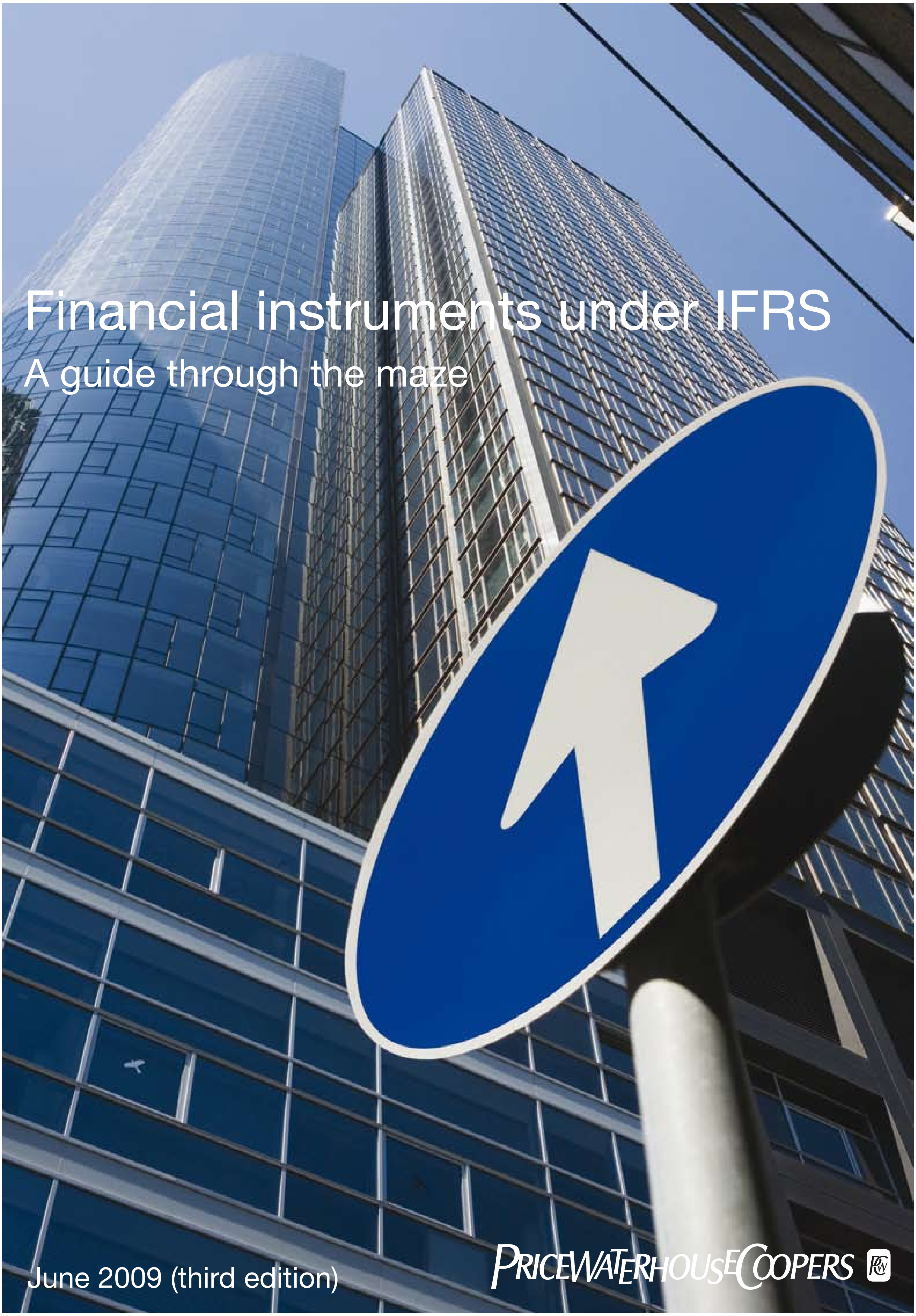
Financial instruments under IFRS

A guide through the maze



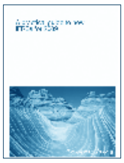
June 2009 (third edition)

PricewaterhouseCoopers

IFRS technical publications

IFRS manual of accounting 2009
PwC's global IFRS manual provides comprehensive practical guidance on how to prepare financial statements in accordance with IFRS. Includes hundreds of worked examples, extracts from company reports and model financial statements.

A practical guide to capitalisation of borrowing costs
Guidance in question and answer format addressing the challenges of applying IAS 23R, including how to treat specific versus general borrowings, when to start capitalisation and whether the scope exemptions are mandatory or optional.

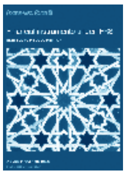


A practical guide to new IFRSs for 2009
40-page guide providing high-level outline of the key requirements of new IFRSs effective in 2009, in question and answer format.

A practical guide to segment reporting
Provides an overview of the key requirements of IFRS 8, 'Operating segments' and some points to consider as entities prepare for the application of this standard for the first time. Includes a question and answer section. See also 'Segment reporting – an opportunity to explain the business' below.

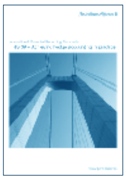
A practical guide to share-based payments
Answers the questions we have been asked by entities and includes practical examples to help management draw similarities between the requirements in the standard and their own share-based payment arrangements. November 2008.

Adopting IFRS – A step-by-step illustration of the transition to IFRS
Illustrates the steps involved in preparing the first IFRS financial statements. It takes into account the effect on IFRS 1 of the standards issued up to and including March 2004.

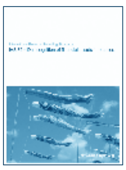


Financial instruments under IFRS – June 2009 update
High-level summary of IAS 32, IAS 39 and IFRS 7. For existing IFRS preparers and first-time adopters.

Financial reporting in hyperinflationary economies – understanding IAS 29
2006 update (reflecting impact of IFRIC 7) of a guide for entities applying IAS 29. Provides an overview of the standard's concepts, descriptions of the procedures and an illustrative example of its application.



IAS 39 – Achieving hedge accounting in practice
Covers in detail the practical issues in achieving hedge accounting under IAS 39. It provides answers to frequently asked questions and step-by-step illustrations of how to apply common hedging strategies.



IAS 39 – Derecognition of financial assets in practice
Explains the requirements of IAS 39, providing answers to frequently asked questions and detailed illustrations of how to apply the requirements to traditional and innovative structures.

IFRS 3R: Impact on earnings – the crucial Q&A for decision-makers
Guide aimed at finance directors, financial controllers and deal-makers, providing background to the standard, impact on the financial statements and controls, and summary differences with US GAAP.

IFRS disclosure checklist 2008
Outlines the disclosures required by all IFRSs published up to October 2008.

IFRS for SMEs (proposals) – pocket guide 2007
Provides a summary of the recognition and measurement requirements in the proposed 'IFRS for Small and Medium-Sized Entities' published by the International Accounting Standards Board in February 2007.

IFRS pocket guide 2009
Provides a summary of the IFRS recognition and measurement requirements. Including currencies, assets, liabilities, equity, income, expenses, business combinations and interim financial statements.

IFRS news
Monthly newsletter focusing on the business implications of the IASB's proposals and new standards. Subscribe by emailing corporatereporting@uk.pwc.com.

Illustrative interim financial information for existing preparers
Illustrative information, prepared in accordance with IAS 34, for a fictional existing IFRS preparer. Includes a disclosure checklist and IAS 34 application guidance. Reflects standards issued up to 31 March 2009.

Illustrative consolidated financial statements

- Banking, 2006
- Corporate, 2008
- Insurance, 2008
- Investment funds, 2008
- Investment property, 2006
- Private equity, 2008

Realistic sets of financial statements – for existing IFRS preparers in the above sectors – illustrating the required disclosure and presentation.

Segment reporting – an opportunity to explain the business
Six-page flyer explaining high-level issues for management to consider when applying IFRS 8, including how the standard will change reporting and what investors want to see.

SIC-12 and FIN 46R – The substance of control
Helps those working with special purpose entities to identify the differences between US GAAP and IFRS in this area, including examples of transactions and structures that may be impacted by the guidance.

Understanding financial instruments – A guide to IAS 32, IAS 39 and IFRS 7
Comprehensive guidance on all aspects of the requirements for financial instruments accounting. Detailed explanations illustrated through worked examples and extracts from company reports.

Understanding new IFRSs for 2009 – supplement to IFRS Manual of Accounting
455-page publication providing guidance on IAS 1R, IAS 27R, IFRS 3R and IFRS 8, helping you decide whether to early adopt. Chapters on the previous versions of these standards appear in the IFRS Manual.

Contents

Introduction

Accounting for financial instruments under IFRS is complex. This publication provides a broad overview of the current requirements of IAS 32, 'Financial instruments: Presentation', IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures'. For first-time adopters and other entities in territories transitioning to IFRS, these standards are likely to change the way they account for financial instruments and will involve substantial changes to systems processes and documentation.

This publication has separate chapters addressing:

- The scope of the requirements.
- Debt/equity classification.
- Initial recognition and classification.
- Derecognition.
- Subsequent measurement.
- Fair values and impairment.
- Hedge accounting.

They provide an 'at a glance' summary of the key issues for the topic. They also contain a summary of the transition rules for first-time adopters. A summary of the disclosure requirements of IFRS 7 and a glossary of terms are included in the Appendix.

Stop press: IASB's projects relating to financial instruments

IAS 39 has been amended several times, but many preparers and users of financial statements still find the requirements of IAS 39 complex. The IASB is keen to find a better accounting solution for financial instruments that will produce meaningful results without undue complexity.

As a first step in that process, the IASB and the FASB identified three projects relating to financial instruments. These form part of the Memorandum of Understanding, which sets out a roadmap for convergence between IFRS and US GAAP. These projects are:

- Derecognition of financial instruments.
- Distinction between liabilities and equity.
- Replacement of IAS 39.

Global financial crisis and regulatory changes

The IASB and the FASB also committed themselves, in October 2008, to a joint approach to dealing with reporting issues arising from the global financial crisis. They set up the Financial Crisis Advisory Group (FCAG) in December 2008, to advise the two boards about standard-setting implications of the global financial crisis and potential changes to the global regulatory environment. Topics being discussed include fair value (including 'mark-to-market') accounting, loan provisioning, and structured entities and other off-balance sheet vehicles.

Replacement of IAS 39

The IASB published a press release on 29 May 2009, detailing an accelerated timetable for publishing a proposal to replace its existing financial instruments standard, IAS 39, in three phases. The IASB's comprehensive project on financial instruments responds directly to and is consistent with the recommendations and timetable set out by the Group of 20 (G20) nations at their meeting held on April 2009. They called for standard-setters 'to reduce the complexity of accounting standards for financial instruments'. They also called on them to address issues arising from the financial crisis (such as loan-loss provisioning) by the end of 2009, in order to ensure globally consistent and appropriate responses to the crisis. The IASB will work jointly with the FASB to pursue the objective of a globally accepted replacement of the requirements on accounting for financial instruments.

Scope

The scope of the standards is wide-ranging. Anything that meets the definition of a financial instrument is covered unless it falls within one of the exemptions.

Within scope	**Out of scope**
Debt and equity investments	Investments in subsidiaries, associates and joint ventures
Loans and receivables Lease receivables (Note 1)	
Own debt Lease payables (Note 1) Own equity	Employee benefits Share-based payments
Cash and cash equivalents	
Derivatives – for example: • Interest rate swaps • Currency forwards/swaps • Purchased/written options • Collars/caps • Credit derivatives • Cash or net share settleable derivatives on own shares • Derivatives on own shares settled only by delivery of a fixed number of shares for a fixed amount of cash (IAS 32 only).	Own-use commodity contracts (Note 2)
Derivatives on subsidiaries (unless it meets definition of equity instrument in IAS 32), associates and joint ventures.	
Embedded derivatives	
Loan commitments held for trading (Note 3) Other loan commitments	Reimbursement rights
Financial guarantees (Note 4)	Insurance contracts Weather derivatives

Note 1 – Leases

Lease receivables are included in the scope of IAS 39 for derecognition and impairment purposes only. Finance lease payables are subject to the derecognition provisions. Any derivatives embedded in lease contracts are also within the scope of IAS 39.

Note 2 – Commodity contracts

Contracts to buy or sell non-financial items are within the scope of IAS 32, IAS 39 and IFRS 7 if they can be settled net in cash or another financial asset and they do not meet the test of being entered into and continuing to be held for the purpose of receipt or delivery of non-financial items to meet the entity's expected purchase, sale or usage requirements (known as 'own-use commodity contracts'). Settling net includes taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price.

Note 3 – Loan commitments

Loan commitments are outside the scope of IAS 39 if they cannot be settled net in cash or by some other financial instrument unless: they are held for trading or to generate assets of a class which the entity has a past practice of selling; or the entity chooses to include them with other derivatives under IAS 39.

Note 4 – Financial guarantees

Financial guarantee contracts are within IAS 39's scope from the issuer's perspective, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts. In this case, either IAS 39 or IFRS 4, 'Insurance contracts', may be applied.

Debt/equity classification

Overview

At a glance – the key issues

- Substance of the contractual arrangements rather than legal form governs the classification by the issuer of a financial instrument.
- The critical feature in identifying a liability is the existence of an obligation to pay cash or to exchange another instrument under conditions that are potentially unfavourable to the issuer.
- The liability and equity components of compound instruments are accounted for separately.
- Derivatives on own shares are treated as derivatives where they contain a right or an obligation to settle on a net basis in cash or shares or where they may be settled by delivery of a variable number of own shares.

Classification

IAS 32 establishes principles for distinguishing between liabilities and equity. The substance of the contractual terms of a financial instrument governs its classification, rather than its legal form.

An instrument is a liability when the issuer is or can be required to deliver either cash or another financial asset to the holder. This is the critical feature that distinguishes a liability from equity. An instrument is classified as equity when it represents a residual interest in the net assets of the issuer.

All relevant features need to be considered when classifying a financial instrument. For example:

- The instrument is a liability if the issuer can or will be forced to redeem the instrument.
- The instrument is a liability if the choice of settling a financial instrument in cash or otherwise is contingent on the outcome of circumstances beyond the control of both the issuer and the holder, as the issuer does not have an unconditional right to avoid settlement.
- An instrument is a liability if it includes an option for the holder to put the rights inherent in that instrument back to the issuer for cash or another financial instrument.

However, some instruments that are puttable or impose on the entity an obligation to pay a pro rata share of the net assets of the entity only on liquidation are classified as equity, provided that all of the strict criteria are met.

The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument.

Not all instruments are either debt or equity. Some, known as compound instruments, contain elements of both in a single contract. These instruments, such as bonds that are convertible into equity shares either mandatorily or at the option of the holder, are split into liability and equity components. Each is then accounted for separately. The liability element is determined by fair valuing the cash flows excluding any equity component; the residual is assigned to equity.

The table below illustrates the decision process to determine whether an instrument is a financial liability or equity instrument.

Instrument	Cash obligation for principal	Cash obligation for coupon/ dividends	Settlement in fixed number of shares	Classification
Ordinary shares	✘	✘	n/a	Equity
Redeemable preference shares with 5% fixed dividend each year subject to availability of distributable profits	✔	✔	✘	Liability
Redeemable preference shares with discretionary dividends	✔	✘	✔	Liability for principal and equity for dividends
Convertible bond that converts into fixed number of shares	✔	✔	✔	Liability for bond and equity for conversion option
Convertible bond that converts into shares to the value of the liability	✔	✔	✘	Liability

Derivatives on own shares

Derivative contracts that only result in the delivery of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments are classified as equity instruments. All other derivatives on own equity are treated as derivatives and accounted for as such under IAS 39. This includes any that:

- Can or must be settled on a net basis in cash (or other financial assets) or in shares;
- May be settled gross by delivery of a variable number of own shares; or
- May be settled by delivery of a fixed number of own shares for a variable amount of cash (or other financial assets).

Any derivative on own equity that gives either party a choice over how it is settled is a financial asset or liability unless all of the settlement alternatives would result in equity classification. The following table illustrates this.

Instrument	Classification	Example
A contract that is settled by the issuer delivering a fixed number of the issuer's own shares in exchange for a fixed monetary amount of cash or other assets	Equity	A warrant giving the counterparty a right to subscribe for a fixed number of the entity's shares for a fixed amount of cash
A contract that requires an entity to repurchase (redeem) its own shares for cash or other financial assets at a fixed or determinable date or on demand	Liability (redemption amount)	Forward contract to repurchase own shares for cash
An obligation to redeem own shares for cash that is conditional on the counterparty exercising a right to redeem	Liability (redemption amount)	Written option to repurchase own shares for cash
A contract that will be settled in cash or other assets where the amount of cash that will be received or delivered is based on changes in the market price of the entity's own equity	Derivative asset or liability	Net cash-settled share option
A contract that will be settled in a variable number of own shares determined so as to equal a fixed value or a value based on changes in an underlying variable (for example, a commodity price)	Derivative asset or liability	Forward contract on the price of gold that is settled in own shares
A contract containing multiple settlement alternatives (for example, net in cash or net in own shares, or by exchanging own shares for cash or other financial assets)	Derivative asset or liability	Derivative asset or liability. Share option that the issuer can decide to settle either in cash or by delivering own shares for cash

For first-time adopters

Point to consider:

- There is no need to separate a compound instrument into its liability and equity components if the liability component is no longer outstanding at the date of transition to IFRS.

Stop press – distinction between liabilities and equity

This is a modified joint project on which the FASB has taken the lead during the research stage. The FASB published a preliminary views document in November 2007, entitled, 'Financial instruments with characteristics of equity'. It describes three approaches for distinguishing equity instruments from financial liabilities: basic ownership, ownership-settlement and reassessed expected outcomes. The IASB published a discussion paper in February 2008, which contains an invitation to comment on the FASB document. The IASB is discussing the responses to that invitation to comment and is expected to publish an exposure draft on this in the fourth quarter of 2009.

Initial recognition and classification

Overview

At a glance – the key issues

- Financial assets and liabilities are initially measured at fair value.
- An entity may designate a financial instrument irrevocably on initial recognition as held at fair value through profit or loss, provided certain criteria are met.
- Loans purchased by the entity that would otherwise meet the definition of loans and receivables are classified as such.
- Failure to comply with the rules for held-to-maturity assets taints the whole category.
- Reclassification of assets between categories is permitted in certain circumstances.
- Embedded derivatives are accounted for separately if their economics are not 'closely related' to those of the host contract.

Initial recognition

IAS 39 requires an entity to recognise a financial asset or liability on its balance sheet only when it becomes a party to the contractual provisions of the instrument.

Initial measurement: financial assets and liabilities are initially measured at fair value (discussed in the measurement chapter). This is usually the same as the fair value of the consideration given (in the case of an asset) or received (in the case of a liability). However, if this is not the case, any difference is accounted for in accordance with the substance of the transaction. For example, if the instrument is valued by reference to a more favourable market than the one in which the transaction took place, an initial profit is recognised.

Transaction costs: These are included in the initial carrying value of financial assets and liabilities unless they are carried at fair value through profit or loss when the transaction costs are recognised in the income statement.

Classification – financial assets

There are four categories of financial asset

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

Financial assets at fair value through profit or loss

This category has two sub-categories: financial assets held for trading, and those designated to the category at inception.

A financial asset is held for trading if acquired or originated principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin or if it is part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

Trading assets include debt and equity securities and loans and receivables acquired by the entity with the intention of making a short-term profit from price or dealer's margin. Derivatives are always categorised as held for trading unless they are accounted for as hedges.

The second sub-category includes any financial asset that an entity has decided to designate to the category on initial recognition provided such a designation results in more relevant information either:

- because it eliminates or significantly reduces a measurement or recognition inconsistency (that is, accounting mismatch); or
- because it is part of a group of financial assets, financial liabilities or both that is managed and its performance is evaluated on a fair value basis in accordance with a documented risk management strategy, and information about this group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24, 'Related party disclosures').

If a financial asset contains one or more embedded derivatives, the entity may designate the entire contract as fair value through profit or loss unless the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract, or it is clear with little or no analysis that separation of such an embedded derivative is prohibited by IAS 39.

This designation is irrevocable. The asset cannot be moved to another category during its life.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They typically arise when an entity provides money, goods or services directly to a debtor with no intention of trading the receivable. However, a loan acquired as a participation in a loan from another lender is also included in this category, as are loans purchased by the entity that would otherwise meet the definition. If the holder does not substantially recover all its initial investment from a financial asset, other than because of credit deterioration, it cannot classify it as a loan or receivable.

Held-to-maturity investments

Held-to-maturity investments are financial assets with fixed or determinable payments and fixed maturity (for example, debt securities and redeemable preference shares) that an entity has the positive intent and ability to hold to maturity. This category excludes loans and receivables. Equity securities cannot be classified as held-to-maturity because they do not have a fixed maturity date. The intent and ability is assessed not only when the assets are initially acquired but also at each subsequent balance sheet date. A positive intent to hold assets to maturity is a much higher hurdle than simply having no present intention to sell.

If an entity sells more than an insignificant amount of held-to-maturity securities, other than in exceptional circumstances, this casts doubt on its intent or ability to hold investments to maturity. The consequences are harsh: the entity is prohibited from using the held-to-maturity classification for any financial assets for two financial years. All its held-to-maturity investments are reclassified as available for sale and measured at fair value. When the prohibition ends (at the end of the second financial year following the tainting), the portfolio becomes 'cleansed', and the entity is once more able to classify the securities as held to maturity.

Available-for-sale financial assets

All financial assets that are not classified in another category are classified as available for sale. The available for sale category includes all equity securities other than those classified as at fair value through profit or loss. An entity also has the right to designate any asset, other than a trading one, to this category at inception.

Classification – financial liabilities

There are two categories of financial liability:

- Financial liabilities at fair value through profit or loss.
- Other financial liabilities.

Financial liabilities at fair value through profit or loss

The category of financial liabilities at fair value through profit or loss also has two sub-categories: liabilities held for trading and those designated to the category at inception.

Financial liabilities held for trading include:

- Derivative liabilities that are not accounted for as hedging instruments.
- Obligations to deliver securities or other financial assets borrowed by a short seller.
- Financial liabilities that are incurred with the intention to repurchase them in the near term.
- Financial liabilities that form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

As with financial assets, an entity has the right to designate any financial liability to this category on initial recognition provided it meets one of the criteria detailed above for assets. This designation is irrevocable. The liability cannot subsequently be transferred to another category.

Reclassification of assets between categories

Reclassifications between categories are relatively uncommon under IAS 39. They are prohibited into and out of the fair value through profit or loss category, except for some non-derivative financial assets, which may be reclassified out of the held-for-trading category in particular circumstances.

An entity may choose to reclassify a non-derivative financial asset out of the held-for-trading category if the financial asset is no longer held for the purpose of selling it in the near term:

- If the financial asset meets the definition of a loan or receivable at the date of reclassification and the entity now has the intent and ability to hold it for the foreseeable future or to maturity; or
- The financial asset may be reclassified only in rare circumstances (that is, those that do not meet the definition of a loan or receivable at the date of reclassification).

Reclassifications from the held-to-maturity category as a result of a change of intent or ability are treated as sales and, other than in exceptional circumstances, result in the whole category being ‘tainted’. The most common reason for a reclassification out of the category, therefore, is when the whole category is tainted and has to be reclassified as available for sale for two years. In such circumstances, the assets are re-measured to fair value, with any difference recognised in equity.

An instrument may be reclassified into the available-for-sale category where the tainted held-to-maturity portfolio has been ‘cleansed’. Assets classified as available for sale may also be reclassified as loans and receivables provided (a) they would have met the definition of a loan or receivable, and (b) the company has the intent and ability to hold the asset for the foreseeable future or to maturity.

Certain changes in circumstances are not reclassifications. For example, a derivative that was initially classified as trading may be designated as a hedging instrument while it is held. Similarly, a derivative that was designated as a hedging instrument may be re-designated as trading following revocation of the hedge.

At the date of reclassification, the fair value of any financial asset reclassified out of held for trading or available for sale into an amortised cost category becomes its new cost or amortised cost as applicable, and no reversals of fair value gains or losses recorded before reclassification date are permitted. Effective interest rates for financial assets reclassified to loans and receivables and held-to-maturity categories are determined at the reclassification date. Further increases in estimates of cash flows adjust effective interest rates prospectively.

Embedded derivatives

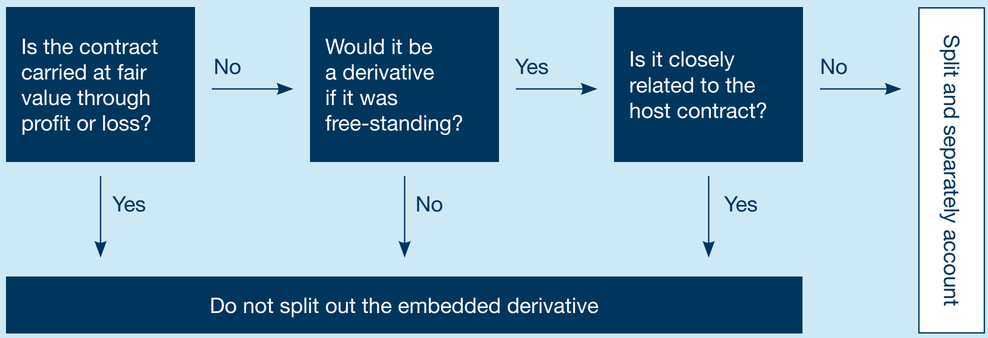
IAS 39 defines a derivative as a financial instrument with all these characteristics:

- Its value changes in response to changes in an ‘underlying’ price or index.
- It requires no initial net investment or an initial net investment that is smaller than would be required to purchase the underlying instrument.
- It is settled at a future date.

IAS 39 prevents abuse of the requirements for carrying derivatives at fair value through profit or loss by requiring separate recognition of derivatives embedded in a host contract that is accounted for differently. An embedded derivative is split from the host contract and accounted for separately if:

- Its economics are not ‘closely related’ to those of the host contract (see examples below).
- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
- The entire contract is not carried at fair value through profit or loss.

Questions that need to be asked



The table below contrasts contracts containing embedded derivatives to identify those that are not 'closely related':

Not 'closely related'	'Closely related'
• Equity conversion or put option in debt instrument • Debt security with interest or principal linked to commodity or equity prices • Credit derivatives embedded in a host debt instrument • Sales or purchases not in (a) measurement currency of either party, (b) currency in which products are routinely denominated in international commerce, or (c) currency commonly used in the economic environment in which transaction takes place	• Interest rate swap embedded in a debt instrument • Inflation-indexed lease contracts • Cap and floor in a sale and purchase contract • Pre-payment option in a mortgage where the option's exercise price is approximately equal to the mortgage's amortised cost on each exercise date • A forward foreign exchange contract that results in payments in either party's reporting currency • Dual currency bonds • Foreign currency denominated debt

For first-time adopters

Points to consider:

- On first-time adoption, an entity classifies all its financial assets in accordance with IAS 39, irrespective of their classification under local GAAP.
- A financial asset can be classified as a held-to-maturity investment if (a) there is at the date of transition a positive intent and ability to hold it to maturity, and (b) the asset does not meet the criteria for classification as loans and receivables.
- A financial asset can be classified as loans and receivables if it meets the definition when the entity first applies IAS 39.
- A non-derivative financial asset or liability is classified as trading if the asset or liability was acquired or incurred principally for the purpose of selling or repurchasing it in the near term or is, at the date of transition, part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.
- Derivatives not designated as hedging instruments are classified as held for trading.
- Any financial asset can be classified as available for sale at the date of transition, and any financial asset or liability can be designated as at fair value through profit or loss provided those assets and liabilities meet the criteria for such designation at the date of transition.
- Assess all contracts for embedded derivatives based on information when the entity first became a party to the contract.

Derecognition

Overview

At a glance – the key issues

- A financial asset (or part of a financial asset) is derecognised when:
  – The rights to the cash flows from the asset expire.
  – The rights to the cash flows from the asset and substantially all risks and rewards of ownership of the asset are transferred.
  – An obligation to transfer the cash flows from the asset is assumed and substantially all risks and rewards are transferred.
  – Substantially all the risks and rewards are neither transferred nor retained but control of the asset is transferred.
- If the entity retains control of the asset but does not retain or transfer substantially all the risks and rewards, the asset is recognised to the extent of the entity's continuing involvement.
- A financial liability is removed from the balance sheet only when it is extinguished – that is, when the obligation specified in the contract is discharged or cancelled – or expires.
- A transaction is accounted for as a collateralised borrowing if the transfer does not satisfy the conditions for derecognition.

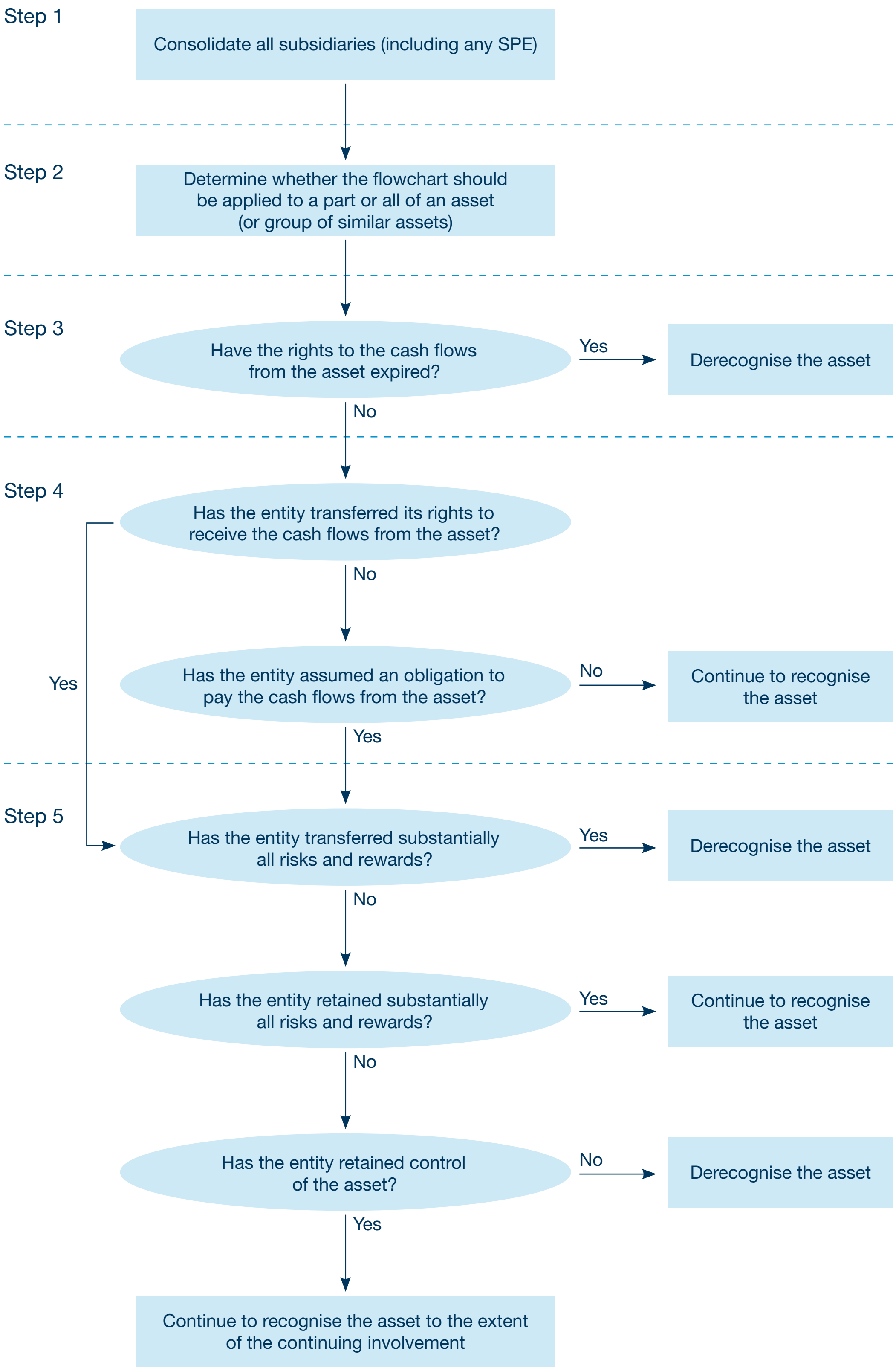
Derecognition is the term used for the removal of an asset or liability from the balance sheet. IAS 39 sets out the criteria for derecognition of financial assets and liabilities and the consequential accounting treatment.

Derecognition of financial assets

In many cases it is not difficult to assess whether or not a financial asset is derecognised. For example, when a manufacturer receives a payment from a customer for the delivery of spare parts, the manufacturer no longer has any rights to further cash flows from the receivable and should remove it from the balance sheet.

Where a company sells a portfolio of trade receivables or mortgages in order to receive finance, it is less obvious whether those financial assets should be derecognised. Examples of such arrangements are debt factoring and securitisation schemes.

The following flow chart summarises the criteria for derecognition in IAS 39. A detailed explanation of each step follows after the flow chart.


Step 1
Consolidate all subsidiaries (including any SPE)
Step 2
Determine whether the flowchart should be applied to a part or all of an asset (or group of similar assets)
Step 3
Have the rights to the cash flows from the asset expired?
Yes
Derecognise the asset
No
Step 4
Has the entity transferred its rights to receive the cash flows from the asset?
No
Yes
Has the entity assumed an obligation to pay the cash flows from the asset?
No
Continue to recognise the asset
Yes
Step 5
Has the entity transferred substantially all risks and rewards?
Yes
Derecognise the asset
No
Has the entity retained substantially all risks and rewards?
Yes
Continue to recognise the asset
No
Has the entity retained control of the asset?
No
Derecognise the asset
Yes
Continue to recognise the asset to the extent of the continuing involvement

Step 1

Consolidate all subsidiaries (including any SPE)

Many derecognition structures use entities (for example, trusts and partnerships) that have been specifically set up for the acquisition of the transferred assets. The transfer of assets to such an entity might qualify as a legal sale. However, if the relationship between the transferor and the transferee suggests that the transferor controls the transferee, the transferor needs to consolidate the transferee.

The derecognition principles therefore have to be applied on a consolidated level.

An entity first consolidates all subsidiaries and special purpose entities in accordance with IAS 27, 'Consolidated and separate financial statements', and SIC 12, 'Service concession arrangements', and then applies the derecognition principles to the resulting group.

Step 2

Determine whether the flowchart should be applied to a part or all of an asset (or group of similar assets)

The next step is to identify the assets (or part of assets) that should be tested for derecognition.

The tests may be applied to any of the following:

- An entire asset (for example, an unconditional sale of a financial asset)
- A fully proportionate share of the cash flows from an asset (for example, a sale of 10 per cent of all principal and interest cash flows)
- Specifically identified cash flows from an asset (for example, a sale of an interest-only strip)
- A fully proportionate share of specifically identified cash flows from an asset (for example, a sale of a 10 per cent interest-only strip).

Step 3

Have the rights to the cash flows from the asset expired?

If the contractual rights to the cash flows from a financial asset (or part of the asset) have expired or are forfeited, the entity derecognises the financial asset.

This is the case when a debtor discharges its obligation by paying the holder of the financial asset or when the debtor's obligations to the holder have ceased (for example, when the rights under an option expire).

Step 4

Has the asset been transferred?

A transaction qualifies as a transfer if the entity transfers the contractual rights to receive the cash flows to a third party or where it retains the contractual rights but assumes a contractual obligation to pass on these cash flows to another.

Test 1

Has the entity transferred its rights to receive the cash flows from the asset?

Some transactions clearly involve the transfer of rights to another party. For example, an entity that has sold a financial asset (for example., a legal sale of a bond) has transferred its rights to receive the cash flows from the asset. The transfer then has to be assessed in Step 5 to determine whether it meets the derecognition criteria.

Test 2

Has the entity assumed an obligation to pay the cash flows from the asset?

An entity that retains its contractual rights to receive cash flows from a financial asset may still assume a contractual obligation to pass on the cash flows to one or more entities (pass-through arrangements).

This situation may arise, for example, if the transferor is a special purpose entity or trust, and issues beneficial interests in the underlying financial assets that it owns to investors while continuing to service those financial assets (that is, custody of the underlying asset remains with the transferor).

Additional requirements have to be fulfilled to conclude that a pass-through arrangement meets the criteria for a transfer.

If the following conditions are met, the entity performs the derecognition tests in Step 5 in order to determine whether it meets the derecognition criteria:

- The entity has no obligation to pay cash flows to the transferee unless it collects equivalent cash flows from the transferred asset.
- The entity is prohibited from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pass-through cash flows.
- The entity is obliged to remit any cash flows without material delay and subject to certain investment restrictions.

If the conditions are not met, the financial assets remain on the balance sheet.

Step 5

Perform derecognition tests

Test 1

Has the entity transferred substantially all risks and rewards?

If the entity transfers substantially all the risks and rewards of ownership of the asset (for example, an unconditional sale of a financial asset), it derecognises the asset.

The transfer of risks and rewards is evaluated on the entity's exposure before and after the transfer to the variability in amount and timing of the cash flows that are likely to occur in practice. It will be clear in most cases whether the entity has transferred substantially all the risks and rewards without the need for a calculation. If substantially all the risks and rewards have been transferred, the asset is derecognised.

If the entity has not transferred substantially all risks and rewards, it carries out Test 2.

Test 2

Has the entity retained substantially all risks and rewards?

If the entity retains substantially all the risks and rewards of ownership of the asset, it continues to recognise the asset.

If the transferor's exposure has not changed substantially as a result of the transfer, it has retained substantially all risks and rewards of ownership and does not derecognise the asset.

For example, this would be the case in a sale and repurchase transaction where the repurchase price is set at the sales price plus a lender's return, or where a sale of a financial asset is accompanied by a total return swap that transfers the full exposure back to the transferor.

If the entity has not retained substantially all the risks and rewards, it carries out Test 3.

Test 3

Has the entity retained control of the asset?

If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the asset, it determines whether it has retained control of the asset.

Control is based on the transferee's practical ability to sell the asset. The transferee has this ability if it can sell the asset in its entirety unilaterally to an unrelated third party without needing to impose further restrictions on the transfer.

The key issue is what the transferee is able to do in practice and not what contractual rights the transferee has. A transferee has the practical ability to sell the asset if it is traded in an active market because the transferee could purchase the asset in the market if it needs to return the asset to the transferor.

If an asset subject to a call option can be readily obtained by the transferee in the market, the transferor has lost control, although he has retained some of the risks and rewards in relation to the asset.

However, the contractual right to dispose of an asset is of little practical use if there is no market for the asset.

If the entity has lost control, it derecognises the asset.

If the entity has retained control, it continues to recognise the asset to the extent of its continuing involvement.

Consequences of derecognition or failed derecognition

Derecognition of a financial asset – gain recognition

On derecognition of a financial asset in its entirety, the difference between the carrying amount and the consideration received (including any cumulative gain or loss that had been recognised directly in equity) is included in the income statement.

If only a part of a financial asset is derecognised, the previous carrying amount of the financial asset is allocated between the part that continues to be recognised and the part that is derecognised based on relative fair values at the date of transfer.

The difference between the carrying amount allocated to the part derecognised (including any cumulative gain or loss relating to the part derecognised that had previously been recognised in equity) and the consideration received is included in the gain or loss on derecognition.

Failed derecognition of a financial asset – substantially all risks and rewards of ownership retained

A transaction is accounted for as a collateralised borrowing if the transfer does not satisfy the conditions for derecognition. The entity recognises a financial liability for the consideration received for the transferred asset.

If the transferee has the right to sell or repledge the collateral the asset is presented separately in the balance sheet (for example, as loaned asset, pledge securities or repurchase receivable).

Failed derecognition – not substantially all risks and rewards of ownership retained (continuing involvement)

If the asset is not derecognised because the entity has neither transferred nor retained substantially all the risks and rewards of ownership and control has not passed to the transferee, the entity continues to recognise the asset to the extent of its continuing exposure to the asset. Consequently, to that extent a liability is also recognised. IAS 39 contains detailed guidance of how to account for a range of different scenarios. The principle is that the combined presentation of the asset and liability should result in the recognition of the entity's net exposure to the asset on the balance sheet either at fair value, if the asset was previously held at fair value, or at amortised cost, if the asset was accounted for on that basis.

The treatment of the changes in the liability should be consistent with the treatment of changes in the asset. Consequently, when the asset subject to the transfer is classified as available for sale, gains and losses on both the asset and the liability will be taken to equity.

Securitisation

The derecognition model has a significant impact on securitisation structures. A classic receivables securitisation programme, where a company sells its receivables to a multi-seller vehicle on a revolving basis, encounters the following difficulties in achieving derecognition:

- Since the SPE is likely to be consolidated under SIC 12, there will be no transfer of the right to cash flows from the reporting group. The transfer therefore has to meet the criteria for pass through cash flows set out in Test 2 of Step 4. Few securitisations are structured in such a way as to pass these tests.
- Even if the structure does meet the transfer requirements, it is unlikely that substantially all the risks and rewards have been passed to the transferee; full derecognition will not therefore be achieved by that route.

- Assuming that the transferor does not retain substantially all the risks (as may often be the case), the control test will always fail, as the SPE will not have the ability to sell the asset.

The entity will therefore need to recognise the assets to the extent of its continuing involvement.

Derecognition of financial liabilities

A financial liability (trading or other) is removed from the balance sheet when it is extinguished – that is, when the obligation is discharged, cancelled or expired.

The condition is met when the liability is settled by paying the creditor, or when the debtor is released from primary responsibility for the liability either by process of law or by the creditor.

A payment to a third party, including a trust (sometimes called ‘in-substance defeasance’) does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

Management will frequently negotiate with the entity’s bankers or bond-holders to cancel existing debt and replace it with new debt on different terms. For example, an entity may decide to cancel its exposure to high-interest fixed-rate debt, pay a fee or penalty on cancellation, and replace it with variable-rate debt. IAS 39 provides guidance to distinguish between the settlement of debt that is replaced by new debt, and the restructuring of existing debt.

The distinction is based on whether or not the new debt has substantially different terms from the old debt. Terms are substantially different if the present value of the net cash flows under the new terms discounted using the original effective interest rate is at least 10 per cent different from the present value of the remaining cash flows under the original debt. This distinction is important for gain or loss recognition. A gain or loss on extinguishment of a financial liability is recognised in the income statement. Any net cash flow in relation to the restructuring of financial liabilities is an adjustment to the debt’s carrying amount and is amortised over the remaining life of the liability.

For first-time adopters

Points to consider:

- A first-time adopter will apply the derecognition requirements in IAS 39 prospectively from 1 January 2004. Non-derivative assets or liabilities derecognised under previous GAAP remain derecognised provided they were initially derecognised before 1 January 2004.
- Retrospective application from an earlier chosen date is allowed if the required accounting information is available.
- A first-time adopter has to recognise all derivatives and other interests (that is, servicing rights) and consolidate all special purpose entities (SPEs) that it controls at the date of transition to IFRS.

Stop press – derecognition

The IASB issued an exposure draft in March 2009 proposing to amend IAS 39 and IFRS 7 for derecognition of financial instruments. The proposal is one of a series of actions taken by the IASB to respond to the global financial crisis and the recommendations of the Financial Stability Forum. The proposed amendments would replace the approach to derecognition of financial assets in IAS 39 with an approach that is similar in that:

- It uses the same criteria for when a transferred part of a financial asset qualifies to be assessed for derecognition (with some additional guidance to address known application issues).
- It uses a test of control (although unlike IAS 39, that test has primacy).
- Many of the derecognition outcomes will be similar (the notable exceptions being transfers, such as repurchase agreements, involving readily obtainable financial assets).

The exposure draft proposes a revised approach to derecognition based on control rather than risks and rewards. As an alternative view, the exposure draft sets forth an approach based on whether the asset retained after the transfer is the same as the asset existing before the transfer.

The proposed amendments would also revise the approach to derecognition of financial liabilities in IAS 39 to be more consistent with the definition of a liability in the IASB Framework.

The proposed amendments to IFRS 7 would enhance corporate disclosures to improve an investor's ability to evaluate risk exposures and performance with respect to an entity's transferred financial assets.

Subsequent measurement, fair values and impairment

Overview

At a glance – the key issues

- Subsequent measurement of financial assets and liabilities depends on the classification:
  - Trading assets and liabilities and available-for-sale assets are measured at fair value.
  - Loans and receivables and held-to-maturity investments are carried at amortised cost.
- The best evidence of fair value is quoted market prices in an active market.
- If quoted market prices are not available, entities use valuation techniques incorporating observable market data.
- Cost less impairment is a last resort for investments in unlisted equity instruments.
- Objective evidence that a loss has been incurred is required before calculating an impairment loss.

Subsequent measurement – financial assets

There are four categories of financial assets as described in the chapter 'Initial recognition and classification'. This classification is important because it determines the subsequent measurement of the asset. The table below summarises the principles.

Financial assets	Measurement	Changes in carrying amount	Impairment test (if objective evidence)
Financial assets at fair value	Fair value	Income statement	No
Loans and receivables	Amortised cost	Income statement	Yes
Held-to-maturity investments	Amortised cost	Income statement	Yes
Available-for-sale financial assets	Fair value	Equity	Yes

Subsequent measurement – financial liabilities

There are only two categories of financial liabilities: those at fair value through profit or loss (including trading liabilities), and other. Trading liabilities (including derivatives when they have negative fair values) are measured at fair value. The changes in fair value are included in the net profit or loss for the period. All other (non-trading) financial liabilities are carried at amortised cost.

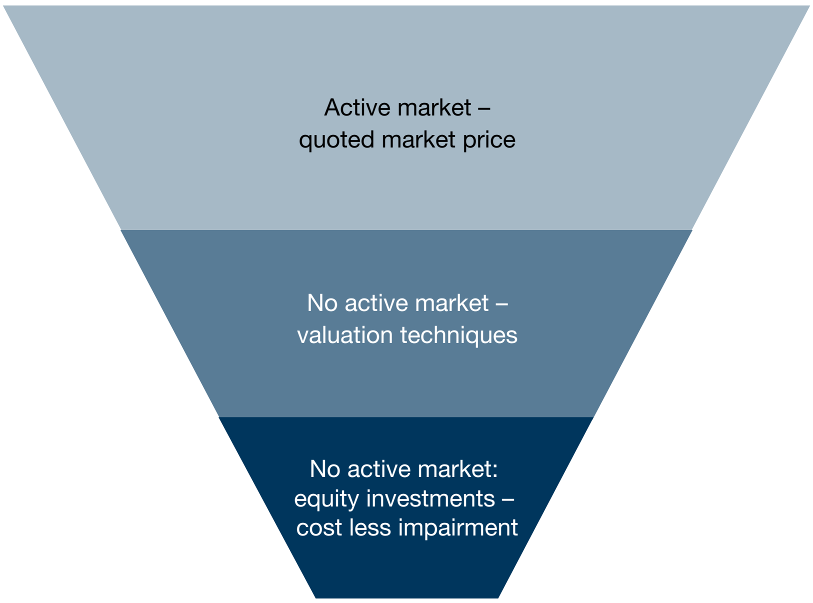
Amortised cost and effective interest method

The carrying amount of a financial instrument carried at amortised cost is calculated as the amount to be paid/repaid at maturity (usually the principal amount or par/face value), plus or minus any unamortised original premium or discount, net of any origination fees and transaction costs and less principal repayments. The amortisation is calculated using the effective interest method. This method calculates the rate of interest that is necessary to discount the estimated stream of principal and interest cash flows (excluding any impact of credit losses) through the expected life of the financial instrument or, when appropriate, a shorter period to equal the amount at initial recognition. That rate is then applied to the carrying amount at each reporting date to determine the interest income (assets) or interest expense (liabilities) for the period. In this way, interest income or expense is recognised on a level yield to maturity basis.

In the determination of the effective interest rate, the estimation of the cash flows does not take into consideration any future credit losses anticipated on that instrument.

Fair value

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. There is a general presumption that fair value can be reliably measured for all financial instruments. In looking for a reliable measure of fair value, IAS 39 provides a hierarchy to be used in determining an instrument's fair value.



Active market – quoted market price: the existence of published price quotations in an active market is the best evidence of fair value, and they are used to measure the financial instrument. 'Quoted in an active market' means that quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The price can be taken from the most favourable market readily available to the entity, even if that was not the market in which the transaction actually occurred. The quoted market price cannot be adjusted for 'blockage' or 'liquidity' factors. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market prices.

No active market – valuation techniques: if the market for a financial instrument is not active, fair value is established by using a valuation technique. Valuation techniques that are well established in financial markets include recent market transactions, reference to a transaction that is substantially the same, discounted cash flows and option pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and should be consistent with accepted economic methodologies for pricing financial instruments. The amount paid or received for a financial instrument is normally the best estimate of fair value at inception. However, where all data inputs to a valuation model are obtained from observable market transactions, the resulting calculation of fair value can be used for initial recognition.

No active market – equity instruments: it is possible normally to estimate the fair value of an equity instrument that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and no reliable estimate can be made, an entity is permitted to measure the equity instrument at cost less impairment as a last resort. A similar dispensation applies to derivative financial instruments that can only be settled by physical delivery of such unquoted equity instruments.

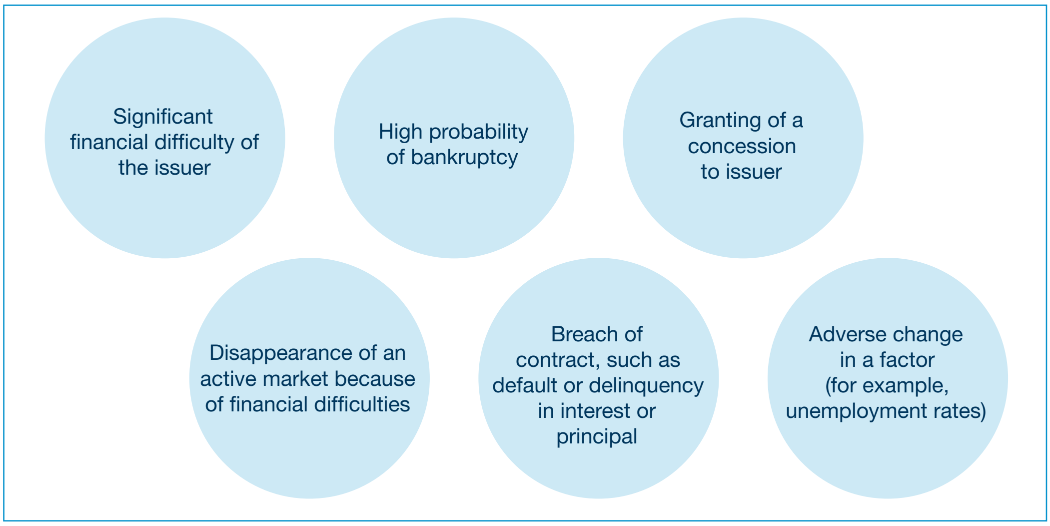
It might be possible in some circumstances to recognise a gain on initial recognition of a financial instrument. However, the circumstances in which this will be permitted are tightly controlled.

Impairment of financial assets

A financial asset or a group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of a past event that occurred subsequent to the initial recognition of the asset. Expected losses as a result of future events, no matter how likely, are not recognised.

An entity assesses at each balance sheet date whether there is objective evidence that a financial asset or group of assets may be impaired.

Examples of factors to consider are:



The disappearance of an active market or the downgrade of an entity's credit rating is not itself evidence of impairment, although it may be evidence of impairment when considered with other information. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

If there is objective evidence that impairment has been incurred and the carrying amount of a financial asset carried at amortised cost exceeds its estimated recoverable amount, the asset is impaired. The recoverable amount is the present value of the expected future cash flows discounted at the instrument's original effective interest rate. The use of this rate prevents a market value approach from being imposed for loans and receivables. The carrying amount is reduced to its recoverable amount either directly or through the use of an allowance account. The amount of the loss is included in net profit or loss for the period.

If there is objective evidence of impairment of available-for-sale financial assets carried at fair value, the cumulative net loss (difference between amortised acquisition cost and current fair value less any impairment loss previously recognised in the income statement) that has previously been recognised in equity is removed and recognised in the income statement, even though the asset has not been sold. Entities are prohibited from reversing impairments on investments in equity securities. However, if the fair value of an available-for-sale debt instrument increases and the increase can be objectively related to an event occurring after the loss was recognised, the loss may be reversed through the income statement.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). Those characteristics should be relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

Estimates of changes in future cash flows for groups of assets should reflect and be directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, payment status and other factors indicative of changes in the probability of losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

For first-time adopters

Points to consider:

- The impairment methodology is likely to be different from that used under an entity's previous GAAP. In particular, general provisions are not permitted, and all impairment of debt instruments is measured using a discounted cash flow methodology.
- An entity's estimates of loan impairments at the date of transition to IFRSs are consistent with estimates made for the same date under previous GAAP.
- Many financial instruments will need to be fair valued, with no adjustments for blockage or liquidity provisions if they are quoted in an active market.
- The amortised cost at the date of transition will need to be calculated, using effective interest rates as set out in IAS 39.

Stop press – fair value measurement

The IASB published an exposure draft on fair value measurement of financial instruments in May 2009. The main tentative decisions that the Board has made to date in the fair value measurement ED are:

- **Scope exclusion:** the Board decided to exclude of IAS 39 paragraph 49 from the scope of the ED on fair value measurement. This paragraph describes the measurement objective for a financial liability with a demand feature.
- **Definition of fair value:** the Board tentatively decided to define fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'. It also decided that a fair value measurement assumes that the transaction to sell an asset or transfer a liability occurs in the most advantageous market for the asset or liability.
- **Fair value disclosures:** the proposed disclosures are similar to disclosure requirements for financial instruments.
- **Unit of account:** the Board confirmed that the measurement objective should be to measure fair value at the individual instrument level. It decided: (a) to exclude blockage factors from a fair value measurement at all levels of the fair value hierarchy; and (b) that a fair value measurement should exclude other discounts or premiums (such as a control premium) that apply to a holding of financial instruments and do not apply to the individual instrument.
- **Day-one gain or losses:** the Board reaffirmed that the transaction price is the best evidence of fair value at initial recognition except in the cases of related parties, duress, different units of account or different markets. If the transaction price does not represent fair value of a financial instrument at initial recognition, an entity recognises the resulting day-one gain or loss when required by the existing criteria in IAS 39. Any deferred gain or loss is a separate item, not part of the fair value. The Board tentatively decided in January that day-one gains or losses should not be recognised for financial instruments measured on a basis other than fair value through profit or loss. To avoid changes to IAS 39 that are beyond the scope of this project, the Board withdrew that decision.
- **Fair value of liabilities:** the Board confirmed that the fair value of a liability reflects non-performance risk (including credit standing).
- **Application guidance:** on determining fair value in illiquid markets will also be included, based on FASB FSP 157-4.

The IASB also decided tentatively that its forthcoming ED on fair value measurement would propose additional disclosure requirements about fair value for interim financial reports to ensure consistency with US GAAP, as follows:

- For financial instruments measured at fair value, the same disclosures as the ED would propose in annual financial statements.
- For financial instruments not measured at fair value:
  - (a) The fair value of financial instruments, as already required in annual financial statements by IFRS 7.
  - (b) The same disclosures as the ED would propose in annual financial statements.
- For non-financial assets and non-financial liabilities, no additional specific requirements beyond the existing disclosure requirements in IAS 34.

Hedge accounting

Overview

At a glance – the key issues

- In order to apply hedge accounting, strict criteria, including the existence of formal documentation and the achievement of effectiveness tests, must be met.
- Hedge accounting can be applied to three types of hedging relationships: fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation.
- Hedge accounting must be discontinued prospectively if the hedging relationship comes to an end (for example, the hedging instrument is sold), one of the hedge accounting criteria is no longer met (for example, the hedge does not pass effectiveness tests) or the hedging relationship is revoked.

Criteria for hedge accounting

IAS 39 requires hedges to meet certain criteria in order to qualify for hedge accounting. These include requirements for formal designation of the hedging relationships, as well as rules on hedge effectiveness.

A hedging relationship qualifies for hedge accounting if, at inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.

Hedge documentation

- Risk management objective and strategy
- Identification of the hedging instrument
- The related hedged item or transaction
- The nature of the risk being hedged
- How the entity will assess the hedging instrument's effectiveness

What instrument can be designated as a hedging instrument?

All derivatives that involve an external party 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.

What items or transactions can be hedged?

The fundamental principle is that the hedged item creates an exposure to risk that could affect the income statement.

The hedged item can be:

- A single asset, liability, firm commitment or highly probable forecast transaction.
- A group of assets, liabilities, firm commitments or highly probable forecast transactions with similar risk characteristics.
- A non-financial asset or liability (such as inventory) for either foreign currency risk or the risk of changes in the fair value of the entire item.
- A held-to-maturity investment for foreign currency risk or credit risk (but not interest rate risk);
- A portion of the risk or cash flows of any financial asset or liability (however, for one-sided risk, only the intrinsic value can be hedged).
- A net investment in a foreign operation.

Hedge accounting is prohibited for hedges of net positions, but it is possible to track back from the net position to a gross position and to designate a portion of the latter as the hedged item if it meets the other criteria for hedge accounting.

Categories of hedges

Hedge accounting may be applied to three types of hedging relationships: fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation.

Fair value hedges

A fair value hedge is a hedge of the exposure to changes in the 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 reported profit or loss.

In a fair value hedge, the gain or loss from remeasuring the hedging instrument at fair value (derivative) or the foreign currency component of its carrying amount (non-derivative) is recognised immediately in the income statement. At the same time, the carrying amount of the hedged item is adjusted for the gain or loss attributable to the hedged risk; the change is also recognised immediately in the income statement to offset the value change on the derivative.

Entities are also permitted to apply fair value hedge accounting to be applied to a portfolio hedge of interest rate risk (sometimes referred to as a ‘macro hedge’). Special requirements apply to this type of hedge.

Cash flow hedges

A cash flow hedge is a hedge of the exposure to variability in cash flows that: (a) is attributable to a particular risk associated with a recognised asset or liability or a forecast transaction; and (b) could affect reported profit or loss. Hedges of the foreign currency risk associated with firm commitments may be designated as cash flow hedges. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity.

The gain or loss deferred in equity is recycled to the income statement when the hedged cash flows affect income. If the hedged cash flows result in the recognition of a non-financial asset or liability on the balance sheet, the entity can choose to adjust the basis of the asset or liability by the amount deferred in equity. This choice has to be applied consistently to all such hedges. However, such basis adjustment is prohibited if a financial asset or liability results from the hedged cash flows.

Hedges of a net investment in a foreign operation

Under IAS 21, 'The effects of changes in foreign operations', the net investment in a foreign operation is the amount of the reporting entity's interest in the net assets of that operation. If a derivative or non-derivative is designated as a hedge of that interest, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity.

Hedge effectiveness/ineffectiveness

IAS 39 requires the hedge to be highly effective if it is to qualify for hedge accounting. There are separate tests to be applied prospectively and retrospectively and these tests are mandatory:

- Prospective effectiveness testing is performed at inception of the hedge and at each subsequent reporting date during the life of the hedge. This testing consists of demonstrating that the entity expects changes in the fair value or cash flows of the hedged item to be almost fully offset (that is, nearly 100 per cent) by the changes in the fair value or cash flows of the hedging instrument.
- Retrospective effectiveness testing is performed at each reporting date throughout the life of the hedge in accordance with a methodology set out in the hedge documentation. The objective is to demonstrate that the hedging relationship has been highly effective by showing that actual results of the hedge are within the range of 80-125 per cent.

Hedge ineffectiveness is systematically and immediately reported in the income statement.

Discontinuing hedge accounting

Hedge accounting is discontinued prospectively if any of the following occurs:

- A hedge fails the effectiveness tests.
- The hedging instrument is sold, terminated or exercised.
- The hedged position is settled.
- Management decides to revoke the hedge relationship.
- In a cash flow hedge, the forecast transaction that is hedged is no longer expected to take place.

When a debt instrument (a non-derivative liability) has been adjusted for changes in fair value under a hedging relationship, the adjusted carrying amount becomes amortised cost. Any 'premium' or 'discount' is then amortised through the income statement over the remaining period to maturity of the liability.

If a cash flow hedge relationship ceases, the amounts accumulated in equity is maintained in equity until the hedged item affects profit or loss. However, if the hedge accounting ceases because the forecast transaction that was hedged is no longer expected to take place, gains and losses deferred in equity have to be recognised in the income statement immediately. Any amounts accumulated in equity while a hedge of net investment was effective remain in equity until the disposal of the related net investment.

For first-time adopters

Points to consider:

- All derivatives that are designated as hedging instruments are measured at fair value.
- All hedge relationships that existed under previous GAAP are recognised in the opening balance sheet. If they do not meet the conditions for hedge accounting under IAS 39, the entity applies the IAS 39 provisions to discontinue hedge accounting prospectively.
- Any hedge relationship that was not designated under previous GAAP cannot be retrospectively designated as a hedge, even if it meets all the IAS 39 criteria.

Appendices

Page

Disclosures

All disclosures relating to financial instruments are set out in IFRS 7. The intention of this standard is to require entities to provide disclosures in their financial statements that enable users to evaluate: the significance of financial instruments for the entity's financial position and performance, and the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date; and how the entity manages those risks.

Summary of required disclosures

Balance sheet and income statement related disclosures

- Balance sheet: the carrying amount of financial instruments by category in IAS 39 (for example, held to maturity or available for sale) either on the face of the balance sheet or in the notes.
- Financial assets or financial liabilities at fair value through profit or loss: for loans and liabilities designated at fair value through profit or loss, the change in fair value that is attributable to credit risk and how that amount is determined.
- Reclassifications: information about amounts reclassified into and out of each category, the reasons for the reclassification and additional disclosures that enable readers to know what the financial position of the company would have been had the assets not been reclassified.
- Income statement: the net gains/net losses for each of the categories of financial assets and financial liabilities in IAS 39 (for example, held to maturity or available for sale) as well as total interest income and expense, and amount of any impairment loss for each class of financial asset.
- Derecognition: certain information regarding financial assets transferred that do not qualify for derecognition, including the nature of the assets and the nature of the risks and reward to which the entity remains exposed.
- Other related disclosures:
  - Disclosures in respect of any accepted and pledged collateral.
  - Movements on the allowance account, if an entity uses such an account to record credit losses.
  - The existence of multiple embedded derivative features whose values are interdependent in a compound instrument, together with the effective yield on the liability component.
  - Defaults of principal/interest in respect of loans payable and any other breaches of loan agreements that permit the lender to demand repayment.

Other disclosures

Accounting policies

Entities are required to disclose, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge accounting

Entities are required to disclose, for each type of hedge:

- A description of the hedge;
- A description of the hedging instruments and their fair values at the balance sheet date;
- The nature of the risks being hedged; and
- The ineffectiveness recognised in the income statement for each type of hedge.

Fair value

Entities are required to disclose the fair value of each class of financial assets and financial liabilities in a way that permits it to be compared with its carrying value. They also disclose the methods and significant assumptions applied in determining fair values for each class of financial assets or financial liabilities.

Management classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements (the same hierarchy as in SFAS No. 157 'Fair Value Measurements issued by the FASB). The fair value hierarchy has the following levels:

- Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs).

For fair value measurements recognised in the statement of financial position management discloses for each class of financial instrument:

- Fair value measurements by level of the fair value hierarchy (Level 1, Level 2 or Level 3).
- Any significant transfers between Level 1 and Level 2 of the fair value hierarchy.
- A reconciliation from the beginning balances to the ending balances for Level 3 items.
- For Level 3, the amount of total gains or losses recognised in the income statement that relate to assets and liabilities held at the end of the reporting period.
- For Level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, state that fact and disclose the effect of those changes

Qualitative and quantitative disclosures of risks

- Disclosing risk 'through eyes of management': IFRS 7 requires quantitative and qualitative disclosures about an entity's exposure to credit risk, liquidity risk and market risk arising from its use of financial instruments. It requires the following qualitative disclosures for each type of risk:
  - The exposures to the risk and how they arise.
  - The entity's objectives, policies and processes for managing the risk.
  - The methods used to measure the risk.
  - Any changes to the above disclosures from the previous reporting period.

  The standard also requires summary quantitative data about the entity's exposure to each type of risk at the reporting date. This information is to be given 'through the eyes of management' – that is, based on internal reports provided to management. Certain minimum disclosures are also required to the extent they are not already covered by the 'through the eyes of management' information, including disclosure of significant concentration of risk.

- Credit risk: disclose by class of financial instrument:
  - Maximum credit-risk exposure at the balance sheet date, without taking account of any collateral held.
  - Description of collateral held as security and other credit enhancements and estimate of their fair value.
  - Information about the credit quality of financial assets that are neither past due nor impaired.
  - The carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.
  - An analysis of the age of financial assets that are past due but not impaired.
  - An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period and the factors considered.
  - When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security, disclose the nature and carrying amount of the assets obtained, and when the assets are not readily convertible into cash, its policies for disposing of such assets of for using them in its operations.
- Liquidity risk: disclose a separate maturity analysis for derivative and non-derivative financial liabilities (including issued financial guarantee contracts and loan commitments) categorised by their earliest contractual maturity date. The contractual amounts disclosed are the contractual undiscounted cash flows. Specific provisions for derivatives and financial assets are provided in IFRS 7.
- Market risk: provide a sensitivity analysis for each component of market risk to which an entity is exposed (currency risk, interest rate risk and other price risk). Every entity discloses the impact of reasonably possible movements in each relevant market risk variable on profit and loss and equity; the methods and assumptions used in preparing the sensitivity analysis; and changes from the previous period in the methods and assumptions used and the reasons for such changes.

Glossary

Amortised cost	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.
Available-for-sale financial assets	Those financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments, or (c) financial assets at fair value through profit or loss.
Cash flow hedge	A hedge of the exposure to variability in cash flows that: (a) is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and (b) could affect profit or loss.
Credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Derecognition	Removal of a previously recognised financial asset or financial liability from an entity's balance sheet.
Derivative	A financial instrument with all three of the following characteristics: (a) Its value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the 'underlying'). (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types. (c) It is settled at a future date.
Effective interest method	A method of calculating the amortised cost of a financial asset or financial liability and of allocating the interest income or interest expense over the relevant period.
Effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity estimates cash flows, considering all contractual terms of the financial instrument (for example, pre-payment, call and similar options) but does not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the

Effective interest rate (continued)	cash flows or the expected life of a financial instrument (or group of financial instruments), the entity uses the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
Embedded derivative	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 the contract would otherwise require to be modified based on a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. 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.
Equity	Any contract that evidences a residual interest in the assets an entity after deducting all of its liabilities.
Fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. In an active market, for assets it is the market bid price; for liabilities it is the market offer price.
Fair value hedge	A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.
Financial asset	Any asset that is: (a) Cash; (b) An equity instrument of another entity; (c) A contractual right: (i) to receive cash or another financial asset from another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or (d) A contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with IAS 32 paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with IAS 32 paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instrument.

Financial asset or financial liability at fair value through profit or loss	A financial asset or financial liability that meets either of the following conditions: (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is: (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). (b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when doing so results in more relevant information, because either: (i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or (ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 – for example, the entity's board of directors and chief executive officer. An entity may also designate an entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss if the contract contains one or more embedded derivatives, unless: (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.
Financial instrument	Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
Financial liability	Any liability that is: (a) A contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

Financial liability (continued)	(b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with IAS 32 paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with IAS 32 paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.
Financial guarantee	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.
Firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or date.
Forecast transaction	An uncommitted but anticipated future transaction.
Financial asset or financial liability at fair value through profit or loss	A financial asset or financial liability that meets either of the following conditions: (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is: (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). (b) Upon initial recognition, it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when doing so results in more relevant information, because either: (i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or (ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24, as revised in 2003) – for example, the entity's board of directors and chief executive officer.

Financial asset or financial liability at fair value through profit or loss	An entity may also designate an entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss if the contract contains one or more embedded derivatives, unless: (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered, that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.
Financial liability	Any liability that is: (a) A contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) A contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. 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.
Financial guarantee	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.
Firm commitment	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or date.
Forecast transaction	An uncommitted but anticipated future transaction.
Hedge effectiveness	The degree to which offsetting changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.
Hedged item	An asset, liability, firm commitment, highly probable forecast future transaction, or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged.
Hedging instrument	A designated derivative or a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. A non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.

Held-to-maturity investments	A financial asset with fixed or determinable payments and fixed maturity that an entity has the positive intent and ability to hold to maturity, other than those that the entity on initial recognition elects to designate as held for trading or available for sale, or that meet the definition of loans and receivables.
Interest rate risk	The risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
Liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) Those that the entity intends to sell immediately or in the near term, which are classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) Those that the entity upon initial recognition designates as available for sale; or (c) Those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which are classified as available for sale. An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.
Market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.
Net investment in a foreign operation	The amount of the reporting entity's interest in the net assets of that operation.
Regular way purchase or sale	A contract for the purchase or sale of a financial asset that requires delivery of the asset within the timeframe generally established by regulation or convention in the marketplace concerned.
Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
Puttable instrument	A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.
Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Puttable instrument	A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.
Tainting	Where an entity sells or transfers more than an 'insignificant amount' of its held-to-maturity investments, it reclassifies all of them as available for sale. It is then prohibited from classifying any assets as held to maturity for the next two full annual financial periods, until confidence in its intentions is restored.
Trading financial assets and liabilities	A financial asset or financial liability is classified as held for trading if it is: (a) Acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) Part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) A derivative (except for a derivative that is a designated and effective hedging instrument).
Transaction costs	Incremental costs that are directly attributable to the acquisition or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. Transaction costs include fees and commissions paid to agents, advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

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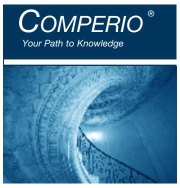

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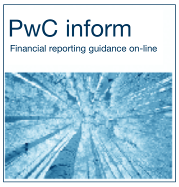

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