IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

FACT SHEET

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This fact sheet is based on existing requirements as at 31 December 2015 and does not take into account recent standards and interpretations that have been issued but are not yet effective.

IMPORTANT NOTE

This fact sheet is based on the requirements of the International Financial Reporting Standards (IFRSs). In some jurisdictions, the IFRSs are adopted in their entirety; in other jurisdictions the individual IFRSs are amended. In some jurisdictions the requirements of a particular IFRS may not have been adopted. Consequently, users of the fact sheet in various jurisdictions should ascertain for themselves the relevance of the fact sheet to their particular jurisdiction. The application date included below is the effective date of the initial version of the standard.

IASB APPLICATION DATE (NON-JURISDICTION SPECIFIC)

IAS 39 is applicable for annual reporting periods commencing on or after 1 January 2005 and will be superseded by IFRS 9 *Financial Instruments* for annual periods beginning on or after 1 January 2018.

OBJECTIVE

IAS 39 *Financial Instruments: Recognition and Measurement* establishes the principles for the recognition and measurement of financial assets, financial liabilities and some contracts to buy or sell non-financial assets. Requirements relating to the presentation of information about financial instruments are in IAS 32 *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in IFRS 7 *Financial Instruments: Disclosure*.

SCOPE

IAS 39 does not apply to the following financial instruments:

- Those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with IFRS 10 *Consolidated Financial Statements*, IAS 27 *Separate Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures*. However, in some cases, IFRS 10, IAS 27 or IAS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to *derivatives* on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in IAS 32.
- Rights and obligations under leases to which IAS 17 *Leases* applies, other than the derecognition and impairment of lessor's lease receivables, the derecognition of lessee's finance lease payables and derivatives embedded in leases.
- Employers' rights and obligations under employee benefit plans to which IAS 19 *Employee Benefits* applies.
- Financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32.
- Rights and obligations under insurance contracts as defined in IFRS 4 *Insurance Contracts,* subject to some exceptions including financial guarantee contracts, or the contract contains a discretionary participation feature.
- Loan commitments subject to some exceptions.
- Financial instruments, contracts and obligations under share-based payment transactions which IFRS 2 *Share-based Payment* applies.
- Rights to payments to reimburse the entity for expenditure to settle a liability that it recognises as a provision in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of IFRS 3 *Business Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.

RECOGNITION AND MEASUREMENT

The main requirements for the recognition and measurement of financial instruments are:

- An entity shall categorise its financial assets into one of the following categories:
  - financial assets at fair value through profit or loss. This category consists of three sub-categories: (1) financial instruments held for trading (2) contingent consideration of an acquirer in a business combination to which IFRS 3 *Business Combinations* applies, and (3) financial instruments designated as at fair value through profit or loss
  - held-to-maturity investments
  - loans and receivables, or
  - available-for-sale financial assets.
- Recognition of a financial asset or financial liability is at the point when, and only when the entity becomes a party to the contractual provisions of the instrument.
- When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.
- After initial recognition:
  - financial assets or financial liabilities at fair value through profit or loss shall be measured at fair value without any deduction for expected transaction costs on disposal and the change in fair value is recognised in profit or loss
  - held-to-maturity investments are measured at amortised cost using the effective interest method, with interest and impairment costs being recognised in profit or loss
  - loans and receivables are measured at amortised cost using the effective interest method, with interest and impairment costs being recognised in profit or loss
  - available-for-sale financial assets are measured at fair value without any deduction for expected transaction costs on disposal and the change in fair value is recognised directly in other comprehensive income (except for an impairment loss and a foreign exchange gain or loss) until the financial asset is derecognised when the cumulative gain or loss previously recognised in other comprehensive income is recognised in profit or loss

- investments in equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured, and derivatives linked to and settled by delivery of such equity instruments, shall be measured at cost
- financial assets and financial liabilities designated as hedged items are subject to measurement under the hedge accounting requirements
- financial liabilities shall be measured at amortised cost using the effective interest method except for those classified as financial liabilities at fair value through profit or loss, financial liabilities that arise out of a failed derecognition of a financial asset, financial guarantee contracts and commitments
- a financial liability at fair value through profit or loss is measured at fair value, including derivatives, but excluding a derivative liability that is linked to and must be settled by delivery of an equity instrument that does not have a quoted price in an active market for an identical instrument (i.e. a Level 1 input) whose fair value cannot be reliably measured; in such an instance, the derivative liability shall be measured at cost.

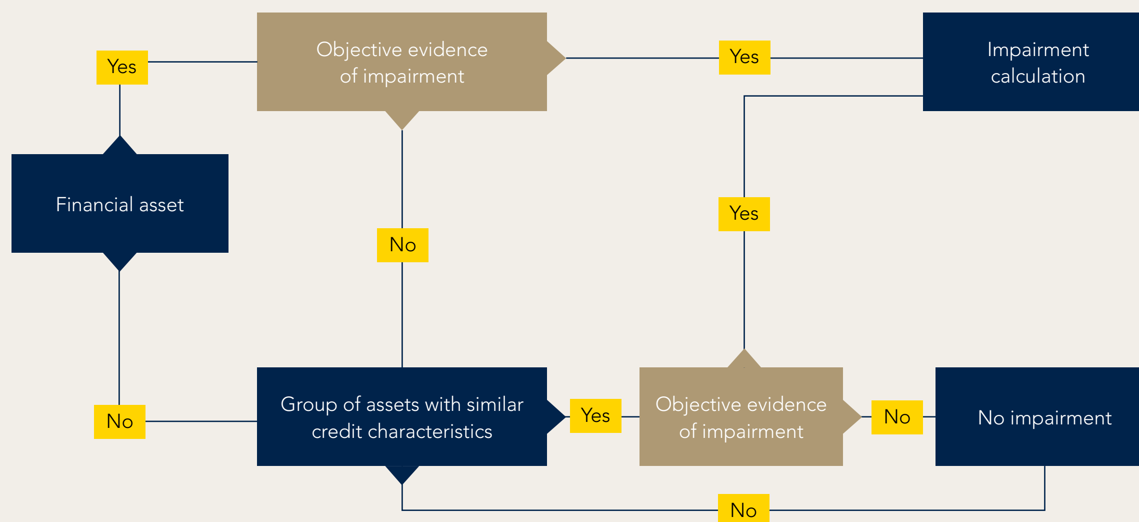
Impairment

An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. Financial assets carried at amortised cost, financial assets carried at cost and available-for-sale financial assets are potentially subject to impairment. IAS 39 distinguishes impairment from other declines in value and requires impairment testing of all asset categories except financial assets measured at fair value through profit or loss. However, this exception does not apply to an investment in an equity instrument that was initially categorised as a financial asset at fair value through profit or loss and is subsequently measured at cost. Financial assets are assessed for impairment at each reporting period as depicted in Diagram 1 below.

The amount of the impairment loss is recognised in profit or loss and measured as follows:

- For loans/receivables or held-to-maturity investments carried at amortised cost, the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss. These impairment losses are also to be tested subsequently for reversal.
- For an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses shall not be reversed.
- For available-for-sale financial assets where a decline in the fair value has been recognised directly in other comprehensive income, the cumulative loss that had been recognised directly in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment even though the financial asset has not been derecognised. Impairment losses recognised in profit and loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss. However, if in a subsequent period the fair value of a debt instrument classified as available for sale increases because of an event occurring after the impairment loss was recognised, the impairment loss is reversed, with the amount of the reversal recognised in profit or loss.

Diagram 1: IAS 39 Impairment Model



Reclassifications

An entity:

a. Shall not reclassify a derivative out of the fair value through profit or loss category while it is held or issued.

b. Shall not reclassify any financial instrument out of the fair value through profit or loss category if upon initial recognition it was designated by the entity as at fair value through profit or loss.

c. May, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term, reclassify that financial asset out of the fair value through profit or loss category if the requirements in paragraphs 50B or 50D applies.

An entity shall not reclassify any financial instrument into the fair value through profit or loss category after initial recognition.

Derecognition of financial assets

A financial asset is derecognised and removed from the statement of financial position when the contractual rights to the cash flows from the financial asset expire or the financial asset is transferred (e.g. the entity transfers the contractual rights to receive the cash flows or the entity retains the right to receive such cash flows but also assumes a contractual obligation to pass such cash flows on to another party and specified conditions are met).

In determining whether a financial asset has been transferred and hence needs to be derecognised, an entity evaluates the extent to which it retains the risks and rewards of ownership. In cases where the entity retains the risks and rewards of ownership of the financial asset, entity continues to recognise the financial asset.

If the entity neither transfers nor retains substantially all the risks and rewards of ownership, then the entity determines whether it has retained control of the financial asset. Where the entity retains control of the financial asset, the financial asset is retained on the entity's statement of financial position to the extent of its continuing involvement in that financial asset. Where the entity does not retain control, it derecognises the financial asset and recognises separate assets and liabilities representing any rights and obligations created or retained in the transfer.

Derecognition of financial liabilities

A financial liability (or part of a financial liability) is derecognised and removed from the statement of financial position when it is extinguished, that is, when the obligation is discharged, cancelled or expires.

An exchange between an existing borrower and lender of debt instruments with substantially different terms, or the substantial modification of the terms of an existing financial liability, shall be recognised as an extinguishment of the original financial liability and the recognition of a new financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

Embedded derivatives

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

An embedded derivative is separated from the host contract and accounted for as a derivative under IAS 39 if, and only if:

a. The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.

b. A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

c. The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract is accounted for under IAS 39 if it is a financial instrument, and in accordance with other appropriate standards if it is not a financial instrument.

Hedge Accounting

Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.

There are three types of hedging relationships:

- **Fair value hedge** – a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or unrecognised firm commitment, that is attributable to a particular risk and could affect profit or loss. The gain or loss from remeasuring the hedging instrument at fair value is recognised in profit or loss. Any change in the value of the hedged item as a result of the hedged risk will affect the carrying amount of the hedged item and be recognised in profit or loss.
- **Cash flow hedge** – a hedge of the exposure to variability in cash flows related to the hedged item that (i) is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and that (ii) could affect profit or loss. The portion of the gain or loss that is effective is recognised in other comprehensive income, while the ineffective portion is recognised in profit or loss. Gains and losses recognised directly in other comprehensive income are reclassified into profit or loss as a reclassification adjustment in the same periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify into profit or loss as a reclassification adjustment the amount that is not expected to be recovered.
- **Hedge of a net investment in a foreign operation** – the accounting treatment for this type of hedge is similar to that described for a cash flow hedge. Refer to IAS 21 *The Effects of Changes in Foreign Exchange Rates* for an illustration and discussion.

To qualify for hedge accounting, the hedging instrument must involve a party external to the entity.

The hedging relationship between the hedged item and the hedging instrument must satisfy prescribed conditions, including:

- a formal designation and documentation of the hedging relationship at inception
- expected to be highly effective in achieving offsetting changes in fair value or cash flows
- reliable measure of hedge effectiveness
- ongoing assessment that demonstrates the instrument is highly effective.

DISCLOSURES

IAS 39 does not include any disclosures; refer to IFRS 7 for disclosures relating to financial instruments.

DEFINITIONS

Term	Definition
Amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.
Available-for-sale financial assets	Those non-derivative financial assets that are designated as available for sale or that are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.
Derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
Derivative	A financial instrument or other contract with all three of the following characteristics: • 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 (sometimes called the 'underlying') • 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 • it is settled at a future date
Effective interest method	A method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability
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.
Held-to-maturity investment	A non-derivative financial asset with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity.
Financial asset or financial liability at fair value through profit or loss	A financial asset or financial liability that is held for trading, is contingent consideration of an acquirer in a business combination to which IFRS 3 *Business Combinations* applies, or a financial asset or financial liability that upon initial recognition, the entity has designated as at fair value through profit or loss (the 'fair value' option).
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

Regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.
Transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.
Firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
Forecast transaction	An uncommitted but anticipated future transaction.
Hedging instrument	Designated derivative or a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.
Hedged item	An asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that: a. exposes the entity to risk of changes in fair value or future cash flows and b. is designated as being hedged
Hedge effectiveness	The degree to which changes in fair value or cash flows attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

RELATED INTERPRETATIONS

- IFRIC 9 *Reassessment of Embedded Derivatives*
- IFRIC 12 *Service Concession Arrangement*s
- IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*
- IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*

IFRICs 9 and 19 are relatively more significant than IFRICs 12 and 16.

IFRIC 9 applies to all embedded derivatives within the scope of IAS 19 except for derivatives in contracts acquired in:

- a business combination
- a combination of entities or businesses under common control
- the formation of a joint venture

IAS 39 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives under the Standard. IFRIC 9 addresses the following issues:

a. Does IAS 39 require such an assessment to be made only when the entity first becomes a party to the contract, or should the assessment be reconsidered throughout the life of the contract?

b. Should a first-time adopter make its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts IFRSs for the first time?

IFRIC 19 addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability. It does not address the accounting by the creditor.

It addresses the following specific issues:

a. Are an entity's equity instruments issued to extinguish all or part of a financial liability 'consideration paid' in accordance with paragraph 41 of IAS 39?

b. How should an entity initially measure the equity instruments issued to extinguish such a financial liability?

c. How should an entity account for any difference between the carrying amount of the financial liability extinguished and the initial measurement amount of the equity instruments issued?

AUSTRALIAN SPECIFIC REQUIREMENTS

The Australian equivalent standard is AASB 139 *Financial Instruments: Recognition and Measurement.*

OTHER MATTERS

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CPAH1814 07-16