

Financial Instruments and IFRS

Caveat

1. *This guidance covers the main points related to the standard on financial instruments and predominantly covers IAS 39 – Financial Instruments: Recognition and Measurement. It is expected to be for general application and is not designed to be a substitute for reading the entire standard and interpretation. The note in isolation should not be relied on for preparing financial statements.*

Relevant Standards

IAS 39 Financial Instruments: Recognition and Measurement

IAS 32 Financial Instruments: Presentation

IFRS 7 Financial Instruments: Disclosure

IFRIC 9: Reassessment of embedded derivatives

IFRS 1: First-Time adoption of International Reporting Standards

2. The full requirements of IFRS 7 – *Financial Instrument: Disclosure* and IAS 32 – *Financial Instruments: Presentation* are not covered in this guidance note. In terms of making disclosures under IFRS 7 it should be noted that the disclosures should ONLY be provided where appropriate: **Disclosures should be given only where they are necessary because the Department holds financial instruments that are complex or play a significant medium to long-term role in the financial risk profile of the department.** The headings in IFRS 7 should be used to the extent that they are relevant. Where the Department does not face significant medium to long-term financial risks, then it is sufficient to make a statement to that effect. **(Given that all departments have financial instruments within the scope of IAS 32, silence is not an option.)**

First Time Adoption of IFRS

3. IFRS 1 specifies that the first IFRS financial statements must contain one full year of comparative information presented in accordance with IFRSs, (IFRS 1 para 36) unless there are specific transitional rules. In relation to financial instruments, IFRS 1 provides an optional exemption from the requirement to restate comparatives in accordance with IAS 39 and IAS 32 on first-time adoption. The FRAB approved the exemption from the requirement to restate comparative information for IAS 32, IAS 39 and IFRS 7 (IFRS 1.36A and 36C) for reporting entities adopting IFRS from 1 April 2008.

4. IFRS 1 para 11 allows any adjustments arising from differing accounting policies resulting from the application of IFRS for the first time shall be taken through the General Fund or equivalent (or if appropriate, another category of reserves).

IAS 39 Financial Instruments: Recognition and Measurement and IFRIC 9: Reassessment of Embedded Derivatives

5. The key implications of applying IAS 39 are as follows:

- Financial instruments are required to be classified at inception into one of five categories (Fair Value through the profit or loss; Loans and receivables; Held to maturity; Available for sale; Non-trading liabilities), which will determine the accounting treatment of the item;
- All derivatives must be recognised and measured at fair value regardless of use;
- Specific measurement rules apply for embedded derivatives; and
- Strict rules apply for derecognition and hedge accounting eligibility.

First Steps

6. The bulk of the provisions in IAS 39 relate to more sophisticated financial instruments and transactions, and as such would not be relevant to all public sector entities. The provisions of the Standard relating to the recognition (and derecognition) and measurement of financial assets and liabilities relevant to most public entities are generally consistent with current recognition and measurement practices, with the addition of the impairment requirements on financial assets.

7. Entities that have financial instruments (mainly derivatives) that are currently unrecognised in their financial statements will be required to recognise these under the Standard. These amounts will require recognition with fair value movements recorded through the Operating Cost Statement (OCS) or equivalent.

Any entity with financial instruments should for first time adoption:

- Identify all financial assets and liabilities;
- Carefully consider each of the categories of financial assets and liabilities and evaluate the consequences – in doing so, classification of financial assets and liabilities will need to be determined in accordance with IAS 39; and
- Consider what information needs to be collected to assist with the initial recognition and subsequent measurement of financial assets and liabilities, especially those that are to be subsequently measured at fair value.
- The following steps should be taken in relation to embedded derivatives:
 - Scrutinise contracts for embedded derivatives (e.g. commodity contracts are likely to contain embedded derivatives);
 - Determine whether embedded derivatives need to be accounted for separately;

- Consider what information needs to be collected to assist with the initial recognition and subsequent measurement of embedded derivatives; and
- Review contracting practices where current practices produce exposure to unfavourable OCS volatility.

Derivatives

8. A derivative is a financial instrument that derives its value from an underlying price or index (e.g. interest rate, foreign exchange rate or commodity price). Derivatives are contracts that allow entities to speculate on future changes in the market at a relatively low or no initial cost. Under IAS 39, for a financial instrument to be derivative, it must have **all** the following characteristics:

- i. the value changes in response to a change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of rates or prices, credit rating or other variable etc ;
- ii. requires no or little initial investment; **and**
- iii. is settled at a future date.

9. Examples of derivatives are contracts such as options, forwards, futures, and swaps. Prior to IAS 39, derivatives were often not recognised in the financial statements as they required little or no initial investment. IAS 39 requires derivatives to be measured at fair value with changes in fair value recognised either in the OCS or the equivalent or in reserves depending on whether hedging is used. Where the derivative is used to offset risk and certain hedging conditions (see below under [Hedges](#) – paras 48 to 56) are met, the changes in fair value can be recognised separately in reserves.

Embedded Derivative

10. A derivative instrument that falls within the scope of IAS 39 does not need to be free standing. The terms and conditions contained (embedded) within a financial instrument and a non-financial contract could have the same attributes as a free standing derivative. The resultant derivative is referred to as an embedded derivative. The combination of the host contract and the embedded derivative is referred to as a 'hybrid instrument'. It may be that the embedded derivative has arisen from deliberate financial engineering for example the inclusion of an equity linked return in low interest-rate debt, but many are inadvertently created through market practices or common contracting terms and arrangements such as an office lease denominated in a currency that is different from the functional currencies of both the lessor and the lessee.

11. IAS 39 defines an embedded derivative as 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 causes some or all

of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

12. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

13. The intention of IAS 39 in relation to embedded derivatives is to ensure that the accounting applied to such instruments is an appropriate representation of the contract's underlying nature and its exposure to various risks, and also to ensure that consistency in accounting with other freestanding derivatives is achieved. It may be possible to achieve a different accounting result from one contract than if the same transaction had occurred via two separate contracts without IAS 39.

14. IAS 39 provides that an embedded derivative should be separated (bifurcated) from the host contract and accounted for as a derivative if all of the following three conditions are met:

- i. the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- ii. a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; **and**
- iii. the hybrid instrument is not measured at fair value with changes in fair value recognised in OCS or its equivalent.

15. IAS 39 states that an entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. This initial assessment is not revised, unless the contractual terms change and the change significantly modifies the expected future cash flows associated with the embedded derivative, the host contract or both relative to the previously expected cash flows on the contract. [IFRIC 9 Para 7].

Embedded Derivative and First Time adoption of IFRS

16. Upon first-time adoption of IFRS the adopter should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required as a result of changes in the contract terms. [IFRIC 9, Para 8]. It therefore follows that the conditions existing at the date the entity

first adopts IFRS are of no relevance to the assessment of whether the embedded derivative is closely related or not.

Identification of host contracts and embedded derivatives

17. There are a limited number of standard host contracts which may have derivatives embedded within them. Although not a complete list, examples would be:

- Executory Contract such as purchase or sale agreements
- Insurance contracts
- Leases (both Operating and Finance Leases)
- Debt Instruments
- Equity Instruments
- Service Concessions

18. However the difficulty in identifying an embedded derivative is made more complex in that the terminology used within the contract will very rarely make an explicit reference to a derivative. There are certain terms, phrases or conditions which may give an indication that the contract contains an embedded derivative:

- Pricing based on a formula
- The right to purchase / sell additional units
- Exchange / exchangeable into
- Indexed to / adjusted by / referenced to
- Premium / Strike / Limits
- Rights to Cancel / Extend / Return / Repurchase

19. It is also worth comparing the terms of the specific contract to the typical market terms applicable in a standard contract. If there are differences it could be that this is centred on an embedded derivative.

20. Examples of host contracts with embedded derivatives are shown in the table below.

Instrument	Host contract	Embedded Derivative
A two-year fixed-quantity sales contract including maximum and minimum pricing limits	Purchase contract	Pricing collar in relation to the item being sold or purchased.
Debt paying interest quarterly based on an equity index	Debt instrument	Four forward contracts p.a. based on an equity index
A loan which pays interest based on changes in the FTSE 100 index	Loan	Interest calculation based on changes in the FTSE 100 Index

Extract from: PWC, 'Manual of Accounting, IFRS for the UK- The Comprehensive Guide for UK users of IFRS - 2007', CCH.

Determining if the embedded derivative and host contract are closely related?

21. As noted above IAS 39 does not provide a definition of “closely related”. However, it does provide a number of examples within the Application Guidance (IAS 39, AG 30 – 33) of situations where the embedded derivative is, or is not, closely related to the host contract.

22. The recurring theme of the examples in the Application Guidance is that the determining factor for separation, or not, is whether the underlying factors impacting upon the derivatives valuation such as risk or economic characteristics are behaving in the same manner as the equivalent factors within the host contract.

Embedded Derivative - Foreign Exchange Contracts

Example 1:

The Ministry of Defence (MOD) enters into a contract to purchase US\$200m of planes from the US, these planes have been built using American components and the planes have been assembled in America. The contract will be settled in US Dollars and due to the timescale of production the contract includes a clause that the final price will be tied to annual US Inflation.

This contract above could on the face of it contain 2 embedded derivatives:

- Foreign Currency Swap
- US Inflation Linked Swap

IAS 39 does provide guidance on foreign currency derivatives stating that in a host contract the embedded derivative would be closely related to the host contract where:

1. there was no leverage (that is, there is no magnification impact, for example on the inflation linked swap, the link is not 2 times the value of inflation) [none identified];
2. there are no options features in the transaction [none identified]; **and**
3. payment is required in **one** of the following currencies:
 - The functional currency of any substantial party to that contract. – *This condition is satisfied as US\$ is the functional currency of the US plane manufacturer.*
 - The currency in which the price of the related goods or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions). – *This condition is satisfied as planes are generally purchased in US\$.*
 - A currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (for example, a relatively stable and liquid currency that is commonly used in local business transactions or external trade). – *This condition is not satisfied as the transaction is occurring in the UK and the US\$ cannot routinely be used in everyday transactions in the UK.*

The above foreign exchange component has met all of the requirements provided within the guidance for it to be classified as closely related and therefore it is not required to be bifurcated and the host contract can be accounted for as a single transaction.

No specific guidance is provided within IAS 39 on inflation linked elements of an executory contract but it does make reference to inflation adjustment features in lease host contracts. Therefore it is this guidance which must be referred to (an embedded inflation-related index is closely related to the lease host contract if the index is not leveraged and the index relates to inflation in the entity's own economic environment. [IAS 39 para AG 33(f)]).

The contract above specifies that there is no leverage in the inflation element of the price and therefore we need only determine whether the index relates to inflation in the entity's own economic environment.

There are two factors, which could indicate that the US\$ inflation rate is closely related to this contract:

- The majority of the components used to manufacture the planes have been produced within the United States.
- A party to the contract is a US firm whose functional currency is the US\$.

However, if most of the inputs into the manufacture of the aircraft were from another economic environment e.g. most inputs were denominated in euros, or the MOD were purchasing the planes from a European supplier but paying in US\$, then the US inflation component would not be closely related and would require bifurcation.

Embedded Derivative - Indexed Link Loan

Example 2:

Another common occurrence across Government would be a loan with an index-linked component. In this example, the Department of Health has provided an RPI Indexed Linked Loan to a PFI Hospital Partnership.

Loans and Receivables are within the scope of IAS 39 and so would be accounted for at their amortised cost. However what is needed to be determined is whether the embedded derivative is closely related.

As with the previous example, we must answer whether or not the index relates to inflation in the entity's own economic environment. In this instance all parties to the contract are UK based, the hospital is being built in the UK and all the materials and workforce are being paid for in Sterling. Therefore the embedded derivative is closely related and does not require bifurcation.

Embedded Derivative - Leasing

Example 3

A British Government Department has entered into a lease for a property in France for the period of five years. The lease has met the definition of an Operating Lease and is denominated in Euros, which is the functional currency of the French counterparty; the functional currency of the British Department is Sterling. Therefore there is an embedded foreign currency forward rate agreement swapping the Sterling payments to Euros.

An operating lease does not meet the definition of a financial instrument, but there is specific guidance in IAS 39 for contracts other than financial instruments. This states that where the payments are made in the functional currency of any substantial party to the contract then the foreign currency embedded derivative is closely related. As the lease payments are in Euros, which are the functional currency of the French counterparty, who is a substantial party to the contract, there is no need to bifurcate the embedded derivative.

Were the lease payments to have been made in US\$ then the payments would not have been related to the functional currency of either party and as such the foreign currency forward would have needed to be bifurcated and accounted for separately as a derivative.

23. In deciding whether the embedded derivative and host contract is closely related it may also be necessary to consider the terms of the contract, the economic characteristics and the risks faced both qualitatively and quantitatively. To illustrate this point, BERR has an obligation under the National Concessionary Fuel Scheme (Scheme), which is a long-standing contractual obligation that the Government inherited responsibility for upon privatisation. The Scheme provides an annual solid fuel allowance (or cash benefit in lieu) for the life of former mineworkers and their dependants. The Scheme currently contains two embedded derivatives, the cash in lieu component is indexed to the fuel and light component of the RPI and the solid fuel allowance is indexed to the RPI-X¹. From a qualitative perspective, linking the value of the solid fuel allowance and linking the cash in lieu benefit to the fuel and light component of the RPI appears related, as coal is an input to the energy generation process and would have been a major component when the scheme was set up. Quantitative analysis shows that coal prices do not directly correlate with energy prices or the general RPI as there are many other factors that affect the price of energy and the general basket of RPI goods. Therefore the quantitative analysis may produce a different result on determining whether the embedded derivative is closely related to the host contract. This illustrates the factors that need careful consideration in determining whether an embedded derivatives is closely related.

¹ RPI-X is RPI excluding mortgage interest payments.

Review process for an embedded derivative in an executory contract

24. Purchase, sale or service contracts, which do not meet the definition of a financial instrument may contain embedded derivatives.

25. There is little or no guidance on derivatives that may be embedded in purchase, sale or service contracts provided within IAS 39. As identification of such embedded derivatives can be a complex process, a flow chart is provided below to aid in the identification process. In practice, such contracts may contain other terms and conditions whose interaction with the host is not obvious but they could still create an embedded derivative. Options that allow early termination of a contract by paying a penalty, options to change the quantities to be delivered and options to defer delivery are some examples of those terms and conditions that can be problematic and would require careful consideration, both in respect of identification and separation of embedded derivatives.

26. Normal purchase and sale contracts may contain price clauses that modify the contract's cash flows. In assessing the closely related criterion for the embedded derivative, it would be necessary to establish whether the underlying¹ in a price adjustment feature is related or unrelated to the cost or fair value of the goods or services being sold or purchased.

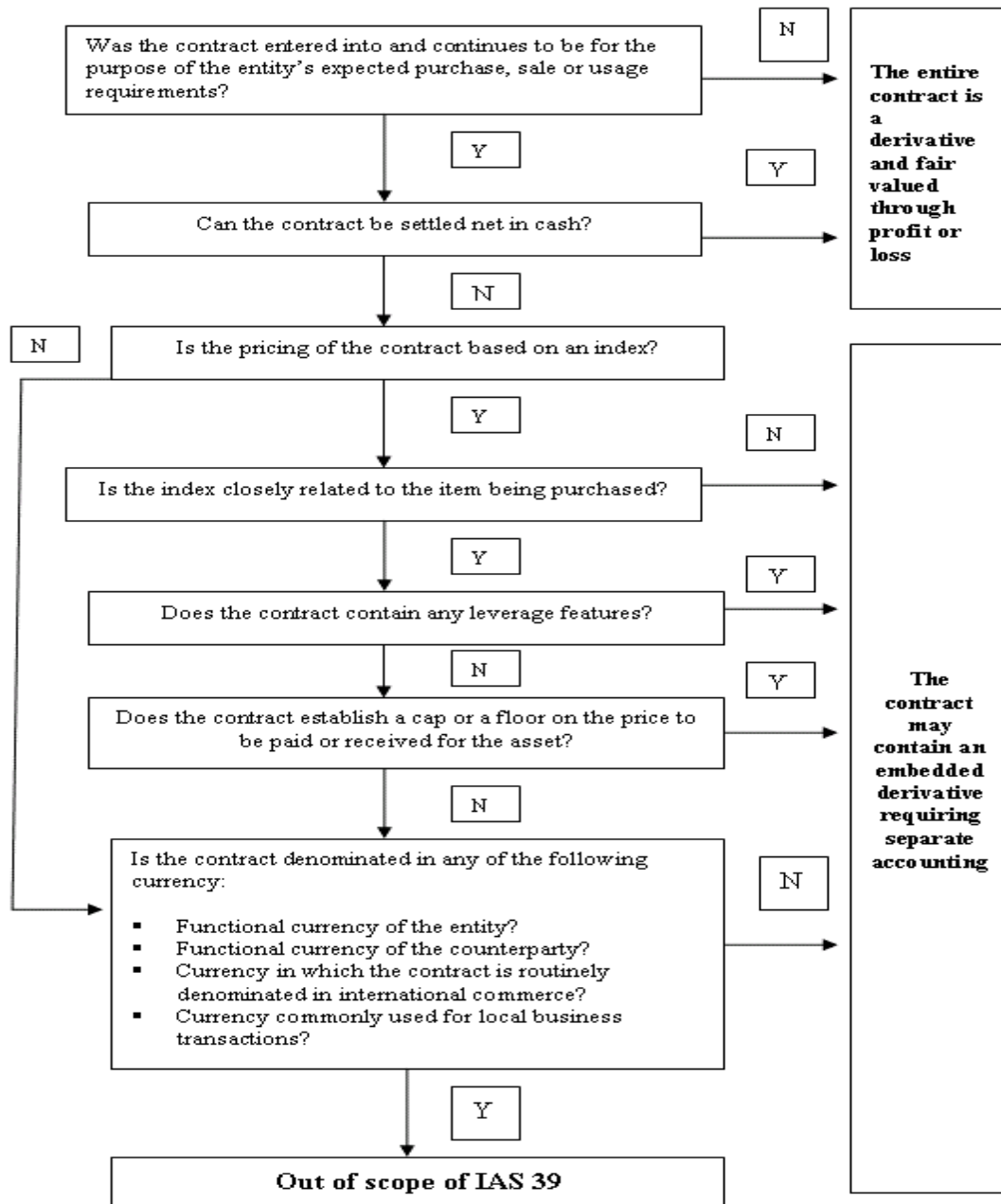
27. To illustrate this point, an entity entered into a coal purchase contract that includes a clause that links the price of coal to a pricing formula based on the prevailing electricity price at the date of delivery. The entity purchases the coal for its own use and there are no provisions to settle the contract net (that is, there is no option to settle the purchase contract by either taking or not taking delivery but having to pay or receive the net difference between the contract price and the price at settlement - this would make it a derivative). In this example the coal purchase contract is the host contract. The pricing formula that changes the price risk from coal price to electricity price is the embedded derivative. Although coal may be used for the production of electricity, a quantitative analysis shows that the movement in electricity prices is not closely related to movement in coal prices. Therefore, the embedded derivative (the electricity price adjustment) is not closely related to the host contract and should be accounted for separately.

28. Conversely, an entity (whose functional currency is pound sterling) contracts to purchase 200 tonnes of aluminium from a UK supplier in 12 months' time. The aluminium is intended for use in the course of the entity's business. The purchase price will be the market price at the contract date plus an amount determined by a specified index of aluminium prices. The contract does not contain any leverage feature. The future cash outflows are linked to movements in the market price for aluminium. The purpose of the embedded

¹ Underlying means the attribute that causes the change in value eg interest rates, credit index, price index etc.

derivative is to ensure that the price paid for the aluminium is the market price at the date of purchase/supply rather than the date the two parties entered into the supply contract. This ensures that the seller passes any price risk to the entity. As the underlying is related to the price of the aluminium purchased, the derivative is closely related to the aluminium supply contract (host) and would not be accounted for separately.

29. The following chart illustrates the steps in the review process for an embedded derivative in an executory contract.



Taken from: PWC, 'Manual of Accounting, IFRS for the UK- The Comprehensive Guide for UK users of IFRS - 2007', CCH, P6097.

Accounting for Embedded Derivatives

30. When an embedded derivative is required to be separated from a host contract, the embedded derivative must be measured at fair value on the balance sheet, with changes in fair value being accounted for through the OCS or its equivalent, consistent with the accounting for a freestanding derivative. The exception to this rule is where the embedded derivative is designated as a hedging instrument and the criteria (see section on Hedge Accounting) for hedge accounting is met, in which case the hedge accounting rules apply. The embedded derivative's fair value must be determined first at inception of the contract. The host contract's carrying value at initial recognition is the difference between the consideration paid or received to acquire the hybrid contract and the embedded derivative's fair value. [IAS 39 Para AG 28].

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

Embedded Derivative - Foreign Exchange requiring bifurcation

Example 4:

Using the information established in Example 1, we shall change the currency in which the planes are purchased to Euros. Hence, in this example, the foreign currency embedded derivative is no longer closely related to the host contract and requires bifurcation.

The purchase contract would be accounted for in accordance with a standard or long-term contract depending upon the time frame of the contract.

The embedded derivative is a 200m swap between Euros and Sterling. In order to fair value a swap contract the net present value of the cash flows must be calculated. In this instance the fair value equals the difference between the €200m translated at the period closing spot rate and the original spot rate when the contract was entered into. If the Euro spot rate when the contract was entered into was 1.48 and the period end spot rate was 1.61, then the accounting treatment would be as follows:

$$\text{€}200\text{m} / 1.48 = 135,135,135.14$$

$$\text{€}200\text{m} / 1.61 = 124,223,602.48$$

The fair value is calculated as £10,911,532.66

The accounting entries for this would be:

Dr	Derivatives (B/S)	£10,911,532.66
Cr	Gains / Losses from derivative financial instruments (OCS)	£10,911,532.66

In subsequent years the fair value of the contract would be calculated and the movement in the period would be taken to the same lines in the balance sheet and OCS.

32. If the embedded derivative is contained within a financial asset or liability which is carried at fair value through the OCS then there is no need to separate out the embedded derivative as the changes in its fair value are included in the changes in the value of the hybrid instrument and hence have already been reported within the OCS. [IAS 39 Para 11c]

33. If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value is measured as the difference between the fair value of the hybrid instrument and the fair value of the host contract, if those can be determined under IAS 39.

34. When an entity is unable to measure an embedded derivative using this method, the entire contract is classified as held for trading and is measured at fair value through profit or loss. This is expected to be a rare circumstance.

Presentation and Disclosure

35. There are no specific presentation or disclosure requirements in IFRS for embedded derivatives. As for all other financial instruments, disclosure is required about the extent and nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows, and the accounting policies and methods adopted.

36. Neither IAS 32 nor IAS 39 addresses whether an embedded derivative shall be presented separately on the face of the financial statements. It is common for derivatives embedded in non-derivative financial instruments to be presented in the same balance sheet classification as the host contract. IFRS 7 does require the net gains or losses on financial instruments at fair value through the profit or loss to be shown in the note disclosures. However, if any embedded derivative is bifurcated then it is treated as a derivative in its own right.

Indemnities and Self Insurance by Government

37. Many Government departments provide indemnities for a range of activities from members of boards of central government departments or NDPBs to civil servants involved in legal proceedings or formal enquiries as a consequence of their employment.

38. Central government organisations generally do not take out commercial insurance because it is better value for money for the taxpayer to cover its own risks. Managing Public Money provides further guidance on appropriateness of when commercial insurance maybe more appropriate.

39. The accounting for indemnities and self insurance activities should be treated as contingent liabilities and recorded as appropriate under IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

Financial Guarantee Contracts and Letters of Comfort

40. Public sector organisations may take on liabilities by issuing specific guarantees (usually for loans) and writing letters of comfort. Managing Public Money states that guarantees should normally arise from statutory powers, typically guarantees against non-payment of debts to third parties, while letters of comfort (however vague) give rise to moral and sometimes legal obligations.

41. The area of financial guarantees is a complex area under IFRS and there can be confusion between financial guarantees, loan commitments, indemnities and contingent liabilities, which may all appear to share common characteristics until the detail is considered.

42. Under IAS 39, a financial guarantee contract is a **contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument** (IAS 39 para 9). These contracts could have various legal forms, including a guarantee, some types of letter of credit, letters of comfort or a credit insurance contract.

Determining a financial guarantee contract

43. The definition of a financial guarantee is only met if the contract requires, as a precondition for payment, that the holder of the contract has incurred a loss on the failure of a debtor to make payments when due. The definition is loss driven and not event driven.

44. The following illustrative examples would not to be treated as a financial guarantee contract:

- An entity writes a credit derivative that is referenced to a specified debtor and that pays out if the specified debtor's credit rating falls below a certain level, regardless of whether the holder actually suffers a loss from that default.
- If a contract pays out on an event such as bankruptcy or restructuring (both of which are mentioned in IAS 39 as impairment indicators).
- If the contract compensates the holder for more than the actual loss.

45. The following illustrative example would be a financial guarantee contract:

- The issuer of a financial guarantee contract enters into a contract with a re-insurer to be reimbursed for a loss it incurs for having to pay the holder of the financial guarantee, as a result of a specified debtor of the holder failing to pay when due.

In this example, both the contract between the issuer and the re-insurer and the contract between the issuer and the holder meet the definition of a financial guarantee. Both the issuer and the re-insurer make payments

only when the counterparty (the holder or the issuer respectively) has suffered a loss due to a specified debtor failing to pay when due.

46. Unless the contract meets the definition of a financial guarantee, it will be accounted for as either a derivative under IAS 39 or an insurance contract within the scope of IFRS 4. The contract meets the definition of a derivative if its value will change in response to a financial underlying (for example, the credit rating of an entity), there is little or no initial net investment (for example, just premium received), and it will be settled at a future date. The contract meets the definition of an insurance contract, for example, in the case of guarantees of pension plan contributions, operating lease rentals and taxes.

47. If an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts (IAS 39 Para 2(e)), but once elected for each contract the election is irrevocable.

Measurement of Financial Guarantee contracts

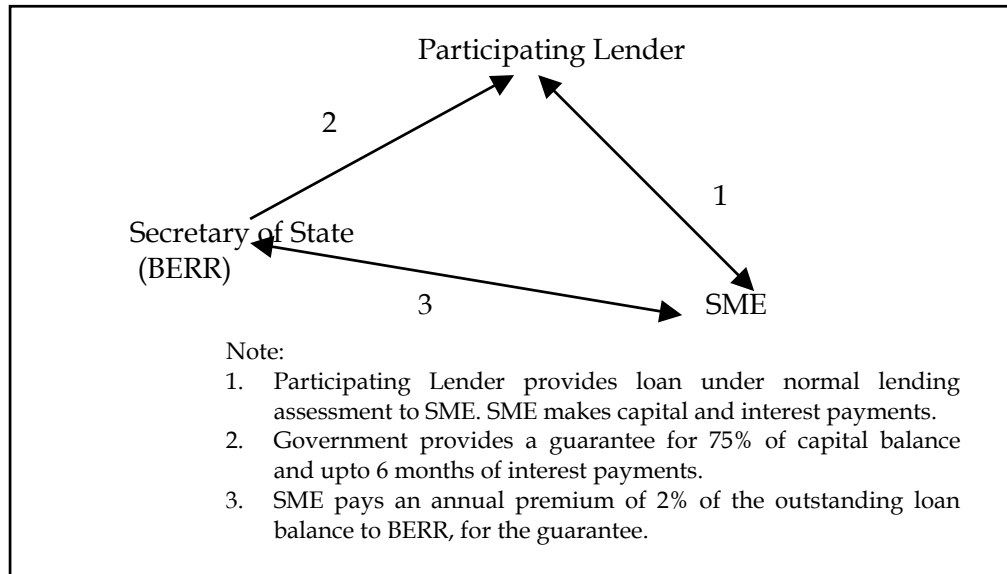
48. Financial guarantees within the scope of IAS 39 are initially recognised at fair value (generally equivalent to the premium) and subsequently measured at the higher of:

- the amount determined in accordance with IAS 37; and
- the amount initially recorded less, when appropriate, cumulative amortisation (IAS 39 Para 47 c). The cumulative amortisation must be in accordance with IAS 18.

Financial Guarantee Contract - within scope of IAS 39

Example 5:

BERR runs the Small Firms Loan Guarantee (SFLG), which facilitates lending by participating lenders to eligible small and medium enterprises (SMEs) in cases where the borrower satisfies the lender's normal commercial criteria except for being unable to provide the necessary security. SFLG provides the lender with a guarantee covering 75% of the outstanding loan amount plus up to six months' interest in the event of the borrower defaulting. A 2% annual premium on the outstanding balance of the loan is payable to BERR by the borrower quarterly in advance, in addition to the capital and interest payments due to the lender.



In this example the SME has a contractual loan commitment to the participating lender which is legally enforceable and which has been guaranteed by the Government. The question to answer is whether a financial guarantee contract under IAS39 exists.

- Is there a contract?
 - The Scheme makes it clear that the event of a borrower defaulting and the guarantee being called, BERR will reimburse up to 75% of the lender's outstanding exposure (contractually provided in the agreement between the participating lender and BERR) - *hence a legally enforceable contract exists.*
- Is a loss suffered?
 - The reimbursement is only required if the SME defaults on its capital and interest payments which would result in the participating lender suffering a loss - *hence a loss has been suffered.*

On the basis of the above two considerations, the SFLG constitutes a financial guarantee contract under IAS 39. In BERR's accounts, initial recognition will at fair value (in this case equivalent to the premium - IAS 39 para AG4(a)) and subsequently measured at the higher of the amount determined in accordance with IAS 37; and the amount initially recorded less, when appropriate, cumulative amortisation (IAS 39 Para 47c). The cumulative amortisation must be in accordance with IAS 18.

Financial Guarantee – Performance versus loss related example

Example 6:

The UK Government has provided a financial guarantee underwriting the 2012 Olympic Games - this guarantee is referenced to “a shortfall between the London Organising Committee for the Olympic Game’s costs and revenues”.

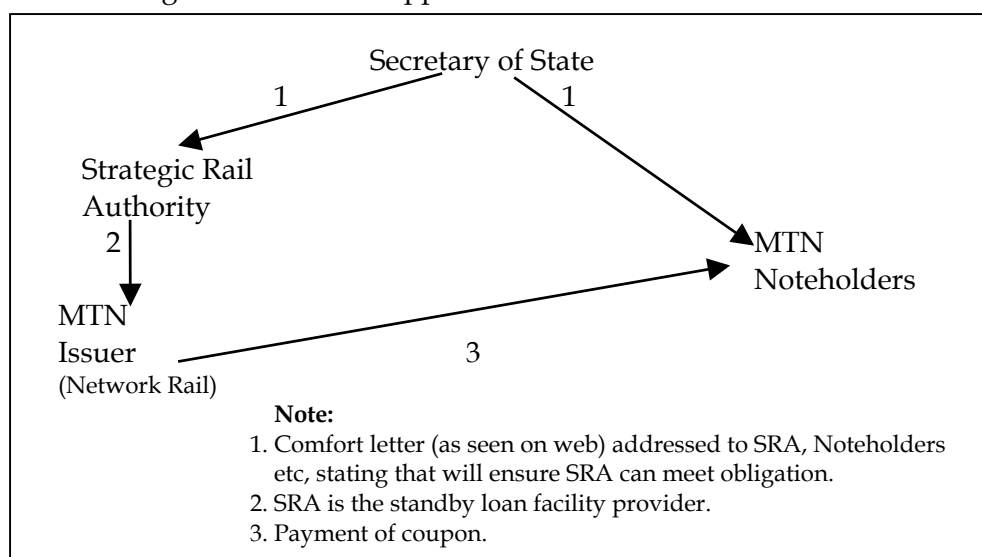
In this example we first need to consider if a contract exists. Due to the pledges required and made, the Government is contractually bound to the International Olympic Committee (IOC) to fund any shortfalls in the staging of the Olympic games.

The second criteria to be considered, is whether there is a loss that the holder of the guarantee incurs because a specified debtor fails to make payment. This guarantee is related to ensuring that the host country takes full responsibility for funding and organising the staging of the Olympic games and there is no specified debtor. In effect it is a performance related guarantee, that is, if the revenue is insufficient to meet the costs incurred then the resulting shortfall will be covered by Government. As such it will not meet the criteria for a financial guarantee contract under IAS 39.

Financial Guarantee Contract – not in scope of IAS 39

Example 7:

During the 1990’s Network Rail entered into a Medium Term Note (MTN) transaction and as party to that the Strategic Rail Authority (“SRA”) took the party of Standby Loan Facility Provider thus ensuring that there was a pool of funds available for the MTN Issuer if required. No fee was earned for this role. As part of the transaction the Secretary of State provided a comfort letter, which was addressed to the Issuer, the Note-holders and all other participants of the transaction stating that he would support the SRA.



In this situation the MTN Issuer has raised debt and is making interest payment to the holders of the notes. If it is unable to make these payments it has an agreement with the SRA, which would allow the MTN Issuer to borrow a set amount of funding from the SRA at an agreed rate (This would be specified in the Loan

Facility Agreement). Given that the SRA is not a self-funding business, the Secretary of State has then stated “ensure that the SRA will be in a position to meet its liabilities as they fall due”. The SRA has a loan commitment to the MTN Issuer as it has a contract for which no fee was received, the contract is legally enforceable and it has an agreed amount that can be drawn by the MTN Issuer at an agreed rate.

The question to answer is whether the Secretary of State has provided a financial guarantee contract.

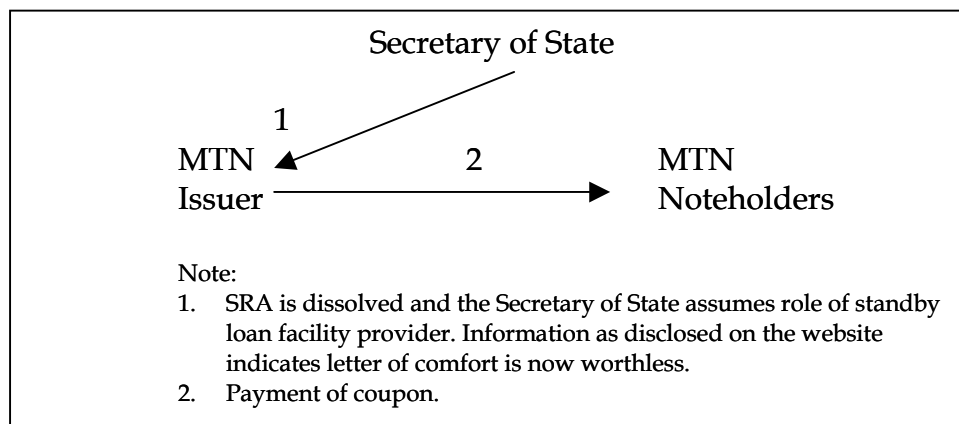
- Is there a contract?
 - The Secretary of State makes it clear in the comfort letter that although it is unforeseeable that the SRA would not be supported he is not legally committed to providing support - *hence no legally enforceable contract exists.*
- Is a loss suffered?
 - There is a pre-agreed contract with the SRA, which allows it to draw a specified amount at a specified rate, but this does not require a loss to be suffered.

On the basis of the above two items, the comfort letter does not constitute a financial guarantee contract. It should be treated in accordance with IAS 37 as a contingent liability with the probability of a drawing being required assessed.

Financial Guarantee Contract – not in scope of IAS 39

Example 8:

Following the dissolution of the SRA the Secretary of State has now assumed responsibility for the standby loan facility provider.



For the purposes of determining whether a financial guarantee contract exists, the Secretary of State has now assumed the legal responsibility and is a party to a legal contract. However as with the previous example there is a set amount, which can be drawn at pre-determined rates, which again means that a loan commitment exists rather than a financial guarantee contract as no loss is being suffered.

Financial Guarantee Contract - in scope of IAS 39

Example 9:

In Example 7, the Secretary of State provided a letter of comfort which was, among others, addressed to the SRA. This letter of comfort was not an enforceable contract and stated that the SRA could draw on funds to enable it to ensure that the MTN Issuer were able to meet its obligations.

If, however, the arrangement were amended to form a contract whereby the Secretary of State would reimburse the SRA for any shortfall arising from the MTN Issuer being unable to repay the loan from the SRA and the SRA paid a fee to the Secretary of State (a premium) for this guarantee, then this could meet the definition of a financial guarantee contract, as:

- Requires SRA to have suffered a loss before a claim can be made.
- The MTN is a “specified debtor” who has failed to make a payment.
- Has been constructed as a legally enforceable arrangement.

Financial Guarantee Contract - Accounting entries

Example 10:

A Government Department has provided a financial guarantee to a third party, Train Company A, on 1 January 2007. Under the guarantee, if Train Company A defaults on a specific loan of £10,000,000 that it has with a bank, the Department will become liable to repay the loan to the bank (excluding any interest). The guarantee will be in force for a period of 5 years.

On the date of the guarantee being provided, Train Company A paid the Department £50,000, which is considered to be the fair value for granting the guarantee. In 2008, the credit market has deteriorated to such a degree that it has become probable that Train Company A will default on its loan to the bank.

The Department accounts for financial guarantees in accordance with IAS 39. The following example sets out how the department should account for the financial guarantee contract in its 31 December 2007 and 2008 accounts.

On initial recognition, the guarantee is recognised at fair value in the Department’s financial statements:

Dr	Cash	£50,000	
	Cr	Financial guarantee liability	£50,000

The liability is subsequently amortised and recorded as income over the period the guarantee applies unless the liability, measured in terms of IAS 37, Provisions, Contingent Liabilities and Contingent Assets, exceeds the carrying amount.

Therefore in 2007, the entry would be:

Dr	Financial guarantee contract	£10,000	
	Cr Income		£10,000

In 2008, because it has become probable that the Department will be required to repay the loan on behalf of Train Company A, the Department would be required to measure the liability in terms of IAS 37, requiring the Department to make a best estimate of the expenditure required to settle the obligation at the balance sheet date, say £9,650,000. The payments received that have not been amortised (£40,000) would be offset against this liability. Therefore the entries in 2008 would be:

Dr	Expense	£9,610,000	
	Cr Financial guarantee liability		£9,610,000

Hedges

49. Managing Public Money refers to public sector organisations considering the merits of using financial instruments provided by commercial markets, including hedging, to control or limit business risk especially those arising from known requirements for specific future purchases of priced market commodities. However it also cautions the use of unfamiliar financing techniques by promoting careful evaluation of any technique, referring to the checklists in boxes 4.3 and 4.7 of the Managing Public Money publication.

50. Managing Public Money allows consideration of the use of hedging as a risk management technique designed to offset changes in fair value or cash flows. In a hedging relationship, 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 entity to risk of changes in fair value or future cash flows.

51. There are three types of hedges under IAS 39 (para 86):

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

Hedge accounting

52. Under IAS 39, when certain conditions (outlined below) are met (IAS 39 para 88), entities are permitted to apply hedge accounting which differs from

the normal accounting methods. 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.

53. When using fair value hedges, changes in fair value of the hedged item are recognised in the current period to offset the recognition of changes in the fair value of the hedging instrument (IAS 39 para 89).

54. 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 to the extent the hedge is effective and released to OCS, or its equivalent, in the time periods in which the hedged item impacts the OCS. Any ineffective element should be recognised directly in the OCS (IAS 39 para 95). The effectiveness of a hedge is the level to which a hedging instrument offsets the changes in fair value or cash flows in their entirety. For a hedge to be classified as effective, IAS 39 requires that it should be within the range 80-125%.

55. Derivatives must be recognised at fair value in the Balance Sheet with all changes in fair value recorded in the current year's OCS or its equivalent. However, this may not be symmetrical with the recognition of gains or losses on the related hedged item, especially if it is not a financial asset or liability that is held at fair value with gains or losses taken through the OCS.

56. IAS 39 limits the use of hedge accounting to situations where certain conditions are met (IAS 39 para 88) . These conditions are as follows:

- i. 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. The documentation will include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how hedging instrument's effectiveness in offsetting the exposure.
- ii. 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.
- iii. 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.

Hedging and First Time Adoption

57. It should be noted that on first time adoption, IFRS 1 .11 requires that any adjustments arising from differing accounting policies resulting from the application of IFRS for the first time shall be taken through the General Fund or equivalent (or if appropriate, another category of reserves). The possibility of using another category of reserves effectively allows existing hedging instruments to match the related future gains and losses to the cumulative gains and losses recorded in the specific reserves.

The key steps to achieving a qualifying hedge are summarised below:

- (a) Identify the type of hedging relationship: fair value, cash flow or net investment;
- (b) Identify the hedge item(s) or transaction;
- (c) Identify the nature of the risk being hedged and the period being hedged;
- (d) Identify the type of hedging instrument;
- (e) Demonstrate that the hedge will be 'highly effective' in reducing risk exposure;
- (f) Document steps (a) to (e) from the start of the hedging relationship; and
- (g) Monitor effectiveness.

58. The Standard contains extensive provisions and Application Guidance on hedging, which includes qualifying items, the three types of hedging relationships, accounting treatment for these hedging relationships and discontinuation thereof, hedge effectiveness and other constraints on hedge accounting. The Standard also covers the strict disclosure requirements.

59. *Public sector entities with any type of hedging should refer to the Standard for full details.*

Financial Instruments

1. **Background Information** – *this annex is provided in support of the guidance note but is not designed to be a substitute for reading the standard and interpretation.*
2. **Financial Asset** – “cash or an equity instrument of another entity, or a contractual right to receive cash or another financial asset from another entity”. Examples include: cash, deposits in other entities, trade receivables, loans to other entities, investments in debt instruments, investments in shares and derivatives¹.
3. **Financial Liability** – “a contractual obligation to deliver cash to another entity or to exchange financial assets or liabilities on unfavourable terms”. Examples include: trade payables, loans from other entities, and debt instruments issued by the entity, derivatives.
4. **Equity** – “any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities”. Examples include: investments in equity instruments issued by other entities, types of preference shares, residual interest (although IAS 39 does not apply to an entity’s own issued equity instruments).

Financial Instrument

5. A financial instrument is “any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument in another entity”.
6. Financial Instruments can be:
 - Financial Assets,
 - Financial Liabilities or
 - Equity Instruments.
7. IAS 39 is very wide in scope and covers **all** financial instruments except where specifically covered by another Standard. The key exceptions are outlined as follows:
 - Interests in subsidiaries, associates and joint ventures unless the applicable standards specify that they should be accounted for under IFRS 3;

¹ Examples of derivatives are options, warrants, futures contracts, forward contracts, swaps.

- Interests in leases, except for any related embedded derivatives in addition to the derecognition and impairment provisions of IAS 17 relating to lease receivables and payables; and
- Assets and liabilities under employee benefit plans.

8. The implementation of IAS 39 may not change the values for many financial assets and liabilities, as they will continue to be based on the transaction amount or because they are already discounted. However the changes that are most likely to affect carrying values in the balance sheet are:

- If not already then some long term debtors and creditors may need to be discounted;
- financial guarantees that may appear for the first time;
- certain types of embedded derivatives; and
- inclusion of hedging instruments.

9. To calculate the impact, the financial assets and liabilities first have to be classified and the classification will determine the measurement and recognition of the item.

Classification

10. The classification of assets and liabilities into categories is required as the IAS39 measurement model is a mixed model allowing some financial instruments to be carried at fair value and some at amortised cost. When classifying a financial instrument, all the relevant features of the asset and liability need to be considered, such as rights, conditions, options. The classification is important as it will determine how the financial instrument is treated in terms of recognition and measurement.

- The classification categories for financial assets are:
 - financial assets at fair value through profit or loss,
 - held to maturity investments,
 - loans and receivables, or
 - available for sale financial assets.
- The classification categories for financial liabilities are:
 - financial liabilities at fair value through profit or loss (if it is held for trading or designated at initial recognition as at fair value through profit or loss), or
 - all other financial liabilities.

Financial assets

11. An entity is required to classify its financial assets into one of the four categories mentioned above. The table below summarises the types of assets, measurement basis and the financial statement impact for changes in carrying amounts.

Classification	Financial Asset	Measurement basis	Changes in carrying amount
At fair value through Profit or Loss (OCS)	Debt	Fair Value	OCS
	Equity ^a	Fair Value	OCS
	Derivatives not designated as effective hedging instruments	Fair Value	OCS
Loans and receivables	Debt	Amortised Cost	OCS
Held to maturity investments	Debt	Amortised Cost	OCS
Available for sale assets	Debt	Fair Value	Reserves (fair value changes) OCS (interest, foreign exchange differences, impairments)
	Equity ^a	Fair Value	Reserves (fair value changes) OCS (interest, foreign exchange differences, impairments)
^a Equity instruments that do not have any quoted market price in an active market and whose fair value cannot be reliably measured can be measured at cost.			

12. Under IFRS all financial assets, including derivatives, should be recognised on the balance sheet. The assets will initially be measured at fair value plus transaction costs (where the financial asset is not at fair value through profit or loss) that are directly attributable to the acquisition of the asset.

Financial liabilities

13. An entity is required to classify its financial liabilities into two categories, namely:

- at fair value through profit or loss; or
- other financial liabilities measured at amortised cost (default category).

14. The conditions to be met in order to designate a financial liability at fair value through the profit or loss are the same as for financial assets (that is, acquired with the intention to sell or repurchase in the near future (held for trading) or designated by entity at fair value through the profit or loss).

15. Financial liabilities measured at amortised cost is the default category for those that do not meet the definition of financial liabilities at fair value through profit or loss. As the fair value category is an option with required criteria, most liabilities will be carried at amortised cost. Examples include trade payables, borrowings and customer deposits.

16. The table below summarises the measurement and the financial statement impact for changes in carrying amounts of the financial liabilities.

Financial Liability Classification	Category	Measurement after initial recognition	Changes in carrying amount
At fair value through profit or loss	Held for trading or opt to measure at fair value	Fair Value	OCS
Other liabilities	Default category	Amortised cost	OCS

Reclassification

17. IAS 39 restricts the ability to reclassify financial assets and liabilities to another category. Reclassifications in or out of the fair value through profit or loss category are not permitted. Reclassifications between the available for sale and held to maturity categories are possible, although reclassifications of a significant amount of held to maturity investments would necessitate reclassification of all remaining held to maturity investments to available for sale. An entity also cannot reclassify from loans and receivables to available for sale.

Fair Value Determination

18. IAS 39 establishes rules for determining fair value. Principally it presumes that the entity is a going concern and therefore fair value reflects the credit quality of the instrument. Generally, a published price quoted in an active market is the best evidence of fair value.

19. 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.

Recognition and Derecognition

20. A financial asset or liability is recognised on the balance sheet when an entity becomes a party to the contract. The rules in IAS 39 for derecognising are more complex.

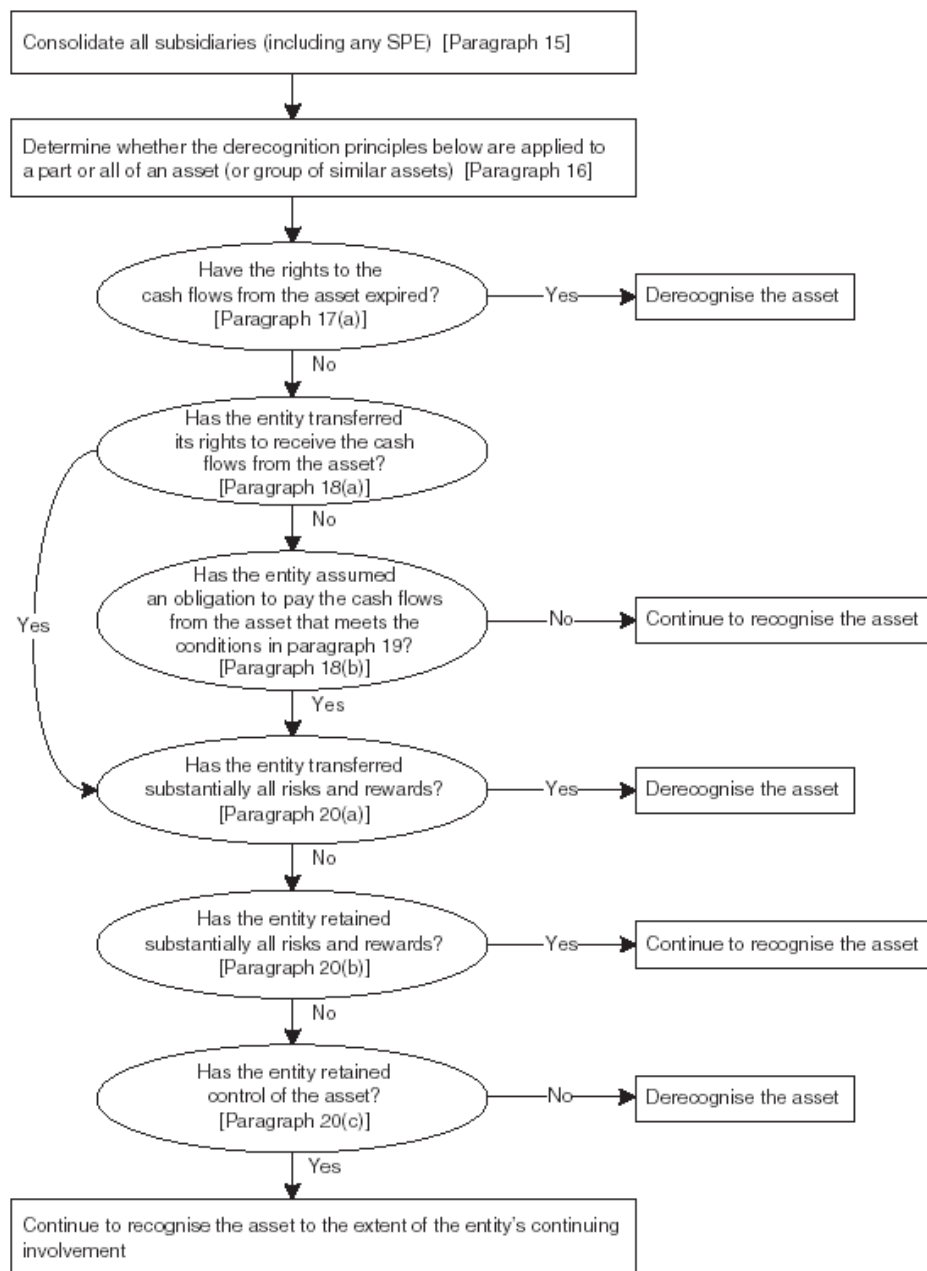
Derecognition

21. Derecognition of a financial asset occurs where:

- i. the contractual rights to the cash flows of the financial asset have expired (e.g. customer has paid off obligation), or
- ii. 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.

22. When an entity sells or transfers a financial asset to another party, the entity 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. The seller can retain the right to repurchase the financial asset in the future at the current fair value of the asset.

23. IAS 39 includes a flow chart in the application guidance (AG 36) that illustrates the evaluation of whether and to what extent a financial asset is derecognised, and is reproduced below.



24. The derecognition 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.

Impairment

Financial Liabilities

25. Financial liabilities are not subject to impairment testing.

Financial Assets

26. IAS 39 requires an assessment at each balance sheet 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 entity recognises any impairment loss in profit or loss. Losses expected from future events are not recognised.

27. 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.

28. The only category of financial asset that is not subject to testing for impairment is financial assets at fair value through profit or loss, as any decline in value for such assets is recognised immediately.

29. **Derivatives** - financial instruments that derive their value from an underlying price or index (eg interest rate, foreign exchange rate or commodity price). Derivatives are contracts that allow entities to speculate on future changes in the market at a relatively low or no initial cost. For a financial instrument to be derivative, it must have **all** the following characteristics:

- i. the value changes in response to a change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of rates or prices, credit rating etc;
- ii. requires little or no investment; and
- iii. is settled at a future date.

30. **Embedded Derivative** - derivative instrument that is embedded in another contract - the host contract. It is a component of a hybrid instrument that includes both a derivative and a host contract - with the effect that some of the cash flows of the combined instrument vary in a similar way to a stand-alone derivative. The host contract could be a debt or equity instrument, a lease, an insurance contract, or a sale or purchase agreement.

31. **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. The effective interest rate method also determines how much interest income or interest expense should be reported in OCS. Under IAS 39, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows

associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

Example – Amortised cost

32. The following example (*from the IAS 39 Guidance on Implementation – B26*) illustrates how amortised cost is calculated using the effective interest method.

33. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of £1,000 (including transaction costs). The instrument has a principal amount of £1,250 and carries fixed interest of 4.7% that is paid annually ($£1,250 \times 4.7\% = £59$ per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

34. It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 per cent annually. The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each reporting period.

Year	(a) Amortised cost at the beginning of the year	(b = a × 10%) Interest income	(c) Cashflows	(d = a + b - c) Amortised cost at the end of the year
20x0	1,000	100	59	1,041
20x1	1,041	104	59	1,086
20x2	1,086	109	59	1,136
20x3	1,136	113	59	1,190
20x4	1,190	119	+1250+59	0

35. On the first day of 20X2 the entity revises its estimate of cash flows. It now expects that 50% of the principal will be prepaid at the end of 20X2 and the remaining 50% at the end of 20X4. In accordance with IAS 39.AG8, the opening balance of the debt instrument in 20X2 is adjusted. The adjusted amount is calculated by discounting the amount the entity expects to receive in 20X2 and subsequent years using the original effective interest rate (10%). This results in the new opening balance in 20X2 of CU1138. The adjustment of CU52 (CU1,138 – CU1,086) is recorded in profit or loss in 20X2.

36. The table below provides information about the amortised cost, interest income and cash flows, as they would be adjusted taking into account the change in estimate.

Year	(a) Amortised cost at the beginning of the year	(b = a × 10%) Interest income	(c) Cashflows	(d = a + b - c) Amortised cost at the end of the year
20x0	1,000	100	59	1,041
20x1	1,041	104	59	1,086
20x2	+1,086+52	114	625+59	568
20x3	568	57	30	595
20x4	595	60	625+30	0

37. If the debt instrument becomes impaired, say, at the end of 20X3, the impairment loss is calculated as the difference between the carrying amount (CU595) and the present value of estimated future cash flows discounted at the original effective interest rate (10%).