

**DELOITTE TOUCHE
TOHMATSU GLOBAL IAS
LEADERSHIP TEAM****IAS GLOBAL OFFICE****Global IAS Leader:**

Ken Wild,
kwild@deloitte.co.uk

**IAS CENTRES OF
EXCELLENCE****Americas:**

D. J. Gannon,
iasplusamericas@deloitte.com

Asia-Pacific:

Stephen Taylor,
iasplus@deloitte.com.hk

Europe-Africa:

JOHANNESBURG –
Graeme Berry,
iasplus@deloitte.co.za

COPENHAGEN –
Stig Enevoldsen,
dk_iasplus@deloitte.dk

LONDON –
Veronica Poole,
iasplus@deloitte.co.uk

PARIS –
Laurence Rivat,
iasplus@deloitte.fr

IAS PLUS WEB SITE

Over 480,000 people visited our www.iasplus.com web site in 2003 (compared to 267,000 in 2002 and 89,000 in 2001). Our goal is to be the most comprehensive source of news about IFRS on the Internet. Please check in regularly during 2004.

Revised Standards on Financial Instruments

In December 2003, the IASB issued revised versions of IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement. Both standards are effective for annual periods beginning on or after 1 January 2005, and both supersede the previous versions of the two standards. Earlier application of the revised standards together, but not individually, is permitted.

There remains one outstanding area that has not been included in the two revised standards. An exposure draft on Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk, commonly referred to as 'macro hedging', was issued in August 2003. The IASB is currently considering the views of the respondents to that exposure draft, with a plan to issue a supplement to the revised IAS 39 by the end of the first quarter of 2004.

Under the European Union's IAS Regulation, European listed companies must use IASB standards in their consolidated financial statements starting in 2005. Because IASs 32 and 39 were being significantly revised, the endorsement of these standards by the European Commission was delayed when the other IASs were endorsed in September 2003. Now that both of those standards have been issued, the EU is in a position to endorse them (though consideration might await completion of the macro hedging component). We recommend that EU listed companies should continue with their preparations assuming that both the standards will be endorsed for use in 2005.

Scope

IASs 32 and 39 should be applied to all types of financial instruments unless scoped out from one or both of the Standards.

The following financial instruments are, according to specific provisions, scoped out of both revised IAS 32 and IAS 39:

- ☐ interests in subsidiaries, associates, and joint ventures accounted for under IAS 27, IAS 28, or IAS 31; however IASs 32 and 39 apply in cases where under IAS 27, IAS 28, or IAS 31 such interests are to be accounted for under IAS 39 – for example, derivatives on an interest in a subsidiary, associate, or joint venture;
- ☐ employers' rights and obligations under employee benefit plans to which IAS 19 applies;
- ☐ contracts for contingent consideration in a business combination;
- ☐ contracts requiring payment based on climatic, geological, or other physical variable, except derivatives embedded in such contracts are subject to IAS 39;
- ☐ rights and obligations under insurance contracts, except IAS 39 does apply to financial instruments that take the form of an insurance (or reinsurance) contract but that principally involve the transfer of financial risks and derivatives embedded in insurance contracts.

In addition, IAS 39 does not apply to financial instruments that meet the definition of own equity under IAS 32.

Scope, continued

Leases

IAS 32 applies to lease receivables and payables. IAS 39 applies to those financial instruments only in limited respects:

- ☐ It applies to lease receivables with respect to the derecognition and impairment provisions.
- ☐ It applies to lease payables with respect to the derecognition provisions.

IAS 39 applies to derivatives embedded in leases.

Financial guarantees

IAS 32 applies to all financial guarantees.

Guarantees that provide for payments to be made in response to changes in a specified variable (price, rate, or index) are derivatives within the scope of IAS 39.

Guarantees are only excluded from IAS 39 if they provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due.

Loan commitments

IAS 32 applies to all loan commitments.

Loan commitments are outside the scope of IAS 39 if they cannot be settled net in cash or another financial instrument, they are not designated as financial liabilities at fair value through profit or loss, and the entity does not have a past practice of selling the loans that resulted from the commitment shortly after origination.

Contracts to buy or sell non-financial items

Contracts to buy or sell non-financial items are within the scope of IASs 32 and 39 if they can be settled net in cash or another financial asset and are not entered into and held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.

IAS 39 includes expanded criteria for the determining whether contracts to buy or sell non-financial items are within its scope

Definition now includes those contracts indexed to or settled in an entity's own equity instruments that do not meet the definition of equity.

Definition of a Financial Asset

Previously, IAS 32 defined a financial asset as cash, a contractual right to receive cash or another financial asset, a contractual right to exchange financial assets or liabilities with another entity under conditions that are potentially favourable, or an equity instrument of another entity.

The definition now includes those contracts where an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable.

A contract that will or may be settled in the entity's own equity instruments is a financial asset if it is:

- ☐ a non-derivative for which the entity is or may be obliged to receive a variable number of its own equity instruments; or
- ☐ a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Any financial asset can now be designated on initial recognition as one to be measured at fair value through profit or loss.

The option to record gains and losses on AFS assets directly in profit or loss has been removed, as the option to designate any financial asset at fair value through profit or loss is introduced.

An entity is now permitted to classify in 'loans and receivables' loans that are purchased, provided they are not quoted in an active market.

Any financial liability can now be designated on initial recognition as one to be measured at fair value through profit or loss

Classification of Financial Assets

IAS 39 requires financial assets to be classified in one of the following categories:

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

Those categories are used to determine how a particular financial asset is recognised and measured in the financial statements.

Financial assets at fair value through profit or loss. This category has two subcategories. The first includes any financial asset that is designated on initial recognition as one to be measured at fair value with fair value changes in profit or loss. The second category includes financial assets that are held for trading. All derivatives (except those designated hedging instruments) and financial assets acquired or held for the purpose of selling in the short term or for which there is a recent pattern of short-term profit taking are held for trading.

Available-for-sale financial assets (AFS) are any non-derivative financial assets designated on initial recognition as available for sale. AFS assets are measured at fair value in the balance sheet. Fair value changes on AFS assets are recognised directly in equity, through the statement of changes in equity, except for interest on AFS assets (which is recognised in income on an effective yield basis), impairment losses, and foreign exchange gains or losses. The cumulative gain or loss that was recognised in equity is recognised in profit or loss when an available-for-sale financial asset is derecognised.

Loans and receivables are non-derivative financial assets with fixed or determinable payments, originated or acquired, that are not quoted in an active market, not held for trading, and not designated on initial recognition as assets at fair value through profit or loss or as available-for-sale. Loans and receivables for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, should be classified as available-for-sale. Loans and receivables are measured at amortised cost.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments that an entity intends and is able to hold to maturity and that do not meet the definition of loans and receivables and are not designated on initial recognition as assets at fair value through profit or loss or as available for sale. Held-to-maturity investments are measured at amortised cost.

If an entity sells a held-to-maturity investment other than in insignificant amounts or as a consequence of a non-recurring, isolated event beyond its control that could not be reasonably anticipated, all of its other held-to-maturity investments must be reclassified as available-for-sale for the current and next two financial reporting years.

Definition of a Financial Liability

A financial liability is any liability that is:

- ☐ a contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable, or
- ☐ a contract that will or may be settled in the entity's own equity instruments where the contract is either a non-derivative for which the entity may have to deliver a variable number of own equity instruments, or a derivative that will be settled other than by exchange of a fixed amount of a financial asset for a fixed number of own equity instruments.

Classification of Financial Liabilities

IAS 39 recognises two classes of financial liabilities:

- ☐ Financial liabilities at fair value through profit or loss.
- ☐ Other financial liabilities measured at amortised cost using the effective interest method.

A financial liability at fair value through profit or loss is either:

- ☐ a financial liability classified as held for trading; or
- ☐ a financial liability that is designated by the entity as a liability at fair value through profit or loss upon initial recognition.

Classification as debt or equity

The fundamental principle of IAS 32 is that an instrument should be classified as either a liability or an equity instrument according to its substance based on the definitions of a financial liability and an equity instrument, and not according to its legal form.

IAS 32 defines an equity instrument as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

A financial liability is defined above. Based on the definition, the following instruments are financial liabilities of the issuer:

- ☐ A financial instrument that provides for mandatory redemption by the issuer or gives the holder the right to require the issuer to redeem the instrument (such as mandatorily redeemable preferred shares).
- ☐ A financial instrument that gives the holder the right to put that instrument back to the issuer for cash or another financial asset.
- ☐ An instrument where the choice of settlement in cash or another financial asset is contingent on the outcome of circumstances beyond the control of both the issuer and the holder.

Derivatives on own shares

A derivative contract that will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. A derivative on own equity that gives the issuer or the holder a choice over how it is settled, such as settlement net in cash or net in shares, is a financial asset or liability unless all of the settlement alternatives would result in equity classification.

Compound financial instruments

In the case of compound financial instruments, which have both a liability and equity component, such component parts are required to be split with each part accounted for and presented separately according to its substance.

IAS 32 requires the issuer's liability on a compound instrument, such as a convertible bond, to be recorded initially at fair value, with the residual value to be assigned to the equity component.

Interest, dividends, losses, and gains

Interest, dividends, losses, and gains relating to a financial liability are to be recognised as income or expense in profit or loss. Distributions to holders of equity instruments as well as transaction costs for an equity transaction (other than costs of issuing an equity instrument that are directly attributable to the acquisition of a business) are to be accounted for within equity.

Treasury shares

If an entity reacquires its own shares (with these being held by the entity or another member of the consolidated group), the cost of those instruments is to be deducted from equity.

No gain or loss is to be recorded in profit or loss on the purchase, sale, issue, or cancellation of an entity's own equity instruments.

The alternative method for the measurement of the equity and liability components of a compound instrument (apportionment of proceeds based on relative fair values of the two components) has been removed

On initial recognition, a financial instrument should be measured at fair value. A gain or loss should not be immediately recognised unless there is evidence of observable market data supporting a fair value different to the consideration paid or received.

Measurement

Initially, financial assets and liabilities should be measured at fair value (including transaction costs, for assets and liabilities not measured at fair value through profit or loss).

Subsequently, financial assets and liabilities (including derivatives) should be measured at fair value, with the following exceptions:

- ❑ Loans and receivables, held-to-maturity investments, and non-derivative financial liabilities should be measured at amortised cost using the effective interest method.
- ❑ Investments in equity investments with no reliable fair value measurement (and related derivatives) should be measured at cost.
- ❑ Financial assets and liabilities that are designated as a hedged item or hedging instrument are subject to measurement under the hedge accounting requirements of the IAS 39.
- ❑ Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition, or that are accounted for using the continuing-involvement method, are subject to particular measurement requirements.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. IAS 39 provides a hierarchy to be used in determining the fair value for a financial instrument:

- ❑ Quoted market prices in an active market are the best evidence of fair value and should be used, where they exist, to measure the financial instrument.
- ❑ If a market for a financial instrument is not active, an entity establishes fair value by using a valuation technique that makes maximum use of market inputs and includes recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments.
- ❑ If there is no active market for an equity instrument and the range of reasonable fair values is significant and these estimates cannot be made reliably, then an entity must measure the equity instrument at cost less impairment.

Amortised cost is calculated using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

Financial assets that are not carried at fair value through profit and loss are subject to an impairment test.

A financial asset or group of assets is impaired and impairment losses are incurred only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset.

The amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate.

Individual assets that are individually assessed and for which no impairment exists are grouped with financial assets with similar credit risk statistics and collectively assessed for impairment.

Impairment losses are recognised as incurred – it is not appropriate to recognise, in advance, expected future losses.

Recognition and Derecognition

Initial recognition

IAS 39 requires recognition of a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument, subject to the following provisions in respect of regular way purchases.

Regular way purchases or sales of a financial asset

A regular way purchase or sale of financial assets is recognised and derecognised using either trade date or settlement date accounting. The method used is to be applied consistently for all purchases and sales of financial assets that belong to the same category of financial asset as defined in IAS 39 (note that for this purpose assets held for trading form a different category from assets designated at fair value through profit or loss). The choice of method is an accounting policy.

Derecognition of a financial asset

The basic premise for the derecognition model in IAS 39 is to determine whether the asset under consideration for derecognition is:

- ☐ an asset in its entirety; or
- ☐ specifically identified cash flows from an asset; or
- ☐ a fully proportionate share of the cash flows from an asset; or
- ☐ a fully proportionate share of specifically identified cash flows from a financial asset.

Once the asset under consideration for derecognition has been determined, an assessment is made as to whether the 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:

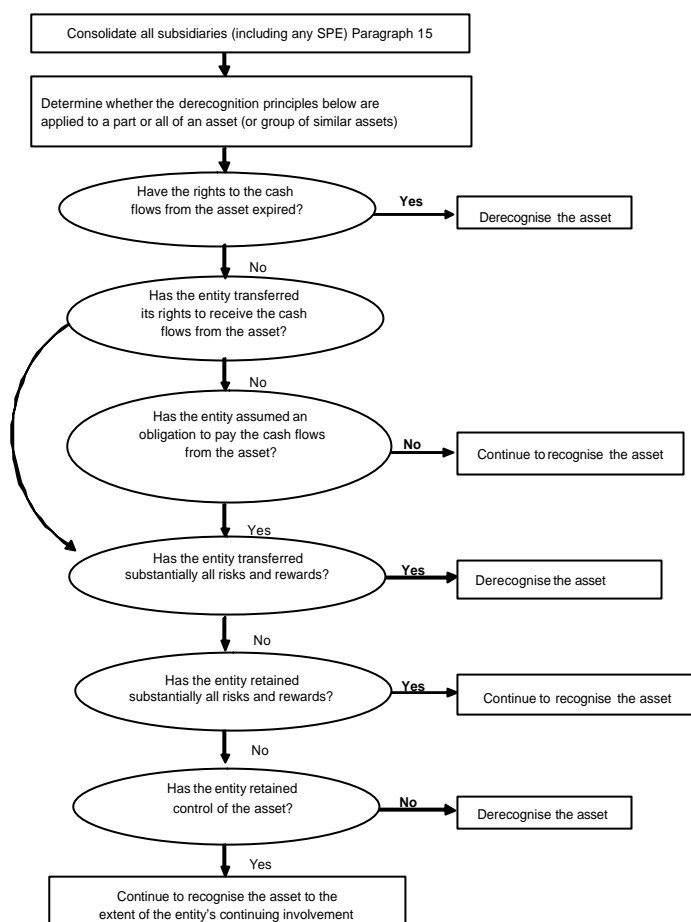
- ☐ the entity has no obligation to pay amounts to the eventual recipient unless it collects equivalent amounts on the original asset,
- ☐ the entity is prohibited from selling or pledging the original asset (other than as security to the eventual recipient), and
- ☐ the entity has an obligation to remit 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.

These various derecognition steps are summarised below in a decision tree.

In determining whether an asset qualifies for derecognition, the evaluation of the transfer of the risks and rewards inherent in the asset takes priority over the assessment as to whether control over that asset has been passed or not.



Derecognition of a financial liability

A financial liability should be removed from the balance sheet when, and only when, it is extinguished, that is, when the obligation specified in the contract is either discharged, cancelled, or expired.

Where there has been an exchange between an existing borrower and lender of debt instruments with substantially different terms, or there has been a substantial modification of the terms of an existing financial liability, this transaction is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. A gain or loss from extinguishment of the original financial liability is recognised in the income statement.

Derivatives

IAS 39 defines a derivative as a financial instrument or other contract within the scope of the standard:

- ☐ whose value changes in response to an underlying;
- ☐ that requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; and
- ☐ that is settled at a future date.

Derivatives, continued

Contracts to buy or sell financial items are always within the scope of IAS 39. Contracts to buy or sell non-financial items are outside the scope of IAS 39 if they were entered into and continue to be held for the purpose of the receipt or delivery of non-financial items in accordance with the entity's expected purchase, sale, or usage requirements; otherwise they are within the scope.

Whilst the principle has not changed, clarification has been added on when a contract is net settled.

Contracts to buy or sell non-financial items are inside the scope if net settlement occurs. The following situations constitute net settlement:

- ☐ the terms of the contract permit either counterparty to settle net;
- ☐ there is a past practice of net settling similar contracts;
- ☐ there is a past practice, for similar contracts, of taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price, or from a dealer's margin; or
- ☐ the non-financial item is readily convertible to cash.

Derivatives must always be recognised at fair value on the balance sheet. Unless the derivative is a hedging instrument in a cash flow or net investment hedge, changes in fair value are recognised in the income statement.

Embedded derivatives

An embedded derivative is a feature within a contract, such that the cash flows associated with that feature behave in a similar fashion to a stand-alone derivative. In the same way that derivatives must be accounted for at fair value on the balance sheet with changes recognised in the income statement, so must some embedded derivatives. IAS 39 requires that an embedded derivative be separated from its host contract and accounted for as a derivative when:

- ☐ the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract;
- ☐ a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- ☐ the entire instrument is not measured at fair value with changes in fair value recognised in the income statement.

If an embedded derivative is separated, the host contract is accounted for under the appropriate standard (for instance, under IAS 39 if the host is a financial instrument). Appendix A to IAS 39 provides examples of embedded derivatives that are closely related to their hosts, and of those that are not. Examples of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- ☐ the equity conversion option in debt convertible to ordinary shares (from the perspective of the holder only);
- ☐ commodity indexed interest or principal payments in host debt contracts;
- ☐ cap and floor options in host debt contracts that are in-the-money when the instrument was issued;
- ☐ leveraged inflation adjustments to lease payments;
- ☐ currency derivatives in purchase or sale contracts for non-financial items where the foreign currency is not that of either counterparty to the contract, is not the currency in which the related good or service is routinely denominated in commercial transactions around the world, and is not the currency that is commonly used in such contracts in the economic environment in which the transaction takes place.

Hedge Accounting

IAS 39 permits hedge accounting under certain circumstances provided that the hedging relationship is:

- ☐ formally designated and documented, including the entity's risk management objective and strategy for undertaking the hedge, identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness; and
- ☐ expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk as designated and documented, and effectiveness can be reliably measured.

Hedging instruments

All derivative contracts with an external counterparty may be designated as hedging instruments except for some written options.

An external non-derivative financial asset or liability may not be designated as a hedging instrument except as a hedge of foreign currency risk.

A proportion of the hedging instrument may be designated as the hedging instrument. Generally, specific cash flows inherent in a derivative cannot be designated in a hedge relationship while other cash flows are excluded. However, the intrinsic value and the time value of an option contract may be separated, with only the intrinsic value being designated. Similarly, the interest element and the spot price of a forward can also be separated, with the spot price being the designated risk.

Hedged items

A hedged item can be:

- ☐ a single recognised asset or liability, firm commitment, highly probable transaction, or a net investment in a foreign operation;
- ☐ a group of assets, liabilities, firm commitments, highly probable forecast transactions, or net investments in foreign operations with similar risk characteristics;
- ☐ a held-to-maturity investment for foreign currency or credit risk (but not for interest risk or prepayment risk);
- ☐ a portion of the cash flows or fair value of a financial asset or financial liability; or
- ☐ a non-financial item for foreign currency risk only or the risk of changes in fair value of the entire item.

Hedge accounting is not permitted for hedges of a net position, that is, the net of a financial asset and financial liability (though the macro hedging exposure draft mentioned on page 1 would change this). However it is possible to designate in a hedging relationship a portion of the gross assets or liabilities, or forecast cash flows that give rise to the net exposure, provided the hedge meets the other hedge accounting criteria.

A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

Effectiveness

IAS 39 requires hedge effectiveness to be assessed both prospectively and retrospectively. A hedge is regarded as highly effective if, at inception and, at a minimum, at each reporting date, the changes in the fair value or cash flows of the hedged item attributable to the hedged risk are expected to be almost fully offset by the changes in the fair value or cash flows of the hedging instrument on a prospective basis, and on a retrospective basis where actual results are within a range of 80% to 125%.

All hedge ineffectiveness is recognised immediately in the income statement.

Hedge Accounting, continued

Categories of hedges

Hedges of firm commitments are now fair value hedges, except that the FX risk component of the commitment may be designated a cash flow hedge

A **fair value hedge** is a hedge of the exposure to changes in fair value of a recognised asset or liability or a previously unrecognised firm commitment to buy or sell an asset at a fixed price or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. The gain or loss from the change in fair value of the hedging instrument is recognised immediately in profit or loss. At the same time the carrying amount of the hedged item is adjusted for the corresponding gain or loss with respect to the hedged risk, which is also recognised immediately in net profit or loss.

A **cash flow hedge** is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.

The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity and recycled to the income statement when the hedged cash transaction affects profit or loss.

Entities have a choice of whether to apply basis adjustment for hedges of forecast transactions resulting in the recognition of a non-financial asset or liability

If the hedged cash flows result in the recognition of a non-financial asset or liability, the entity can choose to adjust the basis of the asset or liability for the amount deferred in equity. This option has the status of an accounting policy and must be applied consistently to all such hedges.

A **hedge of a net investment in a foreign operation** as defined in IAS 21 is accounted for similarly to a cash flow hedge.

Discontinuation of hedge accounting

Hedge accounting must be discontinued prospectively if:

- ☐ the hedging instrument expires or is sold, terminated, or exercised;
- ☐ the hedge no longer meets the hedge accounting criteria – for example it is no longer effective;
- ☐ for cash flow hedges the forecast transaction is no longer expected to occur; or
- ☐ the entity revokes the hedge designation.

If hedge accounting ceases for a cash flow hedge relationship because the forecast transaction is no longer expected to occur, gains and losses deferred in equity must be taken to the income statement immediately. If the transaction is still expected to occur and the hedge relationship ceases, the amounts accumulated in equity will be retained in equity until the hedged item affects profit or loss.

If a hedged financial instrument that is measured at amortised cost has been adjusted for the gain or loss attributable to the hedged risk in a fair value hedge, from the moment the hedge relationship is discontinued, this adjustment is amortised to profit or loss based on a recalculated effective interest rate on this date such that the adjustment is fully amortised by the maturity of the instrument.

Offsetting a financial asset and financial liability

Offsetting of a financial asset and financial liability is appropriate only when the entity:

- ☐ currently has a legally enforceable right to set off the recognised amounts; and
- ☐ intends to either settle on a net basis or to realise the asset and settle the liability simultaneously.

Designation of own debt as a liability at fair value through profit and loss is now permitted, but disclosure is required of (a) the change in fair value not attributable to changes in the benchmark interest rate and (b) the difference between the carrying amount and the amount contractually due on maturity.

Disclosure

The standard requires a description of the entity's financial risk management objectives and policies including its hedging policies.

For each class of financial instrument an entity must disclose:

- ☐ information about extent and nature of instruments including significant terms; and
- ☐ accounting policies and methods adopted, including recognition criteria and measurement principles

In addition, for each class of financial asset or financial liability, an entity must disclose:

- ☐ specified information regarding exposure to interest rate risk and credit risk;
- ☐ fair value of that class, except in the case of unquoted equity investments or derivatives linked to such equity investments that are measured at cost under IAS 39 because their fair value cannot be measured reliably (in which case further specified disclosures are necessary); and
- ☐ specified information about the methods and significant assumptions applied in determining fair values, including information relating to the use of quoted market prices and valuation techniques.

Other disclosure requirements include:

- ☐ in respect of all hedges: a description of the hedge and a description of the financial instrument designated as the hedging instrument and the nature of the risk being hedged;
- ☐ additional disclosures about cash flow hedges;
- ☐ details of transfers of financial assets where the entity continues to recognise all of the asset or continues to recognise the asset to the extent of the entity's continuing involvement;
- ☐ carrying amount of financial assets accepted or pledged as collateral;
- ☐ existence of any multiple embedded derivative features in issued compound financial instruments;
- ☐ for financial assets and financial liabilities carried at fair value through profit or loss, the amount of the change in fair value not attributable to changes in the benchmark interest rate and the difference between the carrying amount and amount contractually due on maturity;
- ☐ reasons for any reclassification of financial assets from measurement at fair value to measurement at cost;
- ☐ material items of income, expense, and gains and losses resulting from financial assets or financial liabilities whether recognised in profit or loss or in equity;
- ☐ nature and amount of any impairment losses recognised;
- ☐ defaults and breaches in relation to loan agreements.

First-time adopters of IFRS in 2005 are not required to restate their 2004 comparatives to comply with IASs 32 and 39

Many of the transitional provisions represent amendments to IFRS 1 First-time Adoption of IFRS

Transition and Effective Date (IAS 39)

Comparative financial statements

In 2005 financial statements only, an entity may elect for the prior-year comparative information to still be prepared under their existing GAAP. If this election is taken the entity must:

- ☐ disclose this fact together with the basis used to prepare this information; and
- ☐ disclose the nature of the main adjustments that would make the information comply with IAS 32 and IAS 39. The entity need not quantify those adjustments. However, the entity must treat any adjustment between the balance sheet at the comparative period's reporting date and the balance sheet at the start of the first IFRS reporting period as arising from a change in accounting policy.

Effective date

IAS 39 must be applied for annual periods beginning on or after 1 January 2005. Earlier application is permitted only if the entity also early applies IAS 32. If the entity early adopts the two standards that fact should be disclosed.

Transition

On initial adoption, subject to the guidance below, IAS 39 should be applied retrospectively, with the opening balance of retained earnings for the earliest period presented and all other comparative amounts adjusted as if the standard had always been in use, except where restating the information would be impracticable, in which case the entity must disclose that fact and indicate the extent to which the information was restated.

Derecognition

With respect to derecognition the entity may either apply the IAS 39 requirements prospectively, or apply the IAS 39 requirements retrospectively from a date of the entity's choosing, provided that the information needed to apply IAS 39 to assets and liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Designation upon transition

On initial adoption of the standard an entity may designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or as available for sale.

Hedging

If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge, but the hedge does not meet the conditions for hedge accounting in IAS 39, the entity must apply the rules on discontinuation of hedge accounting. Transactions entered into before the date of transition to IFRSs may not be retrospectively designated as hedges.

The designation and documentation of a hedge relationship must be completed on or before the date of transition to IFRSs if the hedge relationship is to qualify for hedge accounting from that date.

Transition and Effective Date, continued

Fair value hedges

With respect to fair value hedges, if under previous GAAP the hedged item was not adjusted, the entity should adjust the carrying amount of the hedged item on transition with the adjustment amounting to the lower of:

- a. that portion of the cumulative change in the fair value of the hedged item that reflects the designated hedged risk and that was not recognised under previous GAAP; and
- b. that portion of the cumulative change in the fair value of the hedging instrument that reflects the designated hedged risk.

Cash flow hedges

Under its previous GAAP, an entity may have deferred gains and losses on a cash flow hedge of a forecast transaction. If, at the date of transition to IFRSs, the hedged forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognised in equity. Any net cumulative gain or loss that is reclassified to equity on initial application of IAS 39 remains in equity until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, (b) the forecast transaction affects profit or loss, or (c) circumstances subsequently change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss that had been recognised directly in equity is recognised in profit or loss. If the hedging instrument is still held, but the hedge does not qualify as a cash flow hedge under IAS 39, hedge accounting is no longer appropriate starting from the date of transition to IFRSs.

An entity may not adjust the carrying amount of non-financial assets and non-financial liabilities to exclude gains and losses related to cash flow hedges that were included in the carrying amount before the beginning of the financial year in which IAS 39 is first applied.

ABOUT DELOITTE TOUCHE TOHMATSU

Deloitte Touche Tohmatsu is an organisation of member firms devoted to excellence in providing professional services and advice. We are focused on client service through a global strategy executed locally in nearly 150 countries. With access to the deep intellectual capital of 120,000 people worldwide, our member firms (including their affiliates) deliver services in four professional areas: audit, tax, consulting and financial advisory services. Our member firms serve over one-half of the world's largest companies, as well as large national enterprises, public institutions, and successful, fast-growing global growth companies.

Deloitte Touche Tohmatsu is a Swiss Verein (association), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte", "Deloitte & Touche", "Deloitte Touche Tohmatsu", or other related names. The services described herein are provided by the member firms and not by the Deloitte Touche Tohmatsu Verein. For regulatory and other reasons certain member firms do not provide services in all four professional areas listed above.

This newsletter has been written in general terms and is intended for general reference only. The application of its contents to specific situations will depend on the particular circumstances involved. Accordingly, we recommend that readers seek appropriate professional advice regarding any particular problems they encounter. This newsletter should not be relied on as a substitute for such advice. The partners and managers of Deloitte Touche Tohmatsu will be pleased to advise on any such problems. While all reasonable care has been taken in the preparation of this newsletter, no responsibility is accepted by Deloitte Touche Tohmatsu for any errors it might contain, or for any loss, howsoever caused, that happens to any person by their reliance on it.