



# The KPMG Guide: FRS 139, Financial Instruments: Recognition and Measurement

AUDIT





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## Introduction

This KPMG Guide introduces the requirements of the new FRS 139, *Financial Instruments: Recognition and Measurement*. This standard applies to all entities with a wide range of “financial instruments”. The term “financial instruments” covers both financial assets and financial liabilities.

The application of the requirements to simple financial instruments, such as bank loans, trade receivables and payables, is straight forward and is unlikely to require changes in current accounting practices, except to the extent of disclosures. The simplest example is cash; although identified as being a financial asset, in fact there are no particular accounting requirements in FRS 139 for cash and cash is by definition stated at fair value. The application becomes more complex when there are unusual or more complex financial instruments or arrangements, for example compound instruments, factoring arrangements, hedging arrangements, over-the-counter derivatives etc.

First-time adopters will need to spend significant amounts of time in 2005 preparing to implement FRS 139. Implementing FRS 139 requires a structured process which includes identifying and addressing the entity’s major issues and potential changes to current business practices as well as to information systems. Preparers and users will have to develop a fundamental understanding of the concepts and principles of accounting for financial instruments.

This Guide aims to introduce the requirements of FRS 139 to non-financial institutions, by focusing on the aspects of the standards that are most likely to be of relevance to them, for example:

- the different classifications and accounting treatments, where informed decisions need to be made over whether policies can or should change; and
- the derecognition rules, which may require changes to past policies where financial assets were transferred to others other than in an outright sale.

## Executive summary

- All derivatives are recognised on the balance sheet and measured at fair value.
- All financial assets must be classified into:
  - “loans and receivables”,
  - “held to maturity”,
  - “fair value through profit or loss” or
  - “available for sale” categories.
- Loans and receivables and held to maturity financial assets are measured at amortised cost. All other financial assets are measured at fair value (with limited exceptions).
- Changes in the fair value of available for sale assets are recognised directly in equity.
- Financial liabilities, other than those held for trading purposes or designated as at fair value through profit or loss, are measured at amortised cost.
- A financial instrument may be designated on initial recognition as one measured at fair value through profit or loss under certain limited circumstances.
- Evaluating whether a transfer of a financial asset qualifies for derecognition requires considering:
  - Whether substantive risks and rewards are transferred. If substantially all the risks and rewards are transferred, then a financial asset is derecognised. If substantially all the risks and rewards are retained, then the asset is not derecognised.
  - If some but not substantially all of the risks and rewards are transferred, then an asset is derecognised if control of the asset is transferred.
  - If control is not transferred, then the entity continues to recognise the transferred asset to the extent of its continuing involvement in the asset.
- Whenever there is objective evidence that a financial asset measured at amortised cost, or fair value with changes recognised in equity, may be impaired the amount of any impairment loss must be calculated and recognised in the income statement.
- Generally, derivatives embedded in host contracts must be accounted for as stand-alone derivatives. Exceptions are provided when the host contract is measured at fair value with changes in fair value recognised in the income statement and for embedded derivatives that are closely related, in economic terms, to the host contract.
- Hedge accounting is permitted only when strict documentation and effectiveness testing requirements are met.
- The type of hedge accounting applied depends on whether the hedged exposure is a fair value exposure, a cash flow exposure, or a currency exposure on a net investment in a foreign operation.

Note that this is not an exhaustive list and there may be other changes in the details of FRS 139 which will have a significant effect on a particular entity. If in doubt, please refer to the text of the standard. Alternatively, please ask your usual KPMG contact for assistance.

FRS 139 is effective for annual periods beginning on or after 1 January 2006.

Paragraph references have been added in case you wish to read further. Except where otherwise indicated, all references are to Financial Reporting Standards (“FRSs”). For example, “139.15” refers to paragraph 15 of FRS 139.

# 1. Scope of FRS 139

- *FRS 139 applies to all financial assets and liabilities, including derivatives, except for certain specified exemptions (139.2)*

FRS 139 deals with recognition, derecognition, measurement and hedge accounting requirements for financial instruments. FRS 139 applies to all financial assets and liabilities, including derivatives, except as scoped out in paragraph 2 of FRS 139 as discussed in further detail in item 1.1 below.

The term “financial instruments” covers both financial assets and financial liabilities, from straightforward cash to embedded derivatives.

For example, all trade receivables, payables, bank loans, inter-company balances and debts and shares in another entity fall within the scope of this standard. As a result, care needs to be taken to ensure that the requirements of this standard are taken into account when determining accounting policies for any financial instrument, particularly in the first year of adoption of the standard.

## 1.1 Financial instruments outside the scope of FRS 139

- *The financial instruments outside the scope of FRS 139 are generally those covered by other standards (139.2)*

The financial instruments outside the scope of FRS 139 are listed in FRS 139.2. These are generally financial instruments where other FRSSs are applicable and include the following:

- interests in subsidiaries, associates and joint ventures accounted for under FRS 127, *Consolidated and Separate Financial Statements*, FRS 128, *Investments in Associates* or FRS 131, *Interests in Joint Ventures*; however, FRS 139 applies in cases where under FRS 127, 128 or 131 such interests are to be accounted for under FRS 139 - for example, derivatives on an interest in a subsidiary, associate or joint venture;
- leases accounted for under FRS 117, *Leases*, (although certain of FRS 139’s requirements apply to balances created under FRS 117 and derivatives embedded in leases);
- employer’s rights and obligations under employee benefit plans to which FRS 119, *Employee Benefits*, applies;
- financial instruments, contracts and obligations for share-based payment transactions accounted for under FRS 2, *Share-based Payment*;
- contracts for contingent consideration in a business combination (FRS 3, *Business Combinations*); and
- insurance contracts that fall within the scope of FRS 4, *Insurance Contracts*.

## 1.2 Definitions

- *Definitions (139.9)*

### **Financial asset**

A financial asset is defined as any asset that is:

- cash;
- a contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial instruments with another entity under conditions that are potentially favourable;
- an equity instrument of another entity; or
- a contract that will or may be settled in the entity’s own equity instruments and is:
  - 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
  - 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 shares.

**Financial liability**

A financial liability is defined as:

- a contractual obligation;
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial instruments with another entity under conditions that are potentially unfavourable; or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - 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
  - 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.

Deferred revenue and prepaid expenses generally are not financial instruments.

**Derivatives**

- *Derivatives are financial instruments whose value fluctuates depending on an underlying (139.9, 132 AG15 - 19)*

A derivative is a financial instrument that changes in value in response to an underlying share, interest rate etc. and creates the rights and obligations that usually have the effect of transferring between parties to the instrument one or more of the financial risks inherent in an underlying. For example, a share option allows the holder the option to benefit if the share price of the underlying share increases above the option's strike price, and places an obligation on the issuer of the option to supply the shares at the strike price, if the holder exercises the option. A key characteristic of derivatives is that they require little or no initial net investment and will be settled at a future date. Common examples are options, forwards and interest rate swaps.

- *Derivatives can be financial assets or financial liabilities (139.9)*

A derivative can be a financial asset or a financial liability depending on the direction of the changes in value of the underlying variables. That is, where a cumulative holding gain has been made through an increase in the fair value, the derivative will be a "financial asset"; whereas cumulative losses could result in the derivative becoming a liability.

**Embedded derivatives**

- *Embedded derivatives may need to be separated from the host contracts for accounting purposes (139.11, AG27 - 33, IG Section C)*

Derivatives may be "embedded" in a "host contract", such as the conversion option embedded in a convertible bond. Where a combined instrument is not carried at fair value with movements recognised directly through profit or loss, FRS 139 may require the embedded derivative to be separated from the host contract and accounted for as a stand-alone derivative. The application and implementation guidance to FRS 139 should be referred to when accounting for embedded derivatives, as it contains details on this area of FRS 139.

## 2. Classifications and their accounting treatments

### 2.1 Designation on initial recognition and subsequently

- *Classification is decided on initial recognition on an instrument-by-instrument basis (139.9)*

Under FRS 139, financial instruments are classified on initial recognition. In some cases entities have no choice and in others, choices may be made on an instrument-by-instrument basis.

The classifications are for the purposes of identifying the appropriate accounting treatment under FRS 139. They do not necessarily dictate the presentation on the face of the balance sheet. For example, there is no requirement to show a single category “loans and receivables” which includes all loans and receivables accounted for under that classification in FRS 139.

### 2.2 Accounting treatments applicable to each class

- *The classification of a financial instrument determines its subsequent measurement (139.45 - 47)*

The table below sets out a summary of the classifications available and the associated accounting treatments, followed by some discussion of the meaning of the various terms, and the impairment rules. These accounting treatments are summarised in a table in Appendix 1.

Available classifications		Measurement rules for each classification	Subject to impairment loss rules
<b>Financial assets</b>	Fair value through profit or loss	Fair value with changes in fair value recognised in profit or loss <sup>1</sup>	N/A
	Held to maturity investments	Amortised cost, using the effective interest method	Yes
	Loans and receivables	Amortised cost, using the effective interest method	Yes
	Available for sale	Fair value with changes in fair value recognised in equity <sup>1,2</sup>	Yes
<b>Financial liabilities</b>	Fair value through profit or loss	Fair value with changes in fair value recognised in profit or loss	N/A
	Other financial liabilities	Amortised cost, using the effective interest method	N/A

<sup>1</sup> Exceptions are equity investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured, and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments. These should be measured at cost (139.9, 46c).

<sup>2</sup> The part of any change in fair value attributable to interest income, calculated using the effective interest method, and/or the foreign exchange translation of a foreign currency of an available for sale debt investment is recognised in profit or loss, instead of in equity (139.55b, AG 83, 121.28).

### 2.3 Financial instruments at “fair value through profit or loss”

“Fair value through profit or loss” means that at each balance sheet date the asset or liability is re-measured to fair value and any movement in that fair value is taken directly to the income statement.

There are 2 reasons for carrying a financial asset or liability at “fair value through profit or loss” under FRS 139. These are that the instrument is either:

- held for trading; or
- designated as “fair value through profit or loss” on initial recognition.

- The “held for trading” category includes short term investments and all derivatives not held for hedging purposes or linked to certain unquoted equity instruments (139.9, 46c)

In the case of instruments “held for trading” the classification is not optional; if the financial asset or liability meets the definition of “held for trading” then it must be classified (and accounted for) as fair value through profit or loss.

A financial asset or financial liability is classified as held for trading if it is:

- acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- 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
- a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

- A financial instrument may be designated as fair value through profit or loss upon initial recognition only in limited circumstances (139.9, 139.11A)

In the case of designated as “fair value through profit or loss” on initial recognition, this is an option available to management for any financial asset or any financial liability (including, in theory, inter-company balances, bank loans, preference shares classified as liability if management so chose) on an instrument-by-instrument basis subject to situations set out below:

- when the designation results in more relevant information, because either:
  - it eliminates or significantly reduces an “accounting mismatch” arising from measuring assets or liabilities or recognising gains and losses on such instruments on different bases; or
  - a group of financial assets and/or financial liabilities is managed on a fair value basis, in accordance with a documented risk management or investment strategy, with information being provided to key management personnel on this basis; or
- when a contract contains one or more embedded derivatives - unless: (i) the embedded derivative does not significantly modify the cash flows of the host contract; or (ii) it is clear with little or no analysis that FRS 139 would prohibit separation of the embedded derivative.

The designation can be used if any one of the above situations applies. For example, if an accounting mismatch would be eliminated through use of the option it would not be necessary to demonstrate the existence of an embedded derivative or that the instruments are managed on a fair value basis.

- Subsequent reclassifications into or out of the “fair value through profit or loss” category are not allowed (139.50, BC73)

Note that subsequent reclassification into or out of the “fair value through profit or loss” category is not permitted i.e. the identification of a held for trading instrument, or the choice to be in or out of this category for other instruments, is made on initial recognition only, even if circumstances or management’s intentions later change. The reasons for this are discussed in the Basis for Conclusions to FRS 139.

## 2.4 “Held to maturity” investments

- “Held to maturity” investments are debt securities quoted in an active market (139.9)

Put simply, held to maturity investments (“HTM”) are quoted debt investments that the entity is able to and intends to hold until their fixed maturity date, provided the instrument has fixed or determinable payments. For example, a 5 year interest bearing bond quoted in an active market may be classified as held to maturity investment.

- Unquoted debt securities would be classified as “loans and receivables” (139.9)

The HTM definition is restricted to those that are quoted in an active market, since debt securities that are not quoted in an active market would instead meet the definition of “loans and receivables”.

- The classification of a financial asset as held to maturity is optional (139.9)

The classification of a financial asset as held to maturity is optional even if all the criteria are met. Alternatively, management has the choice investment-by-investment to classify the investment as “fair value through profit or loss” or “available for sale”.

- *There is a tainting rule for held to maturity investments with a mandatory 2 year time-out period (139.9)*

An entity is not allowed to classify any financial assets as held to maturity if more than an insignificant amount of held to maturity investments has been sold or reclassified before maturity, except in certain limited circumstances. This is often described as the “tainting rule”. The practical result of the portfolio being tainted is that the held to maturity investments will have to be classified as available for sale i.e. carried at fair value rather than at amortised cost.

The FRS 139 rule includes a 2 year time-out period i.e. an entity is not allowed to classify any financial assets as held to maturity if during the current financial year, or during the 2 preceding financial years, the portfolio has been tainted.

- *Held to maturity investments are carried at amortised cost (139.46b). This is the method already required in 118<sub>2004</sub> for interest income (118<sub>2004</sub> 31a)*

The main advantage of classifying financial assets as “held to maturity” is that the accounting treatment is amortised cost, rather than fair value, even though the debt instrument is quoted in an active market.

Amortised cost is a method of recognising the gross difference between the amount initially recognised, and the sum of all the expected cash flows while the instrument is held (including on maturity) using the effective interest method. This method calculates a single amount of “interest income” as the effective yield on the asset, ignoring any legal form descriptions such as “premium”, “discount”, “principal” or “interest” and is consistent with the method already required for interest income under FRS 118<sub>2004</sub>, *Revenue*.

## 2.5 "Loans and receivables"

- *Loans and receivables include both originated and purchased loans and receivables (139.9, AG26)*

Put simply, loans and receivables are also a form of debt with fixed or determinable payments. However, they may differ from held to maturity investments in one or more of the following respects:

- by definition, they are not quoted in an active market;
- they need not have a fixed maturity date; and
- even if they do have a fixed maturity date, management need not have the intention to hold them to maturity.

This category is not restricted to loans and receivables originated by the entity, but also include purchased loans and receivables. Common examples include trade receivables, loans made by the entity to others (including inter-company debit balances), and loan books acquired.

- *Loans and receivables are carried at amortised cost (139.46a)*

As with held to maturity investments, the main advantage of classifying financial assets as “loans and receivables” is that the accounting treatment is amortised cost, rather than fair value.

- *Impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (139.63)*

For short-lived debts, such as trade receivables on normal commercial terms, this simply means that they will be carried at the amount of the debt less any doubtful or bad debt allowances, as is currently practiced. It should be noted that FRS 139 changes the way an entity provides for doubtful debts. If the entity's existing practice is to provide based on the **expectation** that a certain percentage of sales or the receivables balance will ultimately be unrecoverable, it is **not acceptable**. However, if the entity provides based on historical information representing **actual incurred losses**, for example, a certain percentage of the receivables balance in each age category, it may be acceptable.

- *The effective interest method is a method of calculating amortised cost and allocating the interest income/expense over the relevant period (139.9)*

Where the debt has extended credit terms, for example it is a loan repayable in 1 year's time, as explained above, “amortised cost” is the form of accounting whereby interest income is recognised over the duration of the loan, by comparing total cash flows to original carrying amount and spreading the difference.

- *The classification of a financial asset as loans and receivables is optional (139.9)*

As with held to maturity investments, even if the criteria for classifying an asset as “loans and receivables” are met, such classification is optional. Alternatively, management may choose to classify them as “fair value through profit or loss” or “available for sale”.

## 2.6 "Available for sale"

- *“Available for sale” is a residual category (139.9)*

“Available for sale” (“AFS”) is the residual category for financial assets. That is, after management has determined that it is not required to classify the asset as “held for trading” and has either rejected, or the asset is not eligible for, the classifications of “fair value through profit or loss”, “held to maturity investments” or “loans and receivables”, the asset will be classified as “available for sale”.

- *The measurement basis is fair value, with movements taken to equity (139.46, 55b, AG83, 121.28)*

All assets included in this class are carried at fair value, but the movements in fair value are taken to equity (reserves) rather than the income statement. However, an impairment, or the part of any change in fair value attributable to interest income calculated using the effective interest method, and/or the foreign exchange translation of a foreign currency available for sale debt investment is recognised in profit or loss, instead of equity.

- *While the fair value of equity instruments cannot be reliably measured, these instruments, and derivatives linked to them, are carried at cost (139.9, 46c, 53, 55)*

An exception to the above are equity investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. These are measured at cost (less impairment loss, if any) until such time, if ever, that a reliable fair value becomes available. At this point the equity investments should be carried at fair value in the same way as other available for sale assets.

Any derivatives that are linked to and must be settled by delivery of such unquoted equity investments are also carried at cost until such time, if ever, that a reliable fair value for the equity instrument becomes available.

- *Common examples are non-trading equity securities and certain quoted debt securities*

Typically, AFS will include the following:

- non-trading equity investment securities, that the entity does not wish to carry at fair value through profit or loss or cannot reliably measure fair value; and
- non-trading quoted debt investment securities, that the entity does not intend to hold to maturity and does not wish to carry at fair value through profit or loss.

The AFS may also include debt securities that management does intend to hold to maturity, but cannot account for as such because management is subject to a 2 year time-out ban as a result of tainting the portfolio.

## 3. Other recognition and measurement issues

### 3.1 Initial recognition

- *Financial instruments are recognised initially at fair value plus, in some cases, transaction costs (139.43, AG13)*

The standard states that on initial recognition, financial instruments (i.e. both financial assets and liabilities) are recognised at fair value plus transaction costs. Transaction costs are incremental costs that are directly attributable to the acquisition or issue of the financial instrument. Financial instruments carried at fair value through profit or loss is an exception to this rule. In this case transaction costs are charged to the income statement as and when incurred.

- *Accounting for transaction costs in respect of borrowings (139 AG6)*

If the entity's current accounting policy for transaction costs, for example borrowing costs, is to record them as an expense in the income statement when incurred, the entity will need to revise its policy upon implementing FRS 139. FRS 139 requires such transaction costs to be capitalised when the borrowings are initially recorded. These transaction costs are then amortised to the income statement account as part of the recognition of effective interest over the expected repayment period.

- *In most cases, the fair value on initial recognition will be the transaction price (139 AG64 & 76)*

This initial recognition rule is different from those under other standards, which generally require the asset or liability to be recognised at cost (plus transaction costs), rather than fair value, and potentially this could lead to the recognition of a gain or loss on day 1 of the transaction. However, the guidance to FRS 139 is clear that instruments would only be recognised at other than transaction price if:

- the transaction was not at fair value; and
- the fair value of that instrument was evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets.

This means that in practice for most transactions carried out by non-financial institutions, there will be no need to consider whether the price negotiated represents fair value.

- *Staff loans and inter-company loans below market interest rates with or without fixed terms of repayment*

In the case of staff loans or inter-company loans at preferential interest rates, the fair value of the consideration given would not be the same as the actual cash given. Instead, the fair value of such loans is the present value of all future cash receipts using a market interest rate (estimated at the time of disbursement) for a similar loan. The discounting process will result in a present value that is lower than the amount given and the difference is not a financial asset. It should be expensed off in the income statement unless it qualifies for recognition as an asset under another applicable standard (for example FRS 138, *Intangible Assets*).

### 3.2 Fair value

- *The detailed rules in the application guidance to FRS 139 for establishing fair values should be followed (139.48, AG69 - 82)*

FRS 139 contains detailed guidance on the determination of fair value, focusing on how to determine fair value when there is an active market and when there is no active market, and also when fair value cannot be reliably measured. These rules should be followed, especially where they contain explicit statements concerning how to measure fair value.

- *If a financial instrument is quoted in an active market, the published price is the best estimate (139 AG71)*

For example, as mentioned above, on initial recognition, valuation techniques can only be used in certain specified circumstances. Also, the guidance is explicit that for subsequent measurement, if a financial instrument is quoted in an active market, the published quoted price is the best evidence of fair value. An example in the implementation guidance (E.2.2) makes it clear that as a consequence the market price cannot be adjusted in respect of a premium or discount even when valuing large holdings of securities.

- *Normally fair values can be measured reliably. If they cannot then the asset must be measured at cost (139.46c, AG80 - 81)*

There is a general presumption that fair value can be measured reliably for an asset that is purchased from an outside party, even after initial recognition. The only exception to this is for unquoted equity instruments and derivatives that are linked to, and must be settled by, delivery of such unquoted equity instrument where:

- the variability in the range of reasonable fair value estimates is significant for that instrument; and
- the probabilities of the various estimates within the range cannot be reasonably assessed.

For such situations, the financial instruments are required to be measured at cost, less impairment losses (if any).

### 3.3 Impairment of financial assets

- *Impairment testing only applies to financial assets not carried at fair value through profit or loss (139.46)*

If the asset is carried at fair value through profit or loss the issue of recognition of impairment losses is dealt with automatically under the accounting treatment i.e. all deficits and reversals of deficits are automatically recognised through the income statement.

In all other cases, i.e. if a financial asset is carried at amortised cost, or at fair value with movements taken to equity (i.e. the available for sale treatment), the issue of recognition and reversal of impairment losses arises.

- *The approach to impairment testing is consistent with FRS 136 in that it involves looking for indicators of impairment (139.58)*

Financial assets are outside the scope of FRS 136, *Impairment of Assets*. However, the approach to impairment testing for these assets under FRS 139 is generally consistent with FRS 136. That is, at each balance sheet date, the entity should assess whether there is objective evidence that a financial asset or group of financial assets, other than those classified as fair value through profit or loss, is impaired. If there is objective evidence of impairment, the recoverable amount of the financial asset is calculated and an impairment loss (i.e. the difference between the carrying amount and the recoverable amount) is recognised.

- *FRS 139 includes examples of objective evidence of impairment (139.59 - 62)*

FRS 139 contains guidance in respect of when there is objective evidence that a financial asset or group of financial assets is impaired, for example, the issuer or obligor experiencing significant financial difficulties, the disappearance of an active market because of financial difficulties; and adverse changes in the payment status of borrowers in the group. The standard also explicitly states that a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is objective evidence of impairment, though it does not define “significant” or “prolonged”.

- *The recoverable amount and the extent to which losses may be reversed, are determined differently from FRS 136 and also vary from one class of assets to another (139.58 - 70, BC125 - 130)*

However, the recoverable amount for the purpose of FRS 139 is not determined in the same way as required under FRS 136, nor is it determined in the same way from one class of financial assets to the next. In addition, the reversal of impairment losses booked is not allowed through profit and loss, except for debt instruments (i.e. loans and receivables, held to maturity or available for sale) and even then, only if the reversal can be objectively related to an event that occurred after the impairment loss was recognised. The reasons for this are discussed in the Basis for Conclusions to FRS 139.

Appendix 1 includes an overview of how the recoverable amount is determined and whether reversal of impairment is allowed for each classification of financial assets.

## 4. Derecognition

In addition to recognition requirements, FRS 139 also contains extensive provisions and rules for derecognising financial assets and financial liabilities i.e. for determining when these instruments may be taken off the balance sheet.

For straight forward business transactions, the application of these derecognition rules is not difficult. However, when there is complex transaction or arrangement (for example factoring of debts), the derecognition rules and guidance contained in FRS 139 need to be considered carefully when determining whether, and to what extent, the financial asset or liability should be derecognised.

### 4.1 Derecognition of financial assets

- *Derecognition rules for financial assets focus on the expiry or transfer of contractual rights to receive cash flows, risks and rewards and control of the financial asset (139.17 - 20)*

Financial assets are derecognised when the contractual rights to the cash flows expire. For example, for a loan this would generally be either when the entity has received the cash or it has waived the debt.

Financial assets can also be derecognised when the rights attached to the asset have not expired, and instead the asset has been transferred to another party. This aspect of derecognition is more complex and FRS 139 adopts a step by step approach to analysing whether, and to what extent, a financial asset should be derecognised in such circumstances. The step by step approach focuses on the following key aspects:

- whether there is a transfer of the financial asset (“the asset transfer test”); and
- whether substantially all the risks and rewards of ownership of the financial asset have been transferred (“the risks and rewards test”).

The general principles are that:

- if it passes both the asset transfer test and the risks and rewards test then the entity should derecognise the asset;
- if it fails the asset transfer test, then the asset is not derecognised; and
- if it passes the asset transfer test, but fails the risks and rewards test, the entity needs to consider whether the entity has retained control over the asset and, if so, what the extent of its continuing involvement in the asset is.

Each of the above mentioned issues are discussed in more detail below.

A flow chart illustrating the step by step approach adopted under FRS 139 for the derecognition of financial assets is reproduced in Appendix 2. The guidance on how to evaluate the concepts of risks and rewards and of control are included in paragraph AG36 of the application guidance to FRS 139.

### 4.2 Transfer of a financial asset

- *To qualify as a transfer, the contractual rights to receive the cash flows of the asset must have been transferred or the entity must be acting only as a collection agent (139.18 - 19)*

A transfer of a financial asset occurs when an entity transfers the contractual rights to receive the cash flows of the financial asset i.e. sells the asset.

In addition, a transfer may be achieved when an entity retains the contractual rights to receive the cash flows of a financial asset, if the entity has assumed a contractual obligation to pay the cash flows to other party or parties. This is subject to certain conditions concerning the future cash flows under the asset. These include that:

- the entity should not be required to pass on cash before it has received it from the asset;
- the cash received should be passed on without material delay; and

- the entity should be prohibited from selling or pledging the asset.

If such conditions are met the entity is in substance acting only as a collection agent.

### 4.3 Evaluation of risks and rewards

- *If the transfer rules have been satisfied, then risks and rewards need to be analysed (139.20)*

If it is determined that there is a transfer of a financial asset, an evaluation of the extent of the transfer of risks and rewards of ownership of the financial asset is then made. If substantially all risks and rewards have also been transferred, the financial asset is derecognised. On the other hand, if substantially all risks and rewards have been retained, the financial asset continues to be recognised.

The standard states that often it will be obvious whether the entity has transferred or retained substantially all the risks and rewards. This is determined by looking at the entity's exposure to variability in net cash flows from the asset before and after the transfer.

#### **Example:**

An entity sells (factors) its trade receivables at a discounted price. The entity continues to collect cash from its customers and to chase them when over-due. When it receives the cash it passes it over to the factor.

#### *Scenario A - the factor has no recourse to the entity for failure by the trade debtors to pay their debts*

Under this situation, the entity passes the asset transfer test as it is in substance acting only as the collection agent. It has also transferred all of the risks associated with the trade receivables through the non-recourse arrangement and is not exposed to any further variability in cash flows. Therefore, the trade receivables would be removed from the balance sheet.

If the servicing costs associated with collecting the debts were estimated to be material, then a portion of the proceeds should be set aside (i.e. as deferred income) to cover these expenses.

The discount accepted on the debts (being the carrying value of the debts prior to derecognition compared to the proceeds received, less provision for servicing (if any)), would be recognised immediately in the income statement.

#### *Scenario B - the factor has full recourse to the entity for failure by the trade debtors to pay their debts*

Under this situation, the entity also passes the asset transfer test by acting only as a collection agent. However, as the factor has full recourse to the entity, the entity has retained all of the risks associated with the trade receivables. Therefore, the trade receivables would be retained on the balance sheet and the proceeds received would be recognised as a liability. As and when the trade debtors settled, and the cash was passed over to the factor, the trade receivables and the liability would be reduced.

The discount accepted on the debts is in substance an interest expense on the proceeds received from the factor and would be recognised as such over the period of the arrangement.

- *If risks and rewards have been retained then the asset is not derecognised in full unless the entity has lost control over it (139.20)*

If the entity transfers some, but not substantially all, of the risks and rewards, then whether a financial asset should be derecognised depends on which party now has control over the asset (meaning the ability to sell it). If the entity no longer has control over the asset, then the asset is derecognised (and a gain or loss may arise on derecognition) and any net assets or liabilities created in the transfer are recognised. Otherwise, the asset remains recognised to the extent that the entity has continuing involvement in the asset. Examples of continuing involvement are given in the standard and include the entity guaranteeing the asset or having an option over the asset.

- *Detailed rules and guidance are in the standard and application guidance (139.20 - 23, 29 - 35, AG39 - 52)*

Applying these principles can appear complicated, especially while they are still unfamiliar. Lengthy detailed rules are set out in the standard and the application guidance to the standard contains extensive guidance. However, in practice, most disposals of financial assets will be derecognised by way of straightforward sale or cash settlement. The average non-financial institution is unlikely to have many, if any, transactions that need to be analysed beyond the asset transfer and risks and rewards tests.

#### 4.4 Derecognition of financial liabilities

- *A financial liability is derecognised when it is extinguished (139.39)*

A financial liability is derecognised when it is extinguished, i.e. when the debt has been paid off, or the entity's primary obligation specified in the contract is cancelled or has expired. This may be by way of the process of law or the creditor agreeing to release the entity from primary responsibility (for example, when the creditor agrees to the transfer of the liability to another party).

- *For the obligation to be extinguished the entity must either settle the obligation or be legally released from its primary responsibilities under the contract (139 AG57 - 63)*

If the entity is not legally released from the primary responsibility under the contract, then it cannot derecognise it, even if it has entered into a form of in-substance defeasance arrangement with a third party, i.e. cash has been paid to a third party (e.g. a trust) in exchange for their agreement to settle the entity's obligations to the creditor. In this way the derecognition of liabilities follows much more the legal form than the derecognition of assets.

An exchange of debt instruments with substantially different terms or a substantial modification of terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability at fair value. Gains or losses may arise on derecognition.

## 5. Embedded derivatives

In order to ensure that the general principle of measuring derivatives at fair value and reporting changes in fair value in the income statement is not avoided, a derivative that is attached to another item (a host contract) must be treated like a stand-alone derivative under certain conditions. Derivatives may be embedded in other financial instruments, for example, convertible bonds, or non-financial items such as contracts for the receipt or delivery of other goods or services.

- *An embedded derivative is a component of a hybrid instrument that also includes a non-derivative host contract (139.10)*

Derivatives are typically stand-alone instruments, but they may also be found as components embedded in a financial instrument or in a non-financial contract. A host contract may, for example, be a financial instrument, an insurance contract, a lease, a purchase agreement, a service agreement, a construction contract, a royalty agreement or a franchise agreement.

The component that is a derivative instrument is referred to as an embedded derivative. An embedded derivative is one or more implicit or explicit terms in a contract that affect the cash flows of the contract in a manner similar to a stand-alone derivative instrument. If a contract or set of contracts contains derivative features that may be transferred separately, they are not considered to be embedded derivatives, but rather freestanding derivatives. Such derivatives could be attached at inception or at a later stage by a party to the contract or by a third party.

### 5.1 When to separate embedded derivatives from host contracts

- *Separation required unless measured at fair value (139.11)*

Derivatives that are embedded in a host contract should be accounted for separately as derivatives if they are not closely related to the host contract, unless the hybrid (combined) instrument is measured at fair value with changes in fair value recognised directly in the income statement.

Fair value adjustments on available for sale instruments are reported directly in equity, therefore derivatives embedded in available for sale instruments are required to be separated if those derivatives are not closely related to the available for sale host contract.

Determining whether an embedded derivative is closely related to the host contract requires the nature of the host contract and the nature of the underlying of the derivative to be considered. If the nature of the underlying and the host contract are similar, then they are closely related.

- *Similar risk factors not necessarily closely related (139 AG30 & 33)*

However, a derivative instrument with similar risk factors to the host contract is not necessarily closely related to the host contract. For example:

- an equity host contract and an embedded equity index-linked derivative are not closely related unless they are both exposed to equity characteristics of the same entity;
- a debt host contract and a leveraged interest rate derivative are not closely related unless the effect of the leverage feature is immaterial;
- the derivative embedded in an inflation-indexed lease contract is closely related to the lease only if the inflation index relates to the same economic environment as the lease contract; and
- a leverage feature that is not insignificant always causes an embedded derivative feature not to be closely related.

Evaluating whether an embedded derivative is closely related requires identifying the nature of the host contract. If the host contract is a financial instrument, its nature may not be obvious because of the embedded derivative. A debt host is characterised by a fixed or determinable maturity and fixed or determinable payments, while an equity host contract gives the holder a residual interest in the net assets of the entity. For example, consider a 5 year “debt” instrument with a principal of one million which will be redeemed on a specified date at an amount equal to the principal plus the change in the fair value of 10,000 shares in a listed entity over the term of the instrument. Even though the redemption amount is linked to a listed entity’s share price, the instrument has a stated maturity and the host contract therefore has the nature of a debt instrument.

- *Not closely related (139 AG30)*

Examples of instruments that contain embedded derivatives that are not considered closely related to the host contract include:

- an investment in a note or bond that is (optionally or mandatorily) convertible into shares of the issuer, or another entity;
- an option to extend the remaining term of a debt instrument at an interest rate that is not the market rate at the time of extension;
- a call, put or prepayment option in a debt instrument that is exercisable at an amount other than the amortised cost of the instrument;
- equity or commodity-indexed principal or interest payments;
- an instrument that the holder has an option to put back to the issuer for an amount based on an equity or commodity price or index;
- an equity instrument that the issuer has an option to call (though only from the holder of the equity instrument); and
- an embedded credit derivative that allows the holder to transfer the credit risk of an asset to another party.

- *Closely related (139 AG33)*

Examples of embedded derivatives that are considered closely related to the host contract and therefore do not need to be separated include:

- a fixed rate note with an embedded fixed to floating swap;
- an option to extend the maturity of debt at market rates at the time of the extension;
- a call, put or prepayment option at amortised cost in a debt instrument;
- an embedded cap on an interest rate or the purchase price of an asset, provided that the cap is out of the money (i.e., the cap is at or above the market interest rate or price of the asset) when it is issued and is not leveraged. Similarly, separation is not required for an embedded floor on an interest rate or the purchase price of an asset, provided that the floor is out of the money (i.e., the floor is at or below the market interest rate or price of the asset) when it is issued and is not leveraged.

## 5.2 Foreign currency embedded derivatives

- *Foreign currency (139 AG33(d))*

Contracts denominated in a foreign currency give rise to an embedded derivative. This includes operating lease contracts, purchase or sale contracts and construction contracts.

An embedded foreign currency derivative is considered to be closely related if:

- the currency is the functional currency of one of the parties to the contract;
- the currency is routinely used in international commerce for that good or service (for example the US dollar for crude oil); or
- the currency is commonly used in business transactions in the economic environment in which the transaction takes place (for example the US dollar or Euro may be used for business transactions in a hyperinflationary economy).

Other embedded foreign currency derivatives are not considered closely related and should be separated.

For an embedded derivative to exist, the host contract should represent a contractual commitment. For example, forecast but uncommitted sales in a foreign currency, no matter how likely, would not give rise to an embedded derivative.

### 5.3 Accounting for separable embedded derivatives

- *Measure at fair value (139.46, 56, AG28)*

Separable embedded derivatives are required to be measured at fair value with all changes in fair value recognised in the income statement.

The initial bifurcation of a separable embedded derivative should not result in any gain or loss being recognised. The derivative initially should be measured at its fair value (which usually will be zero for a forward and something other than zero for an option). The remainder of the initial cost or issue proceeds should be allocated to the host contract.

### 5.4 Accounting for more than one embedded derivative

- *Treatment of multiple embedded derivatives depends on underlying risk factors (139 AG29)*

If a single host contract has multiple embedded derivatives, the embedded derivatives generally are evaluated together in determining whether to separate them. However, if the derivatives have different underlying risk exposures and are independent of each other, then they are evaluated separately. For example, a debt instrument may contain an option to choose the interest rate index on which interest is determined and the currency in which the principal is repaid. These are two distinct embedded derivative features with different underlying risk exposures, that should be evaluated separately.

## 6. Hedge accounting

- *Hedging arrangements involve a hedging instrument offsetting movements in a hedged item (139.9)*

A “hedge” under FRS 139 involves 2 components: a “hedging instrument” and a “hedged item”. Under an effective hedge, movements in the fair value or cash flows of the hedging instrument will offset equal and opposite movements in the hedged item. A simple example would be a foreign currency forward contract (the hedging instrument) taken out to hedge the movements in fair value in the reporting currency of a foreign currency debt (the hedged item).

Hedge accounting seeks to match the two halves of the hedging relationship, so as not to affect the income statement one-sidedly. However, as all trading instruments must be classified as fair value through profit or loss, and all other financial instruments may be carried at fair value through profit or loss (if their value can be estimated reliably), there is only a limited need for any particular rules in FRS 139 to cover hedging arrangement.

Application of hedge accounting is not mandatory and in principle can be chosen on a transaction-by-transaction basis. In determining whether and to what extent hedge accounting should be applied, entities may need to consider the possible trade-off between the cost of implementing hedge accounting (i.e. changes to systems and processes) and the potential volatility in reported earnings when hedge accounting is not applied.

- *There are 3 types of hedging arrangements (139.86)*

For the limited situations where special rules are needed to achieve the desired result, FRS 139 is very specific and extensive in its requirements. FRS 139 classifies hedging relationships into 3 categories:

- fair value hedges (the hedge of an exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such items). An example of a fair value hedge is a hedge of the interest rate risk of a fixed rate debt instrument, since the fair value of the debt will vary as market interest rates change;
- cash flow hedges (the hedge of an exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction, and could affect profit or loss). An example of a cash flow hedge is a hedge of the foreign currency risk of a forecasted sale transaction; and
- hedges of a net investment in a foreign operation.

The special hedge accounting rules are summarised in the table below:

<b>Fair value hedge</b>	<ul style="list-style-type: none"> <li>• The hedging instrument is measured at fair value, with fair value changes recognised in the income statement.</li> <li>• A hedged item otherwise carried at (amortised) cost is adjusted by the change in fair value that is attributable to the risk being hedged. This adjustment is recognised in the income statement to offset the effect of the gain or loss on the hedging instrument.</li> <li>• An AFS hedged item whose fair value changes are otherwise recognised in equity continues to be adjusted for fair value changes. However, the part of the fair value change that is attributable to the risk being hedged is recognised in the income statement rather than in equity.</li> </ul>
<b>Cash flow hedge</b>	<ul style="list-style-type: none"> <li>• The hedging instrument is measured at fair value (for a foreign currency hedging instrument that is not a derivative, this applies only to changes in exchange rates).</li> <li>• The change in fair value that relates to the effective part of the hedge is recognised directly in equity. The ineffective part and the fair value changes of the derivative that have been excluded by the entity's choice from the hedge relationship (e.g. time value of options and forward points of forward contracts) are recognised in the income statement.</li> </ul>

<b>Net investment hedge</b>	<ul style="list-style-type: none"> <li>• Gains and losses on a net investment in a foreign entity are recognised directly in equity.</li> <li>• Corresponding gains and losses on related foreign currency liabilities used as hedging instruments are also recognised directly in equity.</li> <li>• Any deferred foreign currency gains and losses are recognised in the income statement at the time of the disposal of the foreign entity.</li> </ul>
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- *Hedge accounting can be used only if certain strict criteria are met (139.88)*

The special hedge accounting rules for the above 3 types of hedges are only allowed to be used if all of the following strict criteria are met:

- the hedge is formally designated and documented at inception. Documentation would include a description of the entity’s risk management objective and strategy for undertaking the hedge, the nature of the risks being hedged, identification of the hedged item and hedging instrument, and how hedge effectiveness will be assessed;
- the hedge is expected to be highly effective (i.e. the actual results of the hedge are within a range of 80%-125% as explained in AG105);
- for cash flow hedges, the forecast transaction must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss;
- the effectiveness of the hedge can be reliably measured; and
- the hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the reporting periods.

- *Reference should always be made to the exact requirements and the guidance on their intended application*

The requirements in FRS 139 are detailed and complex and the standard should be referred to whenever hedge accounting is being considered. In particular, the implementation guidance to FRS 139 contains a significant amount of guidance and worked examples on hedge accounting, which should be referred to whenever there is hedging arrangement.

## 7. Transitional provisions

- *Prospective application is required for first-time adoption (139.103 - 103AA)*

FRS 139 is effective for annual periods beginning on or after 1 January 2006, i.e. they are first applicable to annual financial statements ending on 31 December 2006. It will also need to be applied in quarterly interim reports for any quarter within the annual financial period ending on or after 31 December 2006, for example a first quarter report for a 3 month period ending 31 March 2006.

A first-time adopter shall apply FRS 139 in accordance with paragraph 103AA. As a general principle, a first-time adopter is **not permitted** to apply the standard retrospectively and any recognition, derecognition, measurement, and hedge accounting policies followed prior to the effective date of FRS 139 is not reversed i.e. the financial statements are not restated.

In general, any difference between the carrying amount previously reported and the amount that would be recognised under FRS 139 at the date of first adoption is adjusted to retained earnings. For example:

- Financial assets and liabilities that qualify for recognition under FRS 139 should be measured in the opening balance sheet under FRS 139's relevant measurement rules (i.e. at fair value or amortised cost);
- Financial assets and liabilities that qualify for derecognition under FRS 139 should be removed from the opening balance sheet;
- Entities may choose at the date of adoption to designate any previously recognised financial asset or financial liability to be carried at fair value through profit or loss, or (in the case of assets) as available for sale, irrespective of the treatment prior to adoption of FRS 139; and
- Any financial assets that meet the definition of "held to maturity" at the date of first adoption of FRS 139 can be classified as such, without regard at that time to either the portfolio tainting rules or the 2 year time-out period under FRS 139.

Note that financial instruments that are to be stated at fair value at the balance sheet date under FRS 139 include:

- All derivatives not held for hedging purposes (unless they are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be measured reliably);
- All financial instruments (assets or liabilities) that are acquired and held for trading purposes; and
- Any other financial instruments (assets or liabilities) designated as "fair value through profit or loss" or "available for sale".

Therefore, fair values for these items will need to be identified for 1 January 2006 (or the first day of the accounting period of adoption if different) even though comparatives are not to be restated.

Also, the effect on carrying values at the date of adoption of new rules concerning initial recognition amounts, amortised cost calculations and impairments will need to be considered to the extent the effect could be material.

- *Separate rules apply for other than first-time adoption (139.103A - 108B)*

FRS 139 has separate rules for other than first-time adoption. The transitional provisions for other than first-time adoption require entities to apply the standard **retrospectively** except as specified in paragraphs 105 - 108A. The opening balance of retained earnings for the earliest prior period presented and all other comparative amounts should be adjusted as if the standard had always been in use unless restating the information would be impracticable.

## 8. Action to be taken in the first year of adoption

- *In view of the complexities of the requirements under FRS 139, entities are advised to start thinking about the effect of first adoption of this FRS*

In view of the complex accounting treatments required under FRS 139, many financial institutions have already started considering how these will affect them. However, this standard applies to all entities that have any form of financial instrument either on or off their balance sheets and we would advise every entity to think about how this FRS will affect the entity's financial reporting in 2006 and beyond sooner rather than later.

When considering the effect of FRS 139 in the first year of adoption, the analysis should cover both the following:

- establishing the ongoing policies that the entity will adopt under the new standard; and
- determining the effect of the transitional provisions on opening balances and comparatives.

In relation to the first issue mentioned above, it is also useful to start thinking about the following:

- The acceptability of current accounting policies under FRS 139, such as for:
  - measuring the carrying values of investments;
  - measuring all derivatives, except those held for hedging purposes, at fair value through profit or loss;
  - off-setting financial assets and liabilities;
  - keeping financial assets or liabilities off balance sheet.
- whether the entity wants to take advantage of any new choices of classification available under FRS 139; and
- identifying any hedging arrangements that do not meet FRS 139's requirements and taking the steps necessary to allow the entity to continue to use hedge accounting under FRS 139 for existing and future hedging transactions (e.g. by putting in place documentation and effectiveness testing) or preparing to discontinue the hedge accounting.

This is not an exhaustive list and it is important that each entity identifies the financial instruments that it is involved with and double-checks that it can meet the accounting requirements of the new standard.

## Appendix 1: Accounting treatment required for financial instruments under their required or chosen classification

Financial assets					
Nature (FRS 139.9)	Held for trading and/or non-hedging derivative*	Held to maturity criteria met**	Loans and receivables definition met**	Other financial assets *	
<b>Classifications</b> (FRS 139.9)	Held for trading	Held to maturity investments	Loans and receivables	Fair value through profit or loss	Available for sale investments
<b>Measurement</b>	Fair value with changes recognised in profit or loss (FRS 139.46, 55a)	Amortised cost, using the effective interest method, less impairment loss (FRS 139.46b)	Amortised cost, using the effective interest method, less impairment loss (FRS 139.46a)	Fair value with changes recognised in profit or loss (FRS 139.46, 55a)	Fair value with changes recognised in equity***, until the financial asset is impaired or derecognised, at which time the cumulative gain or loss recognised in equity should be transferred to profit or loss (FRS 139.46, 55b)
<b>Reclassification allowed?</b>	No (FRS 139.50)	Yes Must be reclassified as available for sale when: • There is change in intention or ability; or • Tainting rules triggered (FRS 139.51 - 52)	No (FRS 139.50)	No (FRS 139.50)	Yes May be reclassified as held to maturity investments when: • There is a change in intention or ability; or • Tainting rules expire (FRS 139.54)

\* Equity investments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured should be classified as “available for sale” and measured at cost less impairment loss (139.46c). To assess the impairment loss the recoverable amount is measured at the present value of estimated cash flows discounted at the current market rate of return for a similar financial asset (139.66). Impairment losses are recognised in profit or loss and cannot subsequently be reversed (139.66). If a reliable fair value subsequently becomes available, the investment must be carried at fair value with changes in fair value recognised in equity (139.53, 55). Any derivatives that are linked to and must be settled by delivery of such unquoted equity instruments should also be measured at cost less impairment loss until a reliable fair value of the unquoted equity instruments becomes available.

\*\* Alternatively, entities are permitted to designate these financial assets on initial recognition as “fair value through profit or loss” (provided that the designation results in more relevant information (139.9)) or “available for sale” if fair value can be reliably measured.

\*\*\* Any part of the change in fair value attributable to interest income, calculated using the effective interest method, and/or the foreign exchange translation of a monetary available for sale investment based on amortised cost is recognised in profit or loss instead of equity (139.55b, AG83, 121.28).

Appendix 1: Accounting treatment required for financial instruments under their required or chosen classification (cont'd)

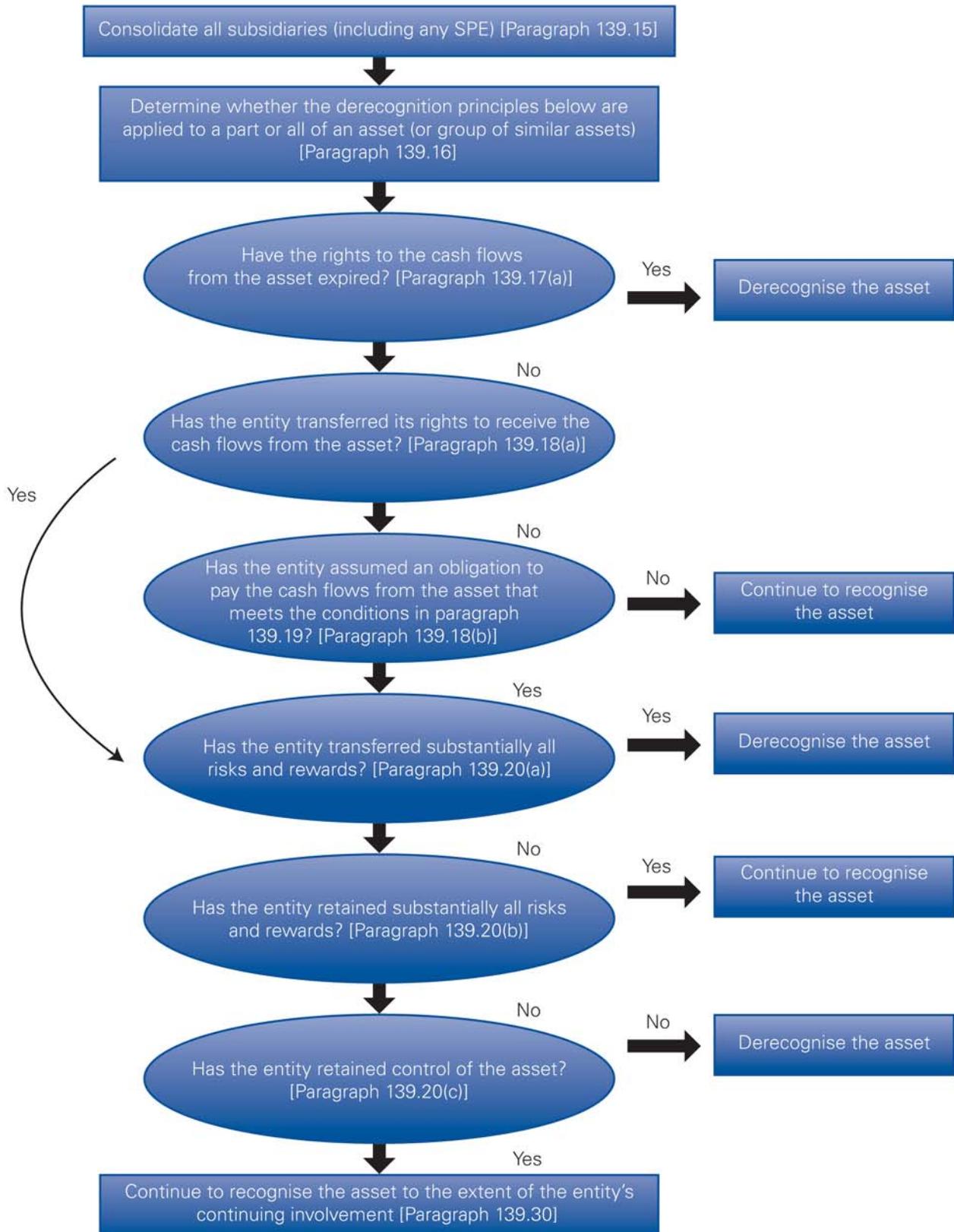
Financial assets (cont'd)					
Classifications (FRS 139.9)	Held for trading	Held to maturity investments	Loans and receivables	Fair value through profit or loss	Or Available for sale investments
Measurement of 'recoverable amount' for impairment testing (FRS 139.9)	N/A	Present value of estimated future cash flows (excluding future credit losses that have not been incurred), discounted at the asset's original effective interest rate (FRS 139.63)		N/A	Fair value (FRS 139.67)
Treatment of impairment loss	N/A	Recognised in profit or loss (FRS 139.63)		N/A	The cumulative loss is removed from equity and recognised in profit or loss (FRS 139.68)
Reversal of impairment loss through profit or loss allowed?	N/A	Yes (if the reversal can be related objectively to an event occurring after the impairment was recognised and to the extent that it does not result in the carrying amount exceeding the amortised cost that would have been had the impairment not been recognised)  (FRS 139.65)		N/A	Yes (for debt instruments if the increase in fair value can be objectively related to an event occurring after the impairment loss was recognised - FRS 139.70)  No (for equity instruments - FRS 139.66, 69)

Appendix 1: Accounting treatment required for financial instruments under their required or chosen classification  
(cont'd)

Financial liabilities		
<b>Nature (FRS 139.9)</b>	Held for trading and/or non-hedging derivative	Other financial liabilities
<b>Measurement</b>	Fair value with changes recognised in profit or loss (FRS 139.47a)	Fair value with changes recognised in profit or loss (FRS 139.47a) Or Amortised cost, using the effective interest method (FRS 139.47)
<b>Reclassification allowed?</b>	No (FRS 139.50)	No (FRS 139.50)

## Appendix 2: Derecognition of a financial asset

This flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised (AG36).



## Appendix 3: Financial Reporting Standards and accounting pronouncements

### The 21 new/revised Financial Reporting Standards

Standard	Title	Standard superseded	Formerly known as
FRS 1	First-time Adoption of Financial Reporting Standards	-	-
FRS 2	Share-based Payment	-	-
FRS 3	Business Combinations	FRS 122 <sub>2004</sub>	MASB 21
FRS 5	Non-current Assets Held for Sale and Discontinued Operations	FRS 135 <sub>2004</sub>	MASB 28
FRS 101	Presentation of Financial Statements	FRS 101 <sub>2004</sub>	MASB 1
FRS 102	Inventories	FRS 102 <sub>2004</sub>	MASB 2
FRS 108	Accounting Policies, Changes in Accounting Estimates and Errors	FRS 108 <sub>2004</sub>	MASB 3
FRS 110	Events After the Balance Sheet Date	FRS 110 <sub>2004</sub>	MASB 19
FRS 116	Property, Plant and Equipment	FRS 116 <sub>2004</sub>	MASB 15
FRS 117	Leases	FRS 117 <sub>2004</sub>	MASB 10
FRS 121	The Effects of Changes in Foreign Exchange Rates	FRS 121 <sub>2004</sub>	MASB 6
FRS 124	Related Party Disclosures	FRS 124 <sub>2004</sub>	MASB 8
FRS 127	Consolidated and Separate Financial Statements	FRS 127 <sub>2004</sub>	MASB 11
FRS 128	Investments in Associates	FRS 128 <sub>2004</sub>	MASB 12
FRS 131	Interests in Joint Ventures	FRS 131 <sub>2004</sub>	MASB 16
FRS 132	Financial Instruments: Disclosure and Presentation	FRS 132 <sub>2004</sub>	MASB 24
FRS 133	Earnings per Share	FRS 133 <sub>2004</sub>	MASB 13
FRS 136	Impairment of Assets	FRS 136 <sub>2004</sub>	MASB 23
FRS 138	Intangible Assets	-	-
FRS 139	Financial Instruments: Recognition and Measurement	-	-
FRS 140	Investment Property	FRS 125 <sub>2004</sub>	-

### The IC Interpretations

IC	Title
IC 107	Introduction of the Euro
IC 110	Government Assistance - No Specific Relation to Operating Activities
IC 112	Consolidation - Special Purpose Entities
IC 113	Jointly Controlled Entities - Non Monetary Contributions by Venturers
IC 115	Operating Leases - Incentives
IC 121	Income Taxes - Recovery of Revalued Non-Depreciable Assets
IC 125	Income Taxes - Changes in the Tax Status of an Entity or its Shareholders
IC 127	Evaluating the Substance of Transactions Involving the Legal Form of a Lease
IC 129	Disclosure - Service Concession Arrangements
IC 131	Revenue - Barter Transactions Involving Advertising Services
IC 132	Intangible Assets - Web Site Costs

## Appendix 3: Financial Reporting Standards and accounting pronouncements (cont'd)

### Other existing Financial Reporting Standards

Standard	Title	Formerly known as
FRS 104 <sub>2004</sub>	Depreciation Accounting	MASB 14
FRS 107 <sub>2004</sub>	Cash Flow Statements	MASB 5
FRS 109 <sub>2004</sub>	Research and Development Costs	MASB 4
FRS 111 <sub>2004</sub>	Construction Contracts	MASB 7
FRS 112 <sub>2004</sub>	Income Taxes	MASB 25
FRS 114 <sub>2004</sub>	Segment Reporting	MASB 22
FRS 118 <sub>2004</sub>	Revenue	MASB 9
FRS 119 <sub>2004</sub>	Employee Benefits	MASB 29
FRS 120 <sub>2004</sub>	Accounting for Government Grants and Disclosure of Government Assistance	MASB 31
FRS 123 <sub>2004</sub>	Borrowing Costs	MASB 27
FRS 126 <sub>2004</sub>	Accounting and Reporting by Retirement Benefit Plans	MASB 30
FRS 129 <sub>2004</sub>	Financial Reporting in Hyperinflationary Economies	IAS 29
FRS 134 <sub>2004</sub>	Interim Financial Reporting	MASB 26
FRS 137 <sub>2004</sub>	Provisions, Contingent Liabilities and Contingent Assets	MASB 20
FRS 201 <sub>2004</sub>	Property Development Activities	MASB 32
FRS 202 <sub>2004</sub>	General Insurance Business	MASB 17
FRS 203 <sub>2004</sub>	Life Insurance Business	MASB 18
FRS 204 <sub>2004</sub>	Accounting for Aquaculture	MAS 5
FRS i-1 <sub>2004</sub>	Presentation of Financial Statements of Islamic Financial Institutions	MASB i-1

Note: The subscript “2004” attached to the names of Financial Reporting Standards refers to standards issued by MASB prior to 1 January 2005. These standards will remain in force until they are revised as approved accounting standards.

When the standards are revised, the subscript “2004” would be removed. For example the Exposure Draft on the proposed improvement to FRS 101<sub>2004</sub>, *Presentation of Financial Statements*, when finalised would be called FRS 101, *Presentation of Financial Statements*.



## Contacts

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