate of 7.65%, the following can be computed.

Year ended 31 December	1 January (amortised cost) (A)	Interest cash inflows at 6% (B)	Interest income (A x 7.65%, rounded to nearest zero) (C)	Amortisation of debt (C-B)	31 December (amortised cost) (A+(C-B))
2006	46,700	3,000	3,570	570	47,270
2007	47,270	3,000	3,620	620	47,890
2008	47,890	3,000	3,660	660	48,550
2009	48,550	3,000	3,710	710	49,260
2010	49,260	3,000	3,740 (rounded down in this example)	740	0 (after repayment of principal)

At 31 December 2006, the entity A makes the following entry:

Dr Cash	3,000	
Dr Debt security	570	
Cr Interest income		3,570

Fair value

IFRS 13 establishes rules for determining fair value. The existence of a published price quoted in an active market is the best evidence of fair value. For assets or liabilities that are not quoted in an active market, fair value is determined using valuation techniques, such as discounted cash flow models or option-pricing models.

Examples - Financial assets at fair value through profit or loss

An entity acquires for cash 1000 shares at \$10 per share and can designate them as at fair value through profit or loss. At the year end 31 December 20X6, the quoted price increases to \$16. The entity sells the shares \$16,400 on 31 January 20X7.

Initial recognition

Dr Financial assets at fair value through profit or loss	\$10,000	
Cr Cash		\$10,000

31 December 20X6

Dr Financial assets at fair value through profit or loss	\$6,000	
Cr Profit or loss		\$6,000

31 January 20X7

Dr Cash	\$16,400	
Cr Financial assets at fair value through profit or loss		\$16,000
Cr Profit or loss		\$400

De-recognition

De-recognition of a financial asset occurs where:

1. the contractual rights to the cash flows of the financial asset have expired, or
2. the financial asset has been transferred (e.g., sold) and the transfer qualifies for de-recognition based on the extent of the transfer of the risks and rewards of ownership of the financial asset.

The contractual rights to cash flows may expire if a customer has paid off an obligation to the company or an option held by the company has expired. De-recognition occurs because the rights associated with the financial asset do not now exist.

When a company sells or transfers a financial asset to another party, the company must evaluate the extent to which it has transferred the risks and rewards of ownership. The risks and rewards of ownership are transferred where the seller does not retain any rights or obligations associated with the sold asset or where the seller retains a right to repurchase the financial asset in the future at the current fair value of the asset.

For example a company retains substantially all risks and rewards of ownership where the asset will be returned to the company for a fixed price at a future date. Here the sale would not qualify for de-recognition.

Examples

If a company sells an investment in shares, but retains the right to repurchase the shares at any time at a price equal to their current fair value then it should derecognise the asset. If a company sells an investment in shares and enters into an agreement whereby the buyer will return any increases in value to the company and the company will pay the buyer interest plus compensation for any decrease in the value of the investment, then the company should not derecognise the investment as it has retained substantially all the risks and rewards.

The de-recognition criteria for financial liabilities are different from those for financial assets. There is no requirement to assess the extent to which the company has retained risks and rewards in order to derecognise a financial liability. The de-recognition requirements focus on whether the financial liability has been extinguished.

Other IFRSs on Financial Instruments

IFRS 7 deals with financial instruments' disclosures and pulls them together in a new standard. Disclosure was formerly dealt with by IAS 32.

The two main categories of disclosures required by IFRS 7 are:

- information about the significance of financial instruments
- information about the nature and extent of risks arising from financial instruments.

IFRS 9 – Financial Instruments was issued to replace IAS 39 Financial Instruments: Recognition and Measurement.

The objective of the IFRS is to establish principles for the financial reporting of financial assets that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

Recognition and Measurement.

The initial classification requirements in IFRS 9 provide the foundation on which the reporting of financial assets is based, including how they are measured and presented in each reporting period. The scope of IFRS 9 has been limited to financial assets. It does not change the classification and measurement requirements of financial liabilities that are set out in IAS 39.

The phase 2 - (impairment methodology) and phase 3 - (hedge accounting) of the project to replace IAS 39, now completed, are concerned with the impairment of financial instruments and hedge accounting.

The standard aim to make it easier for users of financial statements to assess the amounts, timing and uncertainty of cash flows arising from financial assets. IFRS 9 achieves this objective by aligning the measurement of financial assets with the way the entity manages its financial assets (its 'business model') and with their contractual cash flow characteristics.

As a consequence the IASB has reduced the complexity associated with IAS 39 in the following manner:

- the number of classification and measurement categories has been reduced and there is a clearer rationale for the new categories;
- the complex and rule-based requirements in IAS 39 for embedded derivatives have been eliminated by no longer requiring that embedded derivatives be separated from financial asset host contracts;
- the 'tainting rules' that forced entities to reclassify to fair value all instruments in a class that had been classified as held to maturity in the event that one of those instruments is sold have been eliminated; and
- there is a single impairment method for all financial assets not measured at fair value, and impairment reversals are permitted for all assets, eliminating the many different impairment methods used by IAS 39 and its inconsistent requirements on impairment reversal.

Recognition and derecognition - Initial recognition of financial assets

Recognition other than Fair Value Option

An entity shall recognise a financial asset in its statement of financial position when the entity becomes party to the contractual provisions of the instrument. When an entity first recognises a financial asset, it shall classify it thus:

1. unless the above Fair Value Option applies, an entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:
 - the entity's business model for managing the financial assets; and
 - the contractual cash flow characteristics of the financial asset.
2. A financial asset shall be measured at amortised cost if both of the following conditions are met:
 - the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
 - the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.
 - For the purpose of this IFRS, interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.
 - A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with (2) above.

Recognition under Fair Value Option: This is the option to designate a financial asset at fair value through profit or loss. Notwithstanding IFRS 9 provisions, an entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases

Reclassification:

When and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with above provisions.

- If an entity reclassifies financial assets in accordance with the above paragraphs, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses or interest.
- If, in accordance with the above paragraphs, an entity reclassifies a financial asset so that it is measured at fair value, its fair value is determined at the reclassification date.
- Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss.
- If, in accordance with above, an entity reclassifies a financial asset so that it is measured at amortised cost, its fair value at the reclassification date becomes its new carrying amount.

Initial measurement of financial assets

At initial recognition, an entity shall measure a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset.

Subsequent measurement

Subsequent to initial recognition, financial assets and financial liabilities are measured using one of the following methods:

- amortised cost
- fair value.

Whether a financial asset or financial liability is measured at amortised cost, or fair value depends on its classification above and whether its fair value can be reliably determined.

Examples

A debt security that is held for trading is purchased for \$8,000. Transaction costs are \$600. The initial carrying amount is \$8,000 and the transaction costs of \$600 are expensed. This treatment applies because the debt security is classified as held for trading and, therefore, measured at fair value with changes in fair value recognised in profit or loss.

A bond was purchased for \$10,000 and transaction costs are \$1000. The initial carrying amount is \$11,000, i.e. the amount paid for the bond and the transaction costs. This treatment applies because the bond is not measured at fair value with changes in fair value recognised in profit or loss.

Subsequent measurement of financial assets

After initial recognition, an entity shall measure a financial asset at fair value (or amortised cost). An entity shall apply the impairment requirements of IFRS 9 to financial assets measured at amortised cost. An entity shall apply the hedge accounting requirements in IFRS 9 to a financial asset that is designated as a hedged item.

Practice Question 1:

The publication of IFRS 9, *Financial Instruments*, represents the completion of the first stage of a three-part project to replace IAS 39 *Financial Instruments: Recognition and Measurement* with a new standard. The new standard purports to enhance the ability of investors and other users of financial information to understand the accounting of financial assets and reduces complexity.

Required:

(a) (i) Discuss the approach taken by IFRS 9 in measuring and classifying financial assets and the main effect that IFRS 9 will have on accounting for financial assets. (11 marks)

(ii) Grainger, a public limited company, has decided to adopt IFRS 9 prior to January 2012 and has decided to restate comparative information under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The entity has an investment in a financial asset which was carried at amortised cost under IAS 39 but will be valued at fair value through profit and loss (FVTPL) under IFRS 9. The carrying value of the assets was \$105,000 on 30 April 2010 and \$110,400 on 30 April 2011. The fair value of the asset was \$106,500 on 30 April 2010 and \$111,000 on 30 April 2011. Grainger has determined that the asset will be valued at FVTPL at 30 April 2011.

Required:

Discuss how the financial asset will be accounted for in the financial statements of Grainger in the year ended 30 April 2011. (4 marks)

Suggested Solution**(a) Differences and Similarities of IAS 39 & IFRS 9**

IFRS 9 Financial instruments retain a mixed measurement model with some assets measured at amortised cost and others at fair value. The distinction between the two models is based on the business model of each entity and a requirement to assess whether the cash flows of the instrument are only principal and interest. The business model approach is fundamental to the standard and is an attempt to align the accounting with the way in which management uses its assets in its business whilst also looking at the characteristics of the business. A debt instrument generally must be measured at amortised cost if both the 'business model test' and the 'contractual cash flow characteristics test' are satisfied. The business model test is whether the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows rather than have the objective to sell the instrument prior to its contractual maturity to realise its fair value changes.

The contractual cash flow characteristics test is whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding.

All recognised financial assets that are currently in the scope of IAS 39 will be measured at either amortised cost or fair value. The standard contains only the two primary measurement categories for financial assets unlike IAS 39 where there were multiple measurement categories. Thus the existing IAS 39 categories of held to maturity, loans and receivables and available-for-sale are eliminated along with the tainting provisions of the standard.

A debt instrument (e.g. loan receivable) that is held within a business model whose objective is to collect the contractual cash flows and has contractual cash flows that are solely payments of principal and interest generally must be measured at amortised cost. All other debt instruments must be measured at fair value through profit or loss (FVTPL). An investment in a convertible loan note would not qualify for measurement at amortised cost because of the inclusion of the conversion option, which is not deemed to represent payments of principal and interest. This criterion will permit amortised cost measurement when the cash flows on a loan are entirely fixed such as a fixed interest rate loan or where interest is floating or a combination of fixed and floating interest rates.

IFRS 9 contains an option to classify financial assets that meet the amortised cost criteria as at FVTPL if doing so eliminates or reduces an accounting mismatch. An example of this may be where an entity holds a fixed rate loan receivable that it hedges with an interest rate swap that swaps the fixed rates for floating rates. Measuring the loan asset at amortised cost would create a measurement mismatch, as the interest rate swap would be held at FVTPL. In this case the loan receivable could be designated at FVTPL under the fair value option to reduce the accounting mismatch that arises from measuring the loan at amortised cost.

All equity investments within the scope of IFRS 9 are to be measured in the statement of financial position at fair value with the default recognition of gains and losses in profit or loss. Only if the equity investment is not held for trading can an irrevocable election be made at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss. The amounts recognised in OCI are not recycled to profit or loss on disposal of the investment although they may be reclassified in equity.

The standard eliminates the exemption allowing some unquoted equity instruments and related derivative assets to be measured at cost. However, it includes guidance on the rare circumstances where the cost of such an instrument may be appropriate estimate of fair value.

The classification of an instrument is determined on initial recognition and reclassifications are only permitted on the change of an entity's business model and are expected to occur only infrequently. An example of where reclassification from amortised cost to fair value might be required would be when an entity decides to close its mortgage business, no longer accepting new business, and is actively marketing its mortgage portfolio for sale. When a reclassification is required it is applied from the first day of the first reporting period following the change in business model.

All derivatives within the scope of IFRS 9 are required to be measured at fair value. IFRS 9 does not retain IAS 39's approach to accounting for embedded derivatives. Consequently, embedded derivatives that would have been separately accounted for at FVTPL under IAS 39 because they were not closely related to the financial asset host will no longer be separated. Instead, the contractual cash flows of the financial asset are assessed as a whole and are measured at FVTPL if any of its cash flows do not represent payments of principal and interest.

One of the most significant changes will be the ability to measure some debt instruments, for example investments in government and corporate bonds at amortised cost. Many available-for-sale debt instruments currently measured at fair value will qualify for amortised cost accounting.

Many loans and receivables and held-to-maturity investments will continue to be measured at amortised cost but some will have to be measured instead at FVTPL. For example some instruments, such as cash-collateralised debt obligations that may under IAS 39 have been measured entirely at amortised cost or as available-for-sale will more likely be measured at FVTPL. Some financial assets that are currently disaggregated into host financial assets that are not at FVTPL will instead be measured at FVTPL in their entirety.

IFRS 9 may result in more financial assets being measured at fair value. It will depend on the circumstances of each entity in terms of the way it manages the instruments it holds, the nature of those instruments and the classification elections it makes.

Assets that are currently classified as held-to-maturity are likely to continue to be measured at amortised cost as they are held to collect the contractual cash flows and often give rise to only payments of principal and interest.

IFRS 9 does not directly address impairment. However, as IFRS 9 eliminates the available-for-sale (AFS) category, it also eliminates the AFS impairment rules. Under IAS 39 measuring impairment losses on debt securities in illiquid markets based on fair value often led to reporting an impairment loss that exceeded the credit loss that management expected.

Additionally, impairment losses on AFS equity investments cannot be reversed within the income statement section of the statement of comprehensive income under IAS 39 if the fair value of the investment increases. Under IFRS 9, debt securities that qualify for the amortised cost model are measured under that model and declines in equity investments measured at FVTPL are recognised in profit or loss and reversed through profit or loss if the fair value increases.

Suggested Solution -(ii) Under the general rules of retrospective application of IAS 8, the financial statements for the year ended 30 April 2011 would have an opening adjustment to equity of \$1,500 credit as at 1 May 2010 (\$106,500 minus \$105,000). The fair value of the asset was \$106,500 on 30 April 2010 and \$111,000 on 30 April 2011 and therefore \$4,500 will be credited to profit or loss for the year ended 30 April 2011.

Practice Question 2:

Robby held a portfolio of trade receivables with a carrying amount of \$4 million at 31 December 2012. At that date, the entity entered into a factoring agreement with a bank, whereby it transfers the receivables in exchange for \$3.6 million in cash. Robby has agreed to reimburse the factor for any shortfall between the amounts collected and \$3.6 million. Once the receivables have been collected, any amounts above \$3.6 million, less interest on this amount, will be repaid to Robby. Robby has derecognised the receivables and charged \$0.4 million as a loss to profit or loss.

The above scenario is an example of the type of complex transaction that can arise out of normal terms of trade. The rules regarding derecognition are quite complex and are often not understood by entities.

Describe the rules of IFRS 9 *Financial Instruments* relating to the derecognition of a financial asset and how these rules affect the treatment of the portfolio of trade receivables in Robby's financial statements

The basic rules for the derecognition model in IFRS 9 *Financial Instruments* is to determine whether the asset under consideration for derecognition is:

- (i) an asset in its entirety, or
- (ii) specifically identified cash flows from an asset (or a group of similar financial assets), or
- (iii) a fully proportionate (pro rata) share of the cash flows from an asset (or a group of similar financial assets), or
- (iv) a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).

Once the asset under consideration for de-recognition has been determined, an assessment is made as to whether the asset should be derecognised.

Derecognition is required if either:

- (i) the contractual rights to the cash flows from the financial asset have expired, or
- (ii) financial asset has been transferred, and if so, whether the transfer of that asset is subsequently eligible for derecognition.

An asset is transferred if either the entity has transferred the contractual rights to receive the cash flows, or the entity has retained the contractual rights to receive the cash flows from the asset, but has assumed a contractual obligation to pass those cash flows on under an arrangement that meets the following three conditions:

- (i) the entity has no obligation to pay amounts to the eventual recipient unless it collects equivalent amounts on the original asset;
- (ii) the entity is prohibited from selling or pledging the original asset (other than as security to the eventual recipient);
- (iii) the entity has an obligation to remit those cash flows without material delay.

Once an entity has determined that the asset has been transferred, it then determines whether or not it has transferred substantially all of the risks and rewards of ownership of the asset. If substantially all the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been retained, derecognition of the asset is precluded. If the entity has neither retained nor transferred substantially all of the risks and rewards of the asset, then the entity must assess whether it has relinquished control of the asset or not. If the entity does not control the asset then derecognition is appropriate; however, if the entity has retained control of the asset, then the entity continues to recognise the asset to the extent to which it has a continuing involvement in the asset.

Robby has transferred its rights to receive cash flows and its maximum exposure is to repay \$3.6 million. This is unlikely, but Robby has guaranteed that it will compensate the bank for all credit losses. Additionally, Robby receives the benefit of amounts received above \$3.6 million and therefore retains both the credit risk and late payment risk. Substantially, all the risks and rewards remain with Robby and therefore the receivables should still be recognised

Practice Question 3:

Ethan wishes to apply the fair value option rules of IFRS 9 *Financial Instruments* to debt issued to finance its investment properties. Ethan's argument for applying the fair value option is based upon the fact that the recognition of gains and losses on its investment properties and the related debt would otherwise be inconsistent.

Ethan argued that there is a specific financial correlation between the factors, such as interest rates, that form the basis for determining the fair value of both Ethan's investment properties and the related debt

Required:

Discuss how the above transactions and events should be recorded in the consolidated financial statements of Ethan.

Normally debt issued to finance Ethan's investment properties would be accounted for using amortised cost model. However, Ethan may apply the fair value option in IFRS 9 *Financial Instruments* as such application would eliminate or significantly reduce a measurement or recognition inconsistency between the debt liabilities and the investment properties to which they are related. The provision requires there to be a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. The option is not restricted to financial assets and financial liabilities. The IASB concludes that accounting mismatches may occur in a wide variety of circumstances and that financial reporting is best served by providing entities with the opportunity of eliminating such mismatches where that results in more relevant information. Ethan supported the application of the fair value option with the argument that there is a specific financial correlation between the factors that form the basis of the measurement of the fair value of the investment properties and the related debt. Particular importance was placed on the role played by interest rates, although it is acknowledged that the value of investment properties will also depend, to some extent, on rent, location and maintenance and other factors. For some investment properties, however, the value of the properties will be dependent on the movement in interest rates.

Under IFRS 9, entities with financial liabilities designated as FVTPL recognise changes in the fair value due to changes in the liability's credit risk directly in other comprehensive income (OCI). There is no subsequent recycling of the amounts in OCI to profit or loss, but accumulated gains or losses may be transferred within equity. The movement in fair value due to other factors would be recognised within profit or loss. However, if presenting the change in fair value attributable to the credit risk of the liability in OCI would create or enlarge an accounting mismatch in profit or loss, all fair value movements are recognised in profit or loss. An entity is required to determine whether an accounting mismatch is created when the financial liability is first recognised, and this determination is not reassessed. The mismatch must arise due to an economic relationship between the financial liability and the associated asset that results in the liability's credit risk being offset by a change in the fair value of the asset. Financial liabilities that are required to be measured at FVTPL (as distinct from those that the entity has designated at FVTPL), including financial guarantees and loan commitments measured at FVTPL, have all fair value movement recognised in profit or loss. IFRS 9 retains the flexibility that existed in IFRS 7 *Financial Instruments: Disclosures* to determine the amount of fair value change that relates to changes in the credit risk of the liability.

Further Reading –Addendum on New IFRS 9

In July, the International Accounting Standards Board (IASB) completed its response to the financial crisis by issuing the final version of IFRS 9, *Financial Instruments*. IFRS 9 sets out a model for classification and measurement, an ‘expected loss’ impairment model and a transformed approach to hedge accounting. The IASB had previously issued versions of IFRS 9 that introduced new classification and measurement requirements in 2009 and 2010 and a new hedge accounting model in 2013.

The latest publication consolidates the previous versions of the standard, and replaces IAS 39, *Financial Instruments: Recognition and Measurement*. It also changes some of the requirements of the previous publications. IFRS 9 is effective for annual periods beginning on or after 1 January 2018.

Classification determines how financial assets and financial liabilities are accounted for and measured in financial statements. The requirements for impairment and hedge accounting are based upon the instruments classification.

The standard introduces a principle-based system for the classification and measurement of financial assets, which depends upon the entity’s business model for managing the financial asset and the financial asset’s contractual cash flow characteristics.

IFRS 9 utilises a single classification approach for all types of financial assets, which includes those that contain embedded derivative features. Financial assets are no longer subject to complicated bifurcation requirements.

The business model approach refers to how an entity manages its financial assets in order to generate cash flows either by collecting contractual cash flows, selling financial assets or both. Financial assets are measured at amortised cost, where the business model’s objective is to hold assets in order to collect contractual cash flows. The new standard clarifies the existing guidance on the collection of the assets’ contractual cash flows.

When determining the applicability of this business model, an entity should consider past and future sales information.

If an entity holds financial assets for sale, then it will fail the business model test for accounting for the financial assets at amortised cost. However, sales activity is not necessarily inconsistent with the business model if they are infrequent and insignificant in value but, where these sales are frequent and significant in value, an entity needs to assess whether such sales are consistent with an objective of collecting contractual cash flows.

The sales may be consistent with that objective if they ‘are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows’.

For many entities, the assessment will be relatively straightforward, as their financial assets may be simply trade receivables and bank deposits for which the amortised cost criteria are likely to be met. For those entities with a broader range of financial assets such as investors in debt securities, and insurance companies, the motivations behind the disposal of the assets will have to be considered.

IFRS 9 includes a new measurement category whereby financial assets are measured at fair value through other comprehensive income (FVTOCI).

This category is used when financial assets are held in a business model whose objective is both collecting contractual cash flows and selling financial assets. Unlike the available-for-sale criteria in IAS 39, the criteria for measuring at FVTOCI are based on the financial asset's cash flow characteristics and the entity's business model.

This business model will involve a greater frequency and volume of sales with the possible objectives of managing liquidity or matching the duration of financial liabilities to the duration of the assets they are funding.

This category was introduced because of the concerns raised by preparers who sold financial assets in greater volume than was consistent with the previous business model and would, without this category, have to record such assets at fair value through profit or loss. (FVTPL).

Financial assets may qualify for amortised cost or FVOCI only if they give rise to 'solely payments of principal and interest' (SPPI) under the contractual cashflows characteristics test. Many instruments have features that are not in line with the SPPI condition. IFRS 9 makes it clear that such features are disregarded if they are 'non-genuine' or 'de minimis'.

IFRS 9 now provides more guidance on SPPI. For contractual cash flows to be SPPI, they must include returns that are consistent with the return on a basic lending arrangement to the holder, which generally includes consideration for the time value of money, credit risk, liquidity risk, a profit margin and consideration for costs associated with holding the financial asset over time such as servicing costs. Thus if the contractual arrangement includes a return for equity price risk, then this would be inconsistent with SPPI.

IFRS 9 introduces guidance on how the contractual cash flows characteristics assessment applies to debt instruments that may contain a modified time value element; for example, those instruments that may contain a variable interest rate.

These characteristics will result in an instrument failing the contractual cash flow characteristics test if the resulting undiscounted contractual cash flows could be 'significantly different' from the undiscounted cash flows of a benchmark instrument that does not have such features.

Interest rates set by a government or a regulatory authority are accepted as a proxy for the consideration for the time value of money if those rates provide consideration that is 'broadly consistent with consideration for the passage of time'. Such cash flows are considered SPPI as long as they do not introduce risk or volatility, which is inconsistent with a basic lending arrangement.

Any financial assets not held in one of the two business models above are measured at FVTPL, which is essentially a residual category. Also included in this category are financial assets that are held for trading and those managed on a fair-value basis. Financial assets are reclassified when the entity's business model for managing them changes. This is not expected to occur frequently and it ensures that users of financial statements are provided with information on the realisation of cash flows.

IAS 39 was felt to work well as regards the accounting for financial liabilities; therefore the IASB felt there was little need for change. Thus most financial liabilities will continue to be measured at amortised cost. IAS 39 also permitted entities to elect to measure financial liabilities at fair value through profit or loss (fair-value option).

The changes introduced by IFRS 9 are restricted to those liabilities designated at FVTPL using the fair-value option. Fair-value changes of these financial liabilities are presented in other comprehensive income to the extent that they are attributable to the change in the entity's own credit risk. If this would cause an accounting mismatch, then the total fair-value change is presented in profit or loss.

This change is designed to eliminate volatility in profit or loss caused by changes in the credit risk of financial liabilities that an entity has elected to measure at fair value.

IMPAIRMENT OF FINANCIAL ASSETS

Incurred Loss Model vs. Expected Loss Model

IAS 39 requires an assessment at each statement of financial position date as to whether there is any objective evidence that a financial asset is impaired and whether any impairment has any impact on the estimated future cash flows of the financial asset. The company recognises any impairment loss in profit or loss. Losses expected from future events are not recognised. Objective evidence of impairment includes observable data about the loss events such as financial difficulty, breach of contract and bankruptcy. For investments in equity instruments that are classified as available for sale, a significant and prolonged decline in fair value below its cost is objective evidence of impairment. The only category of financial asset that is not subject to testing for impairment is financial assets at fair value through profit or loss, since any decline in value for such assets is recognised immediately. Financial liabilities are not subject to impairment testing.

For loans and receivables and held-to-maturity investments, impaired assets are measured at the present value of the estimated future cash flows discounted using the original effective interest rate of the financial asset.

Example

A company makes a five-year loan of \$15,000 at an effective and original interest rate of 7% received at the end of each year. The loan will be repaid at a value of \$15,000. One year before maturity, there is evidence of impairment due to the financial difficulties of the borrower and it is estimated the company will only receive \$7,500 in the future. The loan is measured at the present value of the estimated future cash flows discounted using the original effective interest rate i.e. \$7,500 discounted for one year at 7% (\$7,009). The impairment loss recognised would be \$ (15,000 – 7,009) i.e. \$7,991. IAS 39 requires accrual of interest on impaired loans and receivables using the effective interest rate. Thus interest of \$491 would be accrued. (\$7,009 x 7%). If the amount of \$7,500 is eventually received then the entry would be:

Dr	Cash	\$7,500	
Cr	Interest income		\$491
Cr	Loans and receivables		\$7,009

Expected Loss Model

IFRS 9 introduces an impairment model for financial assets that is based on expected losses rather than incurred losses. An entity recognises expected credit losses at all times and updates the assessment at each reporting date to reflect any changes in the credit risk. It is no longer necessary for

there to be a trigger event for credit losses to be recognised and the same impairment model is used for all financial instruments that are impairment tested.

By introducing a forward-looking expected credit loss (ECL) model, the impairment requirements in the standard address the concerns raised over the incurred loss model in IAS 39, which resulted in a delayed recognition of credit losses. To provide support to stakeholders and inform the IASB on implementation issues arising from the standard, the IASB has also set up an IFRS Transition Resource Group for Impairment of Financial Instruments (ITG).

The ECL model applies to debt instruments recorded at amortised cost or at fair value through other comprehensive income, lease receivables, contract assets and loan commitments, and financial guarantee contracts that are not measured at fair value through profit or loss. The purpose of the model is to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments.

The loss allowance or provision recognised is based upon the credit deterioration since initial recognition. Lifetime ECL is an expected present value measure of losses that arise on default throughout the life of the instrument. It is the weighted average credit losses with the probability of default as the weighting.

Other than purchased or originated credit-impaired financial assets, IFRS 9 requires entities to measure expected credit losses by recognising a loss allowance

THREE APPROACHES

The entity is required to follow one of three approaches outlined in the standard.

If an entity uses the general approach, a loss allowance should be recognised at each reporting date, based on either 12 month ECLs or lifetime ECLs. The approach taken depends upon whether or not there has been a significant increase in credit risk on the financial instrument since initial recognition. Any changes in the loss allowance balance are recognised in profit or loss.

At each reporting date, an entity must make the following assessment:

- where credit risk is low at the reporting date or there has not been a significant increase in the credit risk since initial recognition, it should provide for 12-month ECLs;
- where there has been a significant increase in credit risk since initial recognition and the resulting credit quality is not considered to be low credit risk, it should calculate a loss allowance based upon lifetime ECLs.

Entities can elect for an accounting policy of always recognising full lifetime expected losses for contract assets, trade receivables, and lease receivables. When measuring expected credit losses, an entity should consider the probability-weighted outcome, the time value of money and information that is available without undue cost or effort.,

If the credit quality of the financial instrument improves in future periods and there is no longer a significant increase in credit risk since initial recognition, then the loss allowance is based again on 12-month ECLs. Entities can assess ECLs on a collective basis.

When assessing whether credit risk has increased significantly since initial recognition, management looks at the change in the risk of a default occurring over the expected life of the financial instrument rather than the change in the ECLs.

A comparison should be made between the risks of default at the date of the financial statements with that at the date of initial recognition. The standard allows a 12-month period to be used to assess the risk of default if it is not expected to give a different result to that of assessing the lifetime default risk. In assessing whether or not the credit risk has increased significantly, reasonable and supportable best information should be used, such as actual and expected changes in external market indicators, internal factors and borrower-specific information.

Normally, a financial instrument would have a significant increase in credit risk before there is objective evidence of impairment or before a default occurs. It is expected that lifetime ECL should be recognised before a financial asset is regarded as credit-impaired or in default.

The entity should always consider forward-looking information. But if this is not available, there is a rebuttable presumption that credit risk has increased significantly since initial recognition where contractual payments are more than 30 days overdue.

Where the financial asset is not a purchased or originated credit-impaired asset or has not become credit impaired since initial recognition, interest revenue is calculated on the gross carrying amount. This is therefore the case for financial instruments that have and have not had a significant increase in credit risk since initial recognition.

If a financial asset subsequently becomes credit-impaired, the interest revenue is calculated by applying the effective interest rate (EIR) to the amortised cost of the financial asset that is the gross carrying amount net of loss allowance, rather than the gross carrying amount. If the financial asset is no longer credit-impaired and the improvement in credit quality can be related objectively to a certain event, such as an improvement in the credit rating of a loan creditor, then the interest revenue can again be calculated by applying the EIR to the gross carrying amount. If there is no reasonable expectation of recovering the financial asset, then the gross carrying amount of the financial asset should be written off.

SIMPLIFIED APPROACH

A second approach has been termed the ‘simplified approach’. Here the entity does not have to track the changes in credit risk, but on recognition it recognises a loss allowance based on lifetime ECLs at each reporting date. This approach is used when accounting for trade receivables or contract assets that fall within the scope of IFRS 15, *Revenue from Contracts with Customers*, and that do not contain a significant financing component. It should also be used when the entity applies the practical expedient for contracts that have a maturity date of one year or less, in accordance with IFRS 15. The loss allowance should be probability-weighted, allow for the time value of money and utilise the best available forward-looking information.

It seems obvious that a considerable amount of judgment will be required when assessing ECLs under this approach. However, entities are required to disclose the basis behind their estimation of lifetime ECLs. In addition, the entity may choose to apply either the simplified approach or the general approach to trade receivables or contract assets within the scope of IFRS 15 and finance or operating

lease receivables. This choice of policy should assist those entities that do not have sophisticated credit risk management systems. For those trade receivables and contract assets that are due within 12 months, the 12-month ECLs will be the same as the lifetime ECLs.

When a financial asset is first recognised, there is a requirement to determine whether or not the asset is credit-impaired. Credit-impairment occurs when events have occurred that have a detrimental impact on the asset's estimated future cash flows. These events include breach of contract, the financial difficulty or bankruptcy of the borrower, or the lack of an active market for the financial asset due to financial issues.

If the entity purchases a credit-impaired asset, it is likely that the acquisition will be deeply discounted. For such assets, the effective interest rate is calculated after accounting for the initial lifetime ECLs. This treatment is unchanged from IAS 39.

Subsequently, the entity recognises any changes in lifetime ECLs as a loss allowance, with any impairment gain recognised in profit or loss. This gain would occur where favourable changes result in the estimate of lifetime ECLs becoming lower than originally calculated. Interest revenue is calculated by applying the credit-adjusted EIR to the amortised cost of these financial assets from initial recognition. The ECL model relies on a relative assessment of credit risk, which means that a loan with the same characteristics could be treated differently by entities, as could different loans with the same counterparty, depending on the credit risk of each at recognition.

ITG GROUP

The first meeting of the ITG Group took place in April 2015. The discussion focused on the implementation of the impairment requirements of IFRS 9. There were several items on the agenda. Here are a few examples of the items discussed.

- The group was asked whether there was a requirement to measure ECLs at the date of de-recognition of a financial asset measured at amortised cost or FVTOCI (fair value through other comprehensive income). The conclusion was that this measurement should occur as a gain or loss on de-recognition and should be calculated.
- It was noted that a recent measure of the loss allowance could serve as a proxy depending upon how frequently the loss allowances were calculated.
- The group was also asked whether a financial guarantee contract should be taken into account when assessing whether there has been a significant increase in the credit risk of the guaranteed debt instrument. The group felt that expected recoveries from integrated guarantee contracts should not be taken into account, but that the behaviour of the guarantor may influence the probability of default.
- On a similar note, the ITG Group was asked whether premiums received from the holder of a guarantee contract should be taken into account when assessing the ECLs of the guarantee contract itself. The group felt that the premiums should not be included in the measurement of ECLs, but the entity should bear in mind that the non-payment of premiums may cause the guarantee to lapse.
- The group was asked to comment on an example where a bank granted a mortgage to a client that had a six-month maturity date, but that was automatically extended unless the borrower or lender terminated the loan. The question posed was surrounding the length of the maximum

period that the bank should consider when assessing expected credit losses. The group felt that the maximum period was six months as the lender was not contractually required to lend beyond six months.

Financial institutions will find the standard very challenging. Most entities do not collect the credit information required to apply the standard. New models will need to be built to determine both 12-month and lifetime ECLs, and significant judgment will be required.

PRACTICE QUESTION

Recently, criticisms have been made against the current IFRS impairment model for financial assets (the incurred loss model). The issue with the incurred loss model is that impairment losses (and resulting write-downs in the reported value of financial assets) can only be recognised when there is evidence that they exist and have been incurred. Reporting entities are not allowed currently to consider the effects of expected losses. There is a view that earlier recognition of loan losses could potentially reduce the problems incurred in a credit crisis.

Grainger has a portfolio of loans of \$5 million which was initially recognised on 1 May 2010. The loans mature in 10 years and carry an interest rate of 16%. Grainger estimates that no loans will default in the first two years, but from the third year onwards, loans will default at an annual rate of about 9%. If the loans default as expected, the rate of return from the portfolio will be approximately 9.07%. The number of loans is fixed without any new lending or any other impairment provisions.

Required:

- (i) Discuss briefly the issues related to considering the effects of expected losses in dealing with impairment of financial assets. (5 marks)**
- (ii) Calculate the impact on the financial statements up to the year ended 30 April 2013 if Grainger anticipated the expected losses on the loan portfolio in year three. (5 marks) (25 marks)**

(i) The expected loss model is more subjective in nature compared to the incurred loss model, since it relies significantly on the cash flow estimates prepared by the reporting entity which are inherently subjective. Therefore safeguards are needed to be built into the process such as disclosures of methods applied. The expected loss model would involve significant operational challenges notably it is onerous in data collection since data needs to be collected for the whole portfolio of financial assets measured at amortised cost held by a reporting entity. This means that data is not only required for impaired financial assets but it also requires having historical loss data for all financial assets held at amortised cost. Entities do not always have historical loss data for financial assets, particularly for some types of financial asset or some types of markets. The historical loss data often does not reflect the losses to maturity or the historical data are not relevant due to significant changes in circumstances.

(ii) Incurred loss model per IAS 39

Date	Loan asset (A)	Interest at 16% (B)	Cash-flow	Loss(C)	Loan-asset	Return (B-C)/A%
	\$000	\$000	\$000	\$000	\$000	
y/e 30 April 11	5,000	800	(800)	0	5,000	16%
y/e 30 April 12	5,000	800	(800)	0	5,000	16%
y/e 30 April 13	5,000	800	(728)	522	4,550	5.56%

being 800 x 91%

Expected loss model

Date	Loan asset (A) \$000	Interest at 9·07% (B) \$000	Cash flow \$000	Loan asset \$000	Return B/A %
y/e 30 April 11	5,000	453·5	(800)	4,653·5	9·07%
y/e 30 April 12	4,653·5	422·1	(800)	4,275·6	9·07%
y/e 30 April 13	4,275·6	387·8	(728)	3,935·4	9·07%

being 800 x 91%

The expected loss model matches the credit loss on the same basis as interest revenue recognised from the financial asset. Under an expected loss model revenue is set aside to cover expected future credit losses. The expected loss model has the effect of smoothing the reported income for cash flows that are not expected to accrue evenly over the life of the portfolio as impairment is recognised earlier. The IAS 39 model is based on the perspective of matching a credit loss to the period in which that loss was incurred. This results in loan loss expenses being recognised later in the life of the instrument. Interest income is recognised in full without considering expected credit losses until they have actually been incurred. This model is therefore characterised by higher revenues due to the period immediately after initial recognition, followed by lower net income if credit losses are incurred.

HEDGE ACCOUNTING

Hedging is a risk management technique designed to offset changes in fair value or cash flows. When certain conditions are met, companies are permitted to apply hedge accounting which differs from the normal accounting methods in IAS 39. These requirements are optional. The main impact of hedge accounting is that gains and losses on the hedging instrument and the hedged item are recognised in the same period. There will be a hedging instrument (a derivative or a non-derivative financial asset or non-derivative financial liability) and a hedged item (an asset, liability, firm commitment, net investment in a foreign operation etc). The hedged item exposes the company to risks of changes in fair value or future cash flows. There are three types of hedging in IAS 39: Fair value hedges, Cash flow hedges and Hedges of a net investment in a foreign operation.

Changes in fair value of the hedged item, when using fair value hedges, are recognised in the current period to offset the recognition of changes in the fair value of the hedging instrument. In the case of cash flow hedges and hedges of a net investment in a foreign entity, changes in fair value of the hedging instrument are deferred in reserves (OCI) to the extent the hedge is effective and released [amortised?] to profit or loss in the time periods in which the hedged item impacts profit or loss.

IAS 39 limits the use of hedge accounting to situations where certain conditions are met.

These conditions are as follows:

1. Formal designation and documentation of the hedging relationship and the company's risk management objective and strategy for undertaking the hedge. Hedge accounting is only permitted from the date such designation and documentation is in place.

2. The hedging relationship is effective:
 - a. The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk
 - b. The effectiveness of the hedge can be reliably measured.
 - c. The hedge is assessed on an ongoing basis and determined to have been highly effective throughout the financial reporting periods for which the hedge was designated
3. For cash flow hedges of forecast transactions, the hedged transaction must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

Example- fair value hedge

A company purchases a \$2 million bond that has a fixed interest rate of 6 % per year. The instrument is classed as an available-for-sale financial asset. The fair value of the instrument is \$2 million. The company enters into an interest rate swap (fair value zero) to offset the risk of a decline in fair value. If the derivative hedging instrument is effective, any decline in the fair value of the bond should offset by opposite increases in the fair value of the derivative instrument. The company designates and documents the swap as a hedging instrument.

Market interest rates increase to 7% and the fair value of the bond decreases to \$1,920,000. Because the instrument is classified as 'available for sale', the decrease in fair value would normally be recorded directly in reserves. However, since the instrument is a hedged item in a fair value hedge, this change in fair value of the instrument is recognised in profit or loss, as follows:

Dr	Income statement	\$80,000
Cr	Bond	\$80,000

The fair value of the swap has increased by \$80,000. Since the swap is a derivative, it is measured at fair value with changes in fair value recognised in profit or loss. The changes in fair value of the hedged item and the hedging instrument exactly offset, the hedge is 100% effective and, the net effect on profit or loss is zero.

Example-cash flow hedge

A company expects to purchase a piece of machinery for €10 million in a years time (31 July 2007). In order to offset the risk of increases in the euro rate, the company enters into a forward contract to purchase €10 million in 1 year for a fixed amount (\$6,500,000). The forward contract is designated as a cash flow hedge and has an initial fair value of zero.

At the year end, (31 October 2006) the euro has appreciated and the value of €10 million is \$6,660,000. The machine will still cost €10 million so the company concludes that the hedge is 100% effective. Thus the entire change in the fair value of the hedging instrument is recognized directly in reserves.

Dr	Forward contract	\$160,000
Cr	Reserves (OCI)	\$160,000

The effect of the cash flow hedge is to lock in the price of €10 million for the machine. The gain in equity at the time of the purchase of the machine will either be released from equity as the machine is depreciated or be deducted from the initial carrying amount of the machine.

A hedge of net investment in a foreign operation is accounted similarly to a cash flow hedge and generally, a hedge is viewed as being highly effective if actual results are within a range of 80% and 125%.

IFRS 9 introduces a reformed model for hedge accounting with enhanced disclosures about risk management activity. Under IFRS 9, a hedging relationship qualifies for hedge accounting only if all of these criteria are met:

- the hedging relationship consists only of eligible hedging instruments and eligible hedged items
- at its inception there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge
- the relationship meets all of the hedge effectiveness requirements. The hedge relationship must meet the effectiveness criteria at the beginning of each hedged period to qualify for hedge accounting
- there is an economic relationship between the hedged item and the hedging instrument
- the effect of credit risk does not dominate the value changes that result from that relationship
- the hedge ratio of the hedging relationship is the same as that used in the economic hedge.

IFRS 9 will affect all sectors through the introduction of an expected loss model for loan loss provisioning, but will impact mostly on banks. It should give investors better insight into the credit quality of all financial assets.