

Supporting Papers November 2017

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Exposure Draft 62
August 24, 2017
Comments due: December 31, 2017

IPSAS®

*Proposed International Public Sector Accounting
Standard®*

Financial Instruments

IPSASB

International Public
Sector Accounting
Standards Board®

This document was developed and approved by the International Public Sector Accounting Standards Board® (IPSASB®).

The objective of the IPSASB is to serve the public interest by setting high-quality public sector accounting standards and by facilitating the adoption and implementation of these, thereby enhancing the quality and consistency of practice throughout the world and strengthening the transparency and accountability of public sector finances.

In meeting this objective the IPSASB sets IPSAS™ and Recommended Practice Guidelines (RPGs) for use by public sector entities, including national, regional, and local governments, and related governmental agencies.

IPSAS relate to the general purpose financial statements (financial statements) and are authoritative. RPGs are pronouncements that provide guidance on good practice in preparing general purpose financial reports (GPFRs) that are not financial statements. Unlike IPSAS RPGs do not establish requirements. Currently all pronouncements relating to GPFRs that are not financial statements are RPGs. RPGs do not provide guidance on the level of assurance (if any) to which information should be subjected.

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REQUEST FOR COMMENTS

This Exposure Draft, *Financial Instruments*, was developed and approved by the International Public Sector Accounting Standards Board® (IPSASB®).

The proposals in this Exposure Draft may be modified in light of comments received before being issued in final form. **Comments are requested by December 31, 2017.** The IPSASB stresses the importance of receiving comments prior to this date. The IPSASB cannot guarantee that late responses will be considered.

Respondents are asked to submit their comments electronically through the IPSASB website, using the [“Submit a Comment”](#) link. Please submit comments in both a PDF and Word file. Also, please note that first-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website. This publication may be downloaded from the IPSASB website: www.ipsasb.org. The approved text is published in the English language.

Objective of the Exposure Draft

The objective of this Exposure Draft is to propose improvements to the relevance, faithful representativeness and comparability of the information that a reporting entity provides in its financial statements about a financial instruments and their effects.

Development of the Exposure Draft

[Draft] IPSAS [X] (ED 62) is based on International Financial Reporting Standard (IFRS) 9, *Financial Instruments*, developed by the International Accounting Standards Board (IASB®). In developing [draft] IPSAS [X] (ED 62), the IPSASB applied its *Process for Reviewing and Modifying IASB Documents* which requires public sector modifications where appropriate.

The IPSASB reviewed IFRS 9, *Financial Instruments*, to determine whether there is a public sector issue that warrants departure, whether the guidance is inappropriate or inapplicable for the public sector. The IPSASB concluded that the authoritative IFRS 9 principles are appropriate for the public sector and that no significant departures from those principles were warranted. The IPSASB's review process resulted in a significant number of public sector terminology changes, the inclusion of public sector specific guidance and the addition of public sector specific examples.

This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring the unique features of the public sector are addressed.

Guide for Respondents

The IPSASB would welcome comments on all of the matters discussed in this Exposure Draft. The IPSASB is particularly interested in comments on the public sector specific guidance developed. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

The Specific Matters for Comment requested for the Exposure Draft are provided below.

Specific Matter for Comment 1:

Consistent with the relief provided in IFRS 9, the IPSASB has agreed in [draft] IPSAS [X] (ED 62) to allow an option for entities to continue to apply the IPSAS 29 hedging requirements. Do you agree with the IPSASB's proposal?

Specific Matter for Comment 2:

The IPSASB recognizes that transition to the new standard [draft] IPSAS [X] (ED 62) may present implementation challenges as a result of the number of significant changes proposed. Therefore, the IPSASB intends to provide a 3 year implementation period until [draft] IPSAS [X] (ED 62) is effective (early adoption will be permitted). Do you agree with the proposed 3-year implementation period before [draft] IPSAS [X] (ED 62) becomes mandatory? Please explain.

Specific Matter for Comment 3:

Do you agree with the proposed transition requirements in paragraphs 153-180, consistent with those provided in IFRS 9? If not, what specific changes do you recommend and why?

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

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Objective

1. The objective of this Standard is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.

Scope

2. **This Standard shall be applied by all entities to all types of financial instruments except:**
 - (a) **Those interests in controlled entities, associates and joint ventures that are accounted for in accordance with IPSAS 34 *Separate Financial Statements*, IPSAS 35 *Consolidated Financial Statements*, or IPSAS 36 *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 34, IPSAS 35 or IPSAS 36 require or permit an entity to account for an interest in a controlled entity, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a controlled entity, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in IPSAS 28 *Financial Instruments: Presentation*.**
 - (b) **Rights and obligations under leases to which IPSAS 13 *Leases* applies. However:**
 - (i) **Finance lease receivables (i.e. net investments in finance leases) and operating lease receivables recognized by a lessor are subject to the derecognition and impairment requirements of this Standard;**
 - (ii) **Lease liabilities recognized by a lessee are subject to the derecognition requirements in paragraph 35 of this Standard; and**
 - (iii) **Derivatives that are embedded in leases are subject to the embedded derivatives requirements of this Standard.**
 - (c) **Employers' rights and obligations under employee benefit plans, to which IPSAS 39 *Employee Benefits* applies.**
 - (d) **Financial instruments issued by the entity that meet the definition of an equity instrument in IPSAS 28 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS 28. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a).**
 - (e) **Rights and obligations arising under:**
 - (i) **An insurance contract, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9; or**
 - (ii) **A contract that is within the scope of relevant international or national accounting standard dealing with insurance contracts because it contains a discretionary participation feature.**

This Standard applies to a derivative that is embedded in a contract if the derivative is not itself an insurance contract (see paragraphs 47–53 and Appendix A paragraphs AG99–AG110 of this Standard). An entity applies this Standard to financial guarantee

contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them. Notwithstanding (i) above, an entity may apply this Standard to other insurance contracts which involve the transfer of financial risk.

- (f) Any forward contract between an acquirer and a selling shareholder to buy or sell an acquired operation that will result in a public sector combination to which IPSAS 40 applies at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.
 - (g) Loan commitments other than those loan commitments described in paragraph 4. However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan commitments are subject to the derecognition requirements of this Standard.
 - (h) Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share based payment applies, except for contracts within the scope of paragraphs 5–8 of this Standard to which this Standard applies.
 - (i) Rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognizes as a provision in accordance with IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it recognized a provision in accordance with IPSAS 19.
 - (j) The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions to which IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)* applies; except as described in AG6.
 - (k) Rights and obligations under service concession arrangements to which IPSAS 32, *Service Concession Assets: Grantor* applies. However, financial liabilities recognized by a grantor under the financial liability model are subject to the derecognition provisions of this Standard (see paragraphs 35–38 and Appendix A paragraphs AG39–AG47).
3. The impairment requirements of this Standard shall be applied to those rights arising from IPSAS 9 and IPSAS 23 transactions which give rise to financial instruments for the purposes of recognizing impairment gains or losses.
4. The following loan commitments are within the scope of this Standard:
- (a) Loan commitments that the entity designates as financial liabilities at fair value through surplus or deficit (see paragraph 46). An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.
 - (b) Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in installments (for

example, a mortgage construction loan that is paid out in installments in line with the progress of construction).

- (c) **Commitments to provide a loan at a below-market interest rate (see paragraph 45(d)).**
5. **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through surplus or deficit in accordance with paragraph 6.**
 6. **A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through surplus or deficit even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognizing that contract because it is excluded from the scope of this Standard (see paragraph 5).**
 7. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:
 - (a) When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
 - (b) When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
 - (c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
 - (d) When the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 5 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.
 8. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 7(a) or 7(d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or

delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Definitions

9. The following terms are used in this Standard with the meanings specified:

12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

The **amortized cost of a financial asset or financial liability** is the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

A **credit-impaired financial asset** is a financial asset that is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

- (a) Significant financial difficulty of the issuer or the borrower;
- (b) A breach of contract, such as a default or past due event;
- (c) The lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
- (d) It is becoming probable that the borrower will enter bankruptcy or other financial reorganization;
- (e) The disappearance of an active market for that financial asset because of financial difficulties; or
- (f) The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event—instead, the combined effect of several events may have caused financial assets to become credit-impaired.

Credit loss is the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

Credit-adjusted effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortized cost of a financial asset that is a purchased or originated credit-impaired financial asset. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and expected 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 (see paragraphs AG153–AG155), 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 reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Derecognition is the removal of a previously recognized financial asset or financial liability from an entity's statement of financial position.

A **derivative** is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

- (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (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 of contracts that would be expected to have a similar response to changes in market factors.
- (c) It is settled at a future date.

Dividends or similar distributions are distributions to holders of equity instruments in proportion to their holdings of a particular class of capital.

The **effective interest method** is the method that is used in the calculation of the amortized cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in surplus or deficit over the relevant period.

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortized cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected 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 (see paragraphs AG153–AG155), 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 reliably estimate the cash flows or the

expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

An expected credit loss is the weighted average of credit losses with the respective risks of a default occurring as the weights.

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

A financial liability at fair value through surplus or deficit is a financial liability that meets one of the following conditions:

- (a) It meets the definition of held for trading.
- (b) Upon initial recognition it is designated by the entity as at fair value through surplus or deficit in accordance with paragraph 46 or 51.
- (c) It is designated either upon initial recognition or subsequently as at fair value through surplus or deficit in accordance with paragraph 149.

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A forecast transaction is an uncommitted but anticipated future transaction.

The gross carrying amount of a financial asset is the amortized cost of a financial asset, before adjusting for any loss allowance.

The hedge ratio is the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

A held for trading financial instrument is a financial asset or financial liability that:

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

An impairment gain or loss is recognized in surplus or deficit in accordance with paragraph 78 and that arise from applying the impairment requirements in paragraphs 71–90.

Lifetime expected credit losses are the expected credit losses that result from all possible default events over the expected life of a financial instrument.

An loss allowance is the allowance for expected credit losses on financial assets measured in accordance with paragraph 40, lease receivables, the accumulated impairment amount for financial assets measured in accordance with paragraph 41 and the provision for expected credit losses on loan commitments and financial guarantee contracts.

A **modification gain or loss** is the amount arising from adjusting the gross carrying amount of a financial asset to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original effective interest rate (or the original credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 136. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the expected credit losses, unless the financial asset is a purchased or originated credit-impaired financial asset, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original credit-adjusted effective interest rate.

A financial asset is **past due** when a counterparty has failed to make a payment when that payment was contractually due.

A **purchased or originated credit-impaired financial asset** is credit-impaired on initial recognition.

The **reclassification date** is the first day of the first reporting period following the change in management model that results in an entity reclassifying financial assets.

A **regular way purchase or sale** is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph AG160). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument. The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Terms defined in other IPSAS are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately. The following terms are defined in either IPSAS 28 or IPSAS 30, *Financial Instruments: Disclosures*: credit risk¹, currency risk, liquidity risk, market risk, equity instrument, financial asset, financial instrument, financial liability and puttable instrument.

Recognition and Derecognition

Initial Recognition

10. An entity shall recognize a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument (see paragraphs AG15 and AG16). When an entity first recognizes a financial asset, it shall classify it in accordance with paragraphs 39–44 and measure it in accordance with

¹ This term (as defined in IPSAS 30) is used in the requirements for presenting the effects of changes in credit risk on liabilities designated as at fair value through surplus or deficit (see paragraph 105).

paragraphs 57 and 58. When an entity first recognizes a financial liability, it shall classify it in accordance with paragraphs 45 and 46 and measure it in accordance with paragraph 57.

Regular Way Purchase or Sale of Financial Assets

11. **A regular way purchase or sale of financial assets shall be recognized and derecognized, as applicable, using trade date accounting or settlement date accounting (see paragraphs AG17–AG20).**

Derecognition of Financial Assets

12. In consolidated financial statements, paragraphs 13–20, AG15, AG16 and AG21–AG38 are applied at a consolidated level. Hence, an entity first consolidates all controlled entities in accordance with IPSAS 35 and then applies those paragraphs to the resulting economic entity.
13. **Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 14–20, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.**
 - (a) **Paragraphs 14–20 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.**
 - (i) **The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 14–20 are applied to the interest cash flows.**
 - (ii) **The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of all cash flows of a debt instrument, paragraphs 14–20 are applied to 90 percent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.**
 - (iii) **The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of interest cash flows from a financial asset, paragraphs 14–20 are applied to 90 percent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.**
 - (b) **In all other cases, paragraphs 14–20 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 percent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 percent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer**

for any credit losses up to 8 percent of the principal amount of the receivables, paragraphs 14–20 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 14–23, the term ‘financial asset’ refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

14. **An entity shall derecognize a financial asset when, and only when:**
 - (a) The contractual rights to the cash flows from the financial asset expire or are waived, or
 - (b) It transfers the financial asset as set out in paragraphs 15 and 16 and the transfer qualifies for derecognition in accordance with paragraph 17.

(See paragraph 11 for regular way sales of financial assets.)
15. **An entity transfers a financial asset if, and only if, it either:**
 - (a) Transfers the contractual rights to receive the cash flows of the financial asset, or
 - (b) Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 16.
16. **When an entity retains the contractual rights to receive the cash flows of a financial asset (the ‘original asset’), but assumes a contractual obligation to pay those cash flows to one or more entities (the ‘eventual recipients’), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.**
 - (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
 - (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
 - (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IPSAS 2 *Cash Flow Statements*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.
17. **When an entity transfers a financial asset (see paragraph 15), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:**
 - (a) If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.

- (b) **If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognize the financial asset.**
 - (c) **If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:**
 - (i) **If the entity has not retained control, it shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.**
 - (ii) **If the entity has retained control, it shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 27).**
18. The transfer of risks and rewards (see paragraph 17) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g. because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (e.g., because the entity has sold a financial asset subject only to an option to buy it back at its *fair value* at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 16).
19. Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison are made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.
20. Whether the entity has retained control (see paragraph 17(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

Transfers that Qualify for Derecognition

21. **If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognize either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognized at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be**

recognized for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 24.

22. **If, as a result of a transfer, a financial asset is derecognized in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognize the new financial asset, financial liability or servicing liability at fair value.**
23. **On derecognition of a financial asset in its entirety, the difference between:**
 - (a) **The carrying amount (measured at the date of derecognition); and**
 - (b) **The consideration received (including any new asset obtained less any new liability assumed)**

shall be recognized in surplus or deficit.
24. **If the transferred asset is part of a larger financial asset (e.g., when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 13(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognized and the part that is derecognized, on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognized. The difference between:**
 - (a) **The carrying amount (measured at the date of derecognition) allocated to the part derecognized and**
 - (b) **The consideration received for the part derecognized (including any new asset obtained less any new liability assumed)**

shall be recognized in surplus or deficit.
25. When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognized and the part that is derecognized, the fair value of the part that continues to be recognized needs to be measured. When the entity has a history of selling parts similar to the part that continues to be recognized or other market transactions exist for such parts, recent prices of actual transactions provide the best estimate of its fair value. When there are no price quotes or recent market transactions to support the fair value of the part that continues to be recognized, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognized.

Transfers that do not Qualify for Derecognition

26. **If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognize the transferred asset in its entirety and shall recognize a financial liability for the consideration received. In subsequent periods, the entity shall recognize any revenue on the transferred asset and any expense incurred on the financial liability.**

Continuing Involvement in Transferred Assets

27. If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognize the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:
- (a) When the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').
 - (b) When the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in the case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG34).
 - (c) When the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.
28. When an entity continues to recognize an asset to the extent of its continuing involvement, the entity also recognizes an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:
- (a) The amortized cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortized cost; or
 - (b) Equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.
29. The entity shall continue to recognize any revenue arising on the transferred asset to the extent of its continuing involvement and shall recognize any expense incurred on the associated liability.
30. For the purpose of subsequent measurement, recognized changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 98, and shall not be offset.
31. If an entity's continuing involvement is in only a part of a financial asset (e.g. when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognize under continuing involvement, and the part it no

longer recognizes on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 25 apply. The difference between:

- (a) The carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognized; and
 - (b) The consideration received for the part no longer recognized shall be recognized in surplus or deficit.
32. If the transferred asset is measured at amortized cost, the option in this Standard to designate a financial liability as at fair value through surplus or deficit is not applicable to the associated liability.

All Transfers

33. If a transferred asset continues to be recognized, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any revenue arising from the transferred asset with any expense incurred on the associated liability (see paragraph 47 of IPSAS 28).
34. If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:
- (a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.
 - (b) If the transferee sells collateral pledged to it, it shall recognize the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.
 - (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the transferee shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.
 - (d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognize the collateral as an asset.

Derecognition of Financial Liabilities

35. An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—i.e., when the obligation specified in the contract is discharged, waived, cancelled or expires.
36. An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

37. **The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognized in surplus or deficit. Where an obligation is waived by the lender or assumed by a third party as part of a non-exchange transaction, an entity applies IPSAS 23.**
38. If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognized and the part that is derecognized based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognized and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognized shall be recognized in surplus or deficit.

Classification

Classification of Financial Assets

39. **Unless paragraph 44 applies, an entity shall classify financial assets as subsequently measured at amortized cost, fair value through net assets/equity or fair value through surplus or deficit on the basis of both:**
- (a) **The entity's management model for financial assets and**
 - (b) **The contractual cash flow characteristics of the financial asset.**
40. **A financial asset shall be measured at amortized cost if both of the following conditions are met:**
- (a) **The financial asset is held within a management model whose objective is to hold financial assets in order to collect contractual cash flows and**
 - (b) **The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

Paragraphs AG48–AG88 provide guidance on how to apply these conditions.

41. **A financial asset shall be measured at fair value through net assets/equity if both of the following conditions are met:**
- (a) **The financial asset is held within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets and**
 - (b) **The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

Paragraphs AG48–AG88 provide guidance on how to apply these conditions.

42. **For the purpose of applying paragraphs 40(b) and 41(b):**
- (a) **Principal is the fair value of the financial asset at initial recognition. Paragraph AG64 provides additional guidance on the meaning of principal.**
 - (b) **Interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. Paragraphs AG63 and**

AG67–AG71 provide additional guidance on the meaning of interest, including the meaning of the time value of money.

43. **A financial asset shall be measured at fair value through surplus or deficit unless it is measured at amortized cost in accordance with paragraph 40 or at fair value through net assets/equity in accordance with paragraph 41. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through surplus or deficit to present subsequent changes in fair value in net assets/equity (see paragraphs 103–104).**

Option to Designate a Financial Asset at Fair Value Through Surplus or Deficit

44. **Despite paragraphs 39–43, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through surplus or deficit if doing so 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 recognizing the gains and losses on them on different bases (see paragraphs AG91–AG94).**

Classification of Financial Liabilities

45. **An entity shall classify all financial liabilities as subsequently measured at amortized cost, except for:**
- (a) **Financial liabilities at fair value through surplus or deficit. Such liabilities, including derivatives that are liabilities, shall be subsequently measured at fair value.**
 - (b) **Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 26 and 28 apply to the measurement of such financial liabilities.**
 - (c) **Financial guarantee contracts. After initial recognition, an issuer of such a contract shall (unless paragraph 45(a) or (b) applies) subsequently measure it at the higher of:**
 - (i) **The amount of the loss allowance determined in accordance with paragraphs 71–90; and**
 - (ii) **The amount initially recognized (see paragraph 57) less, when appropriate, the cumulative amount of amortization recognized in accordance with the principles of IPSAS 9.**
 - (d) **Commitments to provide a loan at a below-market interest rate. An issuer of such a commitment shall (unless paragraph 45(a) applies) subsequently measure it at the higher of:**
 - (i) **The amount of the loss allowance determined in accordance with paragraphs 71–90; and**
 - (ii) **The amount initially recognized (see paragraph 57) less, when appropriate, the cumulative amount of amortization recognized in accordance with the principles of IPSAS 9.**
 - (e) **Contingent consideration recognized by an acquirer in a public sector combination to which IPSAS 40 applies. Such contingent consideration shall subsequently be measured at fair value with changes recognized in surplus or deficit.**

Option to Designate a Financial Liability at Fair Value Through Surplus or Deficit

46. **An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through surplus or deficit when permitted by paragraph 51, or when doing so results in more relevant information, because either:**
- (a) **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 recognizing the gains and losses on them on different bases (see paragraphs AG91–AG94); or**
 - (b) **A group of financial liabilities or financial assets and financial liabilities 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 IPSAS 20 *Related Party Disclosures*), for example, the entity’s governing body and chief executive officer (see paragraphs AG95–AG98).**

Embedded Derivatives

47. An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

Hybrid Contracts with Financial Asset Hosts

48. **If a hybrid contract contains a host that is an asset within the scope of this Standard, an entity shall apply the requirements in paragraphs 39–44 to the entire hybrid contract.**

Other Hybrid Contracts

49. **If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:**
- (a) **The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs AG103 and AG106);**
 - (b) **A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and**
 - (c) **The hybrid contract is not measured at fair value with changes in fair value recognized in surplus or deficit (i.e., a derivative that is embedded in a financial liability at fair value through surplus or deficit is not separated).**

50. **If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the statement of financial position.**
51. **Despite paragraphs 49 and 50, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through surplus or deficit unless:**
- (a) **The embedded derivative(s) do(es) 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 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 amortized cost.**
52. **If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through surplus or deficit.**
53. **If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, paragraph 52 applies and the hybrid contract is designated as at fair value through surplus or deficit.**

Reclassification

54. **When, and only when, an entity changes its management model for financial assets it shall reclassify all affected financial assets in accordance with paragraphs 39–43. See paragraphs 91–97, AG111–AG113 and AG217–AG218 for additional guidance on reclassifying financial assets.**
55. **An entity shall not reclassify any financial liability.**
56. **The following changes in circumstances are not reclassifications for the purposes of paragraphs 54–55:**
- (a) **An item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;**
 - (b) **An item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and**
 - (c) **Changes in measurement in accordance with paragraphs 149–152.**

Measurement

Initial Measurement

57. **At initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value**

through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

58. When an entity uses settlement date accounting for an asset that is subsequently measured at amortized cost, the asset is recognized initially at its fair value on the trade date (see paragraphs AG17–AG20).

Subsequent Measurement of Financial Assets

59. **After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 39–44 at:**
- (a) **Amortized cost;**
 - (b) **Fair value through net assets/equity; or**
 - (c) **Fair value through surplus or deficit.**
60. **An entity shall apply the impairment requirements in paragraphs 71–90 to financial assets that are measured at amortized cost in accordance with paragraph 40 and to financial assets that are measured at fair value through net assets/equity in accordance with paragraph 41.**
61. **An entity shall apply the hedge accounting requirements in paragraphs 134–140 (and, if applicable, paragraphs 99–105 of IPSAS 29 *Financial Instruments: Recognition and Measurement*) for the fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial asset that is designated as a hedged item.²**

Subsequent Measurement of Financial Liabilities

62. **After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 45–46.**
63. **An entity shall apply the hedge accounting requirements in paragraphs 134–140 (and, if applicable, paragraphs 99–105 of IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial liability that is designated as a hedged item.**

Fair Value Measurement Considerations

64. In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, IPSAS 28 or IPSAS 30, an entity shall apply paragraphs AG140–AG152 of Appendix A.
65. The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique

² In accordance with paragraph 175, an entity may choose as its accounting policy to continue to apply the hedge accounting requirements in IPSAS 29 instead of the requirements in paragraphs 110 - 152 of this Standard. If an entity has made this election, the references in this Standard to particular hedge accounting requirements in paragraphs 110 - 152 are not relevant. Instead the entity applies the relevant hedge accounting requirements in IPSAS 29.

commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data.

66. The fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Amortized Cost Measurement

Financial Assets

Effective Interest Method

67. **Interest revenue shall be calculated by using the *effective interest method* (see paragraphs 9 and AG153–AG159). This shall be calculated by applying the *effective interest rate* to the *gross carrying amount of a financial asset* except for:**
- (a) ***Purchased or originated credit-impaired financial assets.*** For those financial assets, the entity shall apply the *credit-adjusted effective interest rate* to the *amortized cost of the financial asset* from initial recognition.
 - (b) ***Financial assets that are not purchased or originated credit-impaired financial assets but subsequently have become credit-impaired financial assets.*** For those financial assets, the entity shall apply the *effective interest rate* to the *amortized cost of the financial asset* in subsequent reporting periods.
68. An entity that, in a reporting period, calculates interest revenue by applying the effective interest method to the amortized cost of a financial asset in accordance with paragraph 67(b), shall, in subsequent reporting periods, calculate the interest revenue by applying the effective interest rate to the gross carrying amount if the credit risk on the financial instrument improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to an event occurring after the requirements in paragraph 67(b) were applied (such as an improvement in the borrower's credit rating).

Modification of Contractual Cash Flows

69. When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognize a *modification gain or loss* in surplus or deficit. The gross carrying amount of the financial asset shall be recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 136. Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortized over the remaining term of the modified financial asset.

Write-off

70. An entity shall directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof. A write-off constitutes a derecognition event (see paragraph AG37(r)).

Impairment

Recognition of Expected Credit Losses

General Approach

71. **An entity shall recognize a loss allowance for expected credit losses on a financial asset that is measured in accordance with paragraphs 40 or 41, a lease receivable, or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2(g), 45(c) or 45(d).**
72. An entity shall apply the impairment requirements for the recognition and measurement of a loss allowance for financial assets that are measured at fair value through net assets/equity in accordance with paragraph 41. However, the loss allowance shall be recognized in net assets/equity and shall not reduce the carrying amount of the financial asset in the statement of financial position.
73. **Subject to paragraphs 83–86, at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition.**
74. The objective of the impairment requirements is to recognize lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.
75. **Subject to paragraphs 83–86, if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.**
76. For loan commitments and financial guarantee contracts, the date that the entity becomes a party to the irrevocable commitment shall be considered to be the date of initial recognition for the purposes of applying the impairment requirements.
77. If an entity has measured the loss allowance for a financial instrument at an amount equal to lifetime expected credit losses in the previous reporting period, but determines at the current reporting date that paragraph 73 is no longer met, the entity shall measure the loss allowance at an amount equal to 12-month expected credit losses at the current reporting date.
78. An entity shall recognize in surplus or deficit, as an *impairment gain or loss*, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognized in accordance with this Standard.

Determining Significant Increases in Credit Risk

79. At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of

the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.

80. An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date (see paragraphs AG183–AG185).
81. If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition. However, when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition. Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due. When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

Modified Financial Assets

82. If the contractual cash flows on a financial asset have been renegotiated or modified and the financial asset was not derecognized, an entity shall assess whether there has been a significant increase in the credit risk of the financial instrument in accordance with paragraph 73 by comparing:
 - (a) The risk of a default occurring at the reporting date (based on the modified contractual terms); and
 - (b) The risk of a default occurring at initial recognition (based on the original, unmodified contractual terms).

Purchased or Originated Credit-impaired Financial Assets

83. **Despite paragraphs 73 and 75, at the reporting date, an entity shall only recognize the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance for purchased or originated credit-impaired financial assets.**
84. At each reporting date, an entity shall recognize in surplus or deficit the amount of the change in lifetime expected credit losses as an impairment gain or loss. An entity shall recognize favourable changes in lifetime expected credit losses as an impairment gain, even if the lifetime expected credit losses are less than the amount of expected credit losses that were included in the estimated cash flows on initial recognition.

Simplified Approach for Receivables

85. **Despite paragraphs 73 and 75, an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for:**
- (a) **Receivables that result from exchange transactions that are within the scope of IPSAS 9 and non-exchange transactions within the scope of IPSAS 23.**
 - (b) **Lease receivables that result from transactions that are within the scope of IPSAS 13, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all lease receivables but may be applied separately to finance and operating lease receivables.**
86. An entity may select its accounting policy for trade receivables and lease receivables independently of each other.

Measurement of Expected Credit Losses

87. **An entity shall measure expected credit losses of a financial instrument in a way that reflects:**
- (a) **An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;**
 - (b) **The time value of money; and**
 - (c) **Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.**
88. When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.
89. The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.
90. However, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For such financial instruments, and only those financial instruments, the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

Reclassification of Financial Assets

91. **If an entity reclassifies financial assets in accordance with paragraph 54, it shall apply the reclassification prospectively from the *reclassification date*. The entity shall not restate any previously recognized gains, losses (including impairment gains or losses) or interest. Paragraphs 92–97 set out the requirements for reclassifications.**

92. If an entity reclassifies a financial asset out of the amortized cost measurement category and into the fair value through surplus or deficit measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortized cost of the financial asset and fair value is recognized in surplus or deficit.
93. If an entity reclassifies a financial asset out of the fair value through surplus or deficit measurement category and into the amortized cost measurement category, its fair value at the reclassification date becomes its new gross carrying amount. (See paragraph AG218 for guidance on determining an effective interest rate and a loss allowance at the reclassification date.)
94. If an entity reclassifies a financial asset out of the amortized cost measurement category and into the fair value through net assets/equity measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortized cost of the financial asset and fair value is recognized in net assets/equity. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph AG217.)
95. If an entity reclassifies a financial asset out of the fair value through net assets/equity measurement category and into the amortized cost measurement category, the financial asset is reclassified at its fair value at the reclassification date. However, the cumulative gain or loss previously recognized in net assets/equity is removed from net assets/equity and adjusted against the fair value of the financial asset at the reclassification date. As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortized cost. This adjustment affects net assets/equity but does not affect surplus or deficit and therefore is not a reclassification adjustment (see *IPSAS 1 Presentation of Financial Statements*). The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph AG217.)
96. If an entity reclassifies a financial asset out of the fair value through surplus or deficit measurement category and into the fair value through net assets/equity measurement category, the financial asset continues to be measured at fair value. (See paragraph AG218 for guidance on determining an effective interest rate and a loss allowance at the reclassification date.)
97. If an entity reclassifies a financial asset out of the fair value through net assets/equity measurement category and into the fair value through surplus or deficit measurement category, the financial asset continues to be measured at fair value. The cumulative gain or loss previously recognized in net assets/equity is reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see *IPSAS 1*) at the reclassification date.

Gains and Losses

98. A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognized in surplus or deficit unless:
 - (a) It is part of a hedging relationship (see paragraphs 134–140 and, if applicable, paragraphs 99–105 of *IPSAS 29* for the fair value hedge accounting for a portfolio hedge of interest rate risk);

- (b) It is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in net assets/equity in accordance with paragraph 103;
 - (c) It is a financial liability designated as at fair value through surplus or deficit and the entity is required to present the effects of changes in the liability's *credit risk* in net assets/equity in accordance with paragraph 105; or
 - (d) It is a financial asset measured at fair value through net assets/equity in accordance with paragraph 41 and the entity is required to recognize some changes in fair value in net assets/equity in accordance with paragraph 108.
99. Dividends or similar distributions are recognized in surplus or deficit only when:
- (a) The entity's right to receive payment of the dividend is established;
 - (b) It is probable that the economic benefits associated with the dividend will flow to the entity; and
 - (c) The amount of the dividend can be measured reliably.
100. A gain or loss on a financial asset that is measured at amortized cost and is not part of a hedging relationship (see paragraphs 134–140 and, if applicable, paragraphs 99-105 of IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognized in surplus or deficit when the financial asset is derecognized, reclassified in accordance with paragraph 92, through the amortization process or in order to recognize impairment gains or losses. An entity shall apply paragraphs 92 and 94 if it reclassifies financial assets out of the amortized cost measurement category. A gain or loss on a financial liability that is measured at amortized cost and is not part of a hedging relationship (see paragraphs 134–140 and, if applicable, paragraphs 99-105 of IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognized in surplus or deficit when the financial liability is derecognized and through the amortization process. (See paragraph AG221 for guidance on foreign exchange gains or losses.)
101. A gain or loss on financial assets or financial liabilities that are hedged items in a hedging relationship shall be recognized in accordance with paragraphs 134–140 and, if applicable, paragraphs 99-105 of IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk.
102. If an entity recognizes financial assets using settlement date accounting (see paragraphs 11, AG17 and AG20), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognized for assets measured at amortized cost. For assets measured at fair value, however, the change in fair value shall be recognized in surplus or deficit or in net assets/equity, as appropriate in accordance with paragraph 98. The trade date shall be considered the date of initial recognition for the purposes of applying the impairment requirements.

Investments in Equity Instruments

103. At initial recognition, an entity may make an irrevocable election to present in net assets/equity subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is neither *held for trading* nor contingent consideration recognized by an acquirer in a public sector combination. (See paragraph AG223 for guidance on foreign exchange gains or losses.)

104. If an entity makes the election in paragraph 103, it shall recognize in surplus or deficit dividends or similar distributions from that investment in accordance with paragraph 99.

Liabilities Designated as at Fair Value Through Surplus or Deficit

105. **An entity shall present a gain or loss on a financial liability that is designated as at fair value through surplus or deficit in accordance with paragraph 46 or paragraph 51 as follows:**
- (a) **The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in net assets/equity (see paragraphs AG233–AG240), and**
 - (b) **The remaining amount of change in the fair value of the liability shall be presented in surplus or deficit**
- unless the treatment of the effects of changes in the liability's credit risk described in (a) would create or enlarge an accounting mismatch in surplus or deficit (in which case paragraph 106 applies). Paragraphs AG225–AG227 and AG230–AG232 provide guidance on determining whether an accounting mismatch would be created or enlarged.**
106. **If the requirements in paragraph 105 would create or enlarge an accounting mismatch in surplus or deficit, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in surplus or deficit.**
107. Despite the requirements in paragraphs 105 and 106, an entity shall present in surplus or deficit all gains and losses on loan commitments and financial guarantee contracts that are designated as at fair value through surplus or deficit.

Assets Measured at Fair Value Through Net Assets/Equity

108. **A gain or loss on a financial asset measured at fair value through net assets/equity in accordance with paragraph 41 shall be recognized in net assets/equity, except for impairment gains or losses (see paragraphs 71–90) and foreign exchange gains and losses (see paragraphs AG221–AG222), until the financial asset is derecognized or reclassified. When the financial asset is derecognized the cumulative gain or loss previously recognized in net assets/equity is reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see IPSAS 1). If the financial asset is reclassified out of the fair value through net assets/equity measurement category, the entity shall account for the cumulative gain or loss that was previously recognized in net assets/equity in accordance with paragraphs 95 and 97. Interest calculated using the effective interest method is recognized in surplus or deficit.**
109. **As described in paragraph 108, if a financial asset is measured at fair value through net assets/equity in accordance with paragraph 41, the amounts that are recognized in surplus or deficit are the same as the amounts that would have been recognized in surplus or deficit if the financial asset had been measured at amortized cost.**

Hedge Accounting

Objective and Scope of Hedge Accounting

110. The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect surplus or deficit (or net assets/equity, in the case of investments in equity

instruments for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103). This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect.

111. An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in accordance with paragraphs 113–125 and AG241–AG271. For hedging relationships that meet the qualifying criteria, an entity shall account for the gain or loss on the hedging instrument and the hedged item in accordance with paragraphs 127–140 and AG291–AG318. When the hedged item is a group of items, an entity shall comply with the additional requirements in paragraphs 143–148 and AG330–AG345.
112. For a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge), an entity may apply the hedge accounting requirements in IPSAS 29 instead of those in this Standard. In that case, the entity must also apply the specific requirements for the fair value hedge accounting for a portfolio hedge of interest rate risk and designate as the hedged item a portion that is a currency amount (see paragraphs 91, 100 and AG157–AG175 of IPSAS 29).

Hedging Instruments

Qualifying Instruments

113. **A derivative measured at fair value through surplus or deficit may be designated as a hedging instrument, except for some written options (see paragraph AG244).**
114. **A non-derivative financial asset or a non-derivative financial liability measured at fair value through surplus or deficit may be designated as a hedging instrument unless it is a financial liability designated as at fair value through surplus or deficit for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in net assets/equity in accordance with paragraph 105. For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103.**
115. **For hedge accounting purposes, only contracts with a party external to the reporting entity (i.e., external to the economic entity or individual entity that is being reported on) can be designated as hedging instruments.**

Designation of Hedging Instruments

116. A qualifying instrument must be designated in its entirety as a hedging instrument. The only exceptions permitted are:
 - (a) Separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value (see paragraphs 141 and AG319–AG323);
 - (b) Separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; similarly, the foreign currency basis spread may be separated

and excluded from the designation of a financial instrument as the hedging instrument (see paragraphs 142 and AG324–AG329); and

- (c) A proportion of the entire hedging instrument, such as 50 percent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.
117. An entity may view in combination, and jointly designate as the hedging instrument, any combination of the following (including those circumstances in which the risk or risks arising from some hedging instruments offset those arising from others):
- (a) Derivatives or a proportion of them; and
 - (b) Non-derivatives or a proportion of them.
118. However, a derivative instrument that combines a written option and a purchased option (for example, an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option at the date of designation (unless it qualifies in accordance with paragraph AG244). Similarly, two or more instruments (or proportions of them) may be jointly designated as the hedging instrument only if, in combination, they are not, in effect, a net written option at the date of designation (unless it qualifies in accordance with paragraph AG244).

Hedged Items

Qualifying Items

119. **A hedged item can be a recognized asset or liability, an unrecognized *firm commitment*, a *forecast transaction* or a net investment in a foreign operation. The hedged item can be:**
- (a) **A single item; or**
 - (b) **A group of items (subject to paragraphs 143–148 and AG330–AG345).**
- A hedged item can also be a component of such an item or group of items (see paragraphs 125 and AG253–AG271).**
120. **The hedged item must be reliably measurable.**
121. **If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.**
122. **An aggregated exposure that is a combination of an exposure that could qualify as a hedged item in accordance with paragraph 119 and a derivative may be designated as a hedged item (see paragraphs AG249–AG250). This includes a forecast transaction of an aggregated exposure (i.e., uncommitted but anticipated future transactions that would give rise to an exposure and a derivative) if that aggregated exposure is highly probable and, once it has occurred and is therefore no longer forecast, is eligible as a hedged item.**
123. **For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting entity can be designated as hedged items. Hedge accounting can be applied to transactions between entities in the same economic entity only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the economic entity, except for:**

- (a) The consolidated financial statements of an investment entity, as defined in IPSAS 35, where transactions between an investment entity and its subsidiaries measured at fair value through surplus or deficit will not be eliminated in the consolidated financial statements; or
 - (b) The consolidated financial statements of a controlling entity of an investment entity, as defined in IPSAS 35, that is not itself an investment entity, where transactions between a controlled investment entity and the investments of a controlled investment entity measured at fair value through surplus or deficit will not be eliminated in the consolidated financial statements.
124. However, as an exception to paragraph 123, the foreign currency risk of an monetary item within an economic entity (for example, a payable/receivable between two controlled entities) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IPSAS 4 *The Effects of Changes in Foreign Exchange Rates*. In accordance with IPSAS 4, foreign exchange rate gains and losses on monetary items within an economic entity are not fully eliminated on consolidation when the monetary item is transacted between two entities within the economic entity that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated surplus or deficit.

Designation of Hedged Items

125. An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:
- (a) Only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable (see paragraphs AG254–AG261). Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).
 - (b) One or more selected contractual cash flows.
 - (c) Components of a nominal amount, i.e., a specified part of the amount of an item (see paragraphs AG262–AG266).

Qualifying Criteria for Hedge Accounting

126. **A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:**
- (a) **The hedging relationship consists only of eligible hedging instruments and eligible hedged items.**
 - (b) **At the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective**

and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the *hedge ratio*).

- (c) The hedging relationship meets all of the following hedge effectiveness requirements:
- (i) There is an economic relationship between the hedged item and the hedging instrument (see paragraphs AG275–AG277);
 - (ii) The effect of credit risk does not dominate the value changes that result from that economic relationship (see paragraphs AG278–AG279); and
 - (iii) The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognized or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs AG280–AG282).

Accounting for Qualifying Hedging Relationships

127. An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 126 (which include the entity's decision to designate the hedging relationship).
128. There are three types of hedging relationships:
- (a) **Fair value hedge:** a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect surplus or deficit.
 - (b) **Cash flow hedge:** a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognized asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect surplus or deficit.
 - (c) **Hedge of a net investment in a foreign operation as defined in IPSAS 4.**
129. If the hedged item is an equity instrument for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103, the hedged exposure referred to in paragraph 128(a) must be one that could affect net assets/equity. In that case, and only in that case, the recognized hedge ineffectiveness is presented in net assets/equity.
130. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or a cash flow hedge.
131. If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio (see paragraph (iii)) but the risk management objective for that designated hedging relationship remains the same, an entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again (this is referred to in this Standard as 'rebalancing'—see paragraphs AG297–AG311).

132. **An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes instances when the hedging instrument expires or is sold, terminated or exercised. For this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such a replacement or rollover is part of, and consistent with, the entity's documented risk management objective. Additionally, for this purpose there is not an expiration or termination of the hedging instrument if:**
- (a) **As a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organization' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organization or a client of a clearing member of a clearing organization, that are acting as a counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties the requirement in this subparagraph is met only if each of those parties effects clearing with the same central counterparty.**
 - (b) **Other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.**

Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship).

133. **An entity shall apply:**
- (a) **Paragraph 136 when it discontinues hedge accounting for a fair value hedge for which the hedged item is (or is a component of) a financial instrument measured at amortized cost; and**
 - (b) **Paragraph 138 when it discontinues hedge accounting for cash flow hedges.**

Fair Value Hedges

134. **As long as a fair value hedge meets the qualifying criteria in paragraph 126, the hedging relationship shall be accounted for as follows:**
- (a) **The gain or loss on the hedging instrument shall be recognized in surplus or deficit (or net assets/equity, if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103).**
 - (b) **The hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognized in surplus or deficit. If the hedged item is a financial asset (or a component thereof) that is measured at fair value through net assets/equity in accordance with paragraph 41, the hedging gain or loss on the hedged**

item shall be recognized in surplus or deficit. However, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103, those amounts shall remain in net assets/equity. When a hedged item is an unrecognized firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognized as an asset or a liability with a corresponding gain or loss recognized in surplus or deficit.

135. When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or the liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognized in the statement of financial position.
136. Any adjustment arising from paragraph 134(b) shall be amortized to surplus or deficit if the hedged item is a financial instrument (or a component thereof) measured at amortized cost. Amortization may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The amortization is based on a recalculated effective interest rate at the date that amortization begins. In the case of a financial asset (or a component thereof) that is a hedged item and that is measured at fair value through net assets/equity in accordance with paragraph 41, amortization applies in the same manner but to the amount that represents the cumulative gain or loss previously recognized in accordance with paragraph 134(b) instead of by adjusting the carrying amount.

Cash Flow Hedges

137. **As long as a cash flow hedge meets the qualifying criteria in paragraph 126, the hedging relationship shall be accounted for as follows:**
- (a) **The separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):**
 - (i) **The cumulative gain or loss on the hedging instrument from inception of the hedge; and**
 - (ii) **The cumulative change in fair value (present value) of the hedged item (i.e., the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.**
 - (b) **The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e., the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognized in net assets/equity.**
 - (c) **Any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognized in surplus or deficit.**
 - (d) **The amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:**
 - (i) **If a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from**

the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see IPSAS 1) and hence it does not affect net assets/equity.

- (ii) **For cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to surplus or deficit as a reclassification adjustment (see IPSAS 1) in the same period or periods during which the hedged expected future cash flows affect surplus or deficit (for example, in the periods that interest revenue or interest expense is recognized or when a forecast sale occurs).**
- (iii) **However, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into surplus or deficit as a reclassification adjustment (see IPSAS 1).**

138. When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 132 and 133(b)) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 137(a) as follows:

- (a) If the hedged future cash flows are still expected to occur, that amount shall remain in the cash flow hedge reserve until the future cash flows occur or until paragraph 137(d)(iii) applies. When the future cash flows occur, paragraph 137(d) applies.
- (b) If the hedged future cash flows are no longer expected to occur, that amount shall be immediately reclassified from the cash flow hedge reserve to surplus or deficit as a reclassification adjustment (see IPSAS 1). A hedged future cash flow that is no longer highly probable to occur may still be expected to occur.

Hedges of a Net Investment in a Foreign Operation

139. **Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IPSAS 4), shall be accounted for similarly to cash flow hedges:**

- (a) **The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in net assets/equity (see paragraph 137); and**
- (b) **The ineffective portion shall be recognized in surplus or deficit.**

140. **The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see IPSAS 1) in accordance with paragraphs 57–58 of IPSAS 4 on the disposal or partial disposal of the foreign operation.**

Accounting for the Time Value of Options

141. When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option (see paragraph 116(a)), it shall account for the time value of the option as follows (see paragraphs AG319–AG323):

- (a) An entity shall distinguish the time value of options by the type of hedged item that the option hedges (see paragraph AG319):
 - (i) A transaction related hedged item; or
 - (ii) A time-period related hedged item.
- (b) The change in fair value of the time value of an option that hedges a transaction related hedged item shall be recognized in net assets/equity to the extent that it relates to the hedged item and shall be accumulated in a separate component of net assets/equity. The cumulative change in fair value arising from the time value of the option that has been accumulated in a separate component of net assets/equity (the 'amount') shall be accounted for as follows:
 - (i) If the hedged item subsequently results in the recognition of a non-financial asset or a non-financial liability, or a firm commitment for a non-financial asset or a non-financial liability for which fair value hedge accounting is applied, the entity shall remove the amount from the separate component of net assets/equity and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see IPSAS 1) and hence does not affect net assets/equity.
 - (ii) For hedging relationships other than those covered by (i), the amount shall be reclassified from the separate component of net assets/equity to surplus or deficit as a reclassification adjustment (see IPSAS 1) in the same period or periods during which the hedged expected future cash flows affect surplus or deficit (for example, when a forecast sale occurs).
 - (iii) However, if all or a portion of that amount is not expected to be recovered in one or more future periods, the amount that is not expected to be recovered shall be immediately reclassified into surplus or deficit as a reclassification adjustment (see IPSAS 1).
- (c) The change in fair value of the time value of an option that hedges a time-period related hedged item shall be recognized in net assets/equity to the extent that it relates to the hedged item and shall be accumulated in a separate component of net assets/equity. The time value at the date of designation of the option as a hedging instrument, to the extent that it relates to the hedged item, shall be amortized on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect surplus or deficit (or net assets/equity, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103). Hence, in each reporting period, the amortization amount shall be reclassified from the separate component of net assets/equity to surplus or deficit as a reclassification adjustment (see IPSAS 1). However, if hedge accounting is discontinued for the hedging relationship that includes the change in intrinsic value of the option as the hedging instrument, the net amount (i.e., including cumulative amortization) that has been accumulated in the separate component of net assets/equity shall be immediately reclassified into surplus or deficit as a reclassification adjustment (see IPSAS 1).

Accounting for the Forward Element of Forward Contracts and Foreign Currency Basis Spreads of Financial Instruments

142. When an entity separates the forward element and the spot element of a forward contract and designates as the hedging instrument only the change in the value of the spot element of the forward

contract, or when an entity separates the foreign currency basis spread from a financial instrument and excludes it from the designation of that financial instrument as the hedging instrument (see paragraph 116(b)), the entity may apply paragraph 141 to the forward element of the forward contract or to the foreign currency basis spread in the same manner as it is applied to the time value of an option. In that case, the entity shall apply the application guidance in paragraphs AG324–AG329.

Hedges of a Group of Items

Eligibility of a Group of Items as the Hedged Item

143. **A group of items (including a group of items that constitute a net position; see paragraphs AG330–AG337) is an eligible hedged item only if:**

- (a) **It consists of items (including components of items) that are, individually, eligible hedged items;**
- (b) **The items in the group are managed together on a group basis for risk management purposes; and**
- (c) **In the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting risk positions arise:**
 - (i) **It is a hedge of foreign currency risk; and**
 - (ii) **The designation of that net position specifies the reporting period in which the forecast transactions are expected to affect surplus or deficit, as well as their nature and volume (see paragraphs AG336–AG337).**

Designation of a Component of a Nominal Amount

144. A component that is a proportion of an eligible group of items is an eligible hedged item provided that designation is consistent with the entity's risk management objective.

145. A layer component of an overall group of items (for example, a bottom layer) is eligible for hedge accounting only if:

- (a) It is separately identifiable and reliably measurable;
- (b) The risk management objective is to hedge a layer component;
- (c) The items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not significantly affected by which particular items from the overall group form part of the hedged layer);
- (d) For a hedge of existing items (for example, an unrecognized firm commitment or a recognized asset) an entity can identify and track the overall group of items from which the hedged layer is defined (so that the entity is able to comply with the requirements for the accounting for qualifying hedging relationships); and
- (e) Any items in the group that contain prepayment options meet the requirements for components of a nominal amount (see paragraph AG266).

Presentation

146. For a hedge of a group of items with offsetting risk positions (i.e., in a hedge of a net position) whose hedged risk affects different line items in the statement of surplus or deficit and net assets/equity, any hedging gains or losses in that statement shall be presented in a separate line from those affected by the hedged items. Hence, in that statement the amount in the line item that relates to the hedged item itself (for example, revenue or expenses) remains unaffected.
147. For assets and liabilities that are hedged together as a group in a fair value hedge, the gain or loss in the statement of financial position on the individual assets and liabilities shall be recognized as an adjustment of the carrying amount of the respective individual items comprising the group in accordance with paragraph 134(b).

Nil Net Positions

148. When the hedged item is a group that is a nil net position (i.e., the hedged items among themselves fully offset the risk that is managed on a group basis), an entity is permitted to designate it in a hedging relationship that does not include a hedging instrument, provided that:
- (a) The hedge is part of a rolling net risk hedging strategy, whereby the entity routinely hedges new positions of the same type as time moves on (for example, when transactions move into the time horizon for which the entity hedges);
 - (b) The hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity uses eligible hedging instruments to hedge the net risk (i.e., when the net position is not nil);
 - (c) Hedge accounting is normally applied to such net positions when the net position is not nil and it is hedged with eligible hedging instruments; and
 - (d) Not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes, because the accounting would not recognize the offsetting risk positions that would otherwise be recognized in a hedge of a net position.

Option to Designate a Credit Exposure as Measured at Fair Value Through Surplus or Deficit*Eligibility of Credit Exposures for Designation at Fair Value Through Surplus or Deficit*

149. **If an entity uses a credit derivative that is measured at fair value through surplus or deficit to manage the credit risk of all, or a part of, a financial instrument (credit exposure) it may designate that financial instrument to the extent that it is so managed (i.e., all or a proportion of it) as measured at fair value through surplus or deficit if:**
- (a) **The name of the credit exposure (for example, the borrower, or the holder of a loan commitment) matches the reference entity of the credit derivative ('name matching'); and**
 - (b) **The seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.**

An entity may make this designation irrespective of whether the financial instrument that is managed for credit risk is within the scope of this Standard (for example, an entity may designate loan commitments that are outside the scope of this Standard). The entity may

designate that financial instrument at, or subsequent to, initial recognition, or while it is unrecognized. The entity shall document the designation concurrently.

Accounting for Credit Exposures Designated at Fair Value Through Surplus or Deficit

150. If a financial instrument is designated in accordance with paragraph 149 as measured at fair value through surplus or deficit after its initial recognition, or was previously not recognized, the difference at the time of designation between the carrying amount, if any, and the fair value shall immediately be recognized in surplus or deficit. For financial assets measured at fair value through net assets/equity in accordance with paragraph 41, the cumulative gain or loss previously recognized in net assets/equity shall immediately be reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see IPSAS 1).
151. An entity shall discontinue measuring the financial instrument that gave rise to the credit risk, or a proportion of that financial instrument, at fair value through surplus or deficit if:
- (a) The qualifying criteria in paragraph 149 are no longer met, for example:
 - (i) The credit derivative or the related financial instrument that gives rise to the credit risk expires or is sold, terminated or settled; or
 - (ii) The credit risk of the financial instrument is no longer managed using credit derivatives. For example, this could occur because of improvements in the credit quality of the borrower or the loan commitment holder or changes to capital requirements imposed on an entity; and
 - (b) The financial instrument that gives rise to the credit risk is not otherwise required to be measured at fair value through surplus or deficit (i.e. the entity's management model has not changed in the meantime so that a reclassification in accordance with paragraph 54 was required).
152. When an entity discontinues measuring the financial instrument that gives rise to the credit risk, or a proportion of that financial instrument, at fair value through surplus or deficit, that financial instrument's fair value at the date of discontinuation becomes its new carrying amount. Subsequently, the same measurement that was used before designating the financial instrument at fair value through surplus or deficit shall be applied (including amortization that results from the new carrying amount). For example, a financial asset that had originally been classified as measured at amortized cost would revert to that measurement and its effective interest rate would be recalculated based on its new gross carrying amount on the date of discontinuing measurement at fair value through surplus or deficit.

Effective Date and Transition

Effective Date

153. **An entity shall apply this Standard for annual periods beginning on or after [DD/MM/YYYY]. Earlier application is permitted. If an entity elects to apply this Standard early, it must disclose that fact and apply all of the requirements in this Standard at the same time (but see also paragraph 175). It shall also, at the same time, apply the amendments in Appendix D.**

Transition

154. **An entity shall apply this Standard retrospectively, in accordance with IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 157–180. This Standard shall not be applied to items that have already been derecognized at the date of initial application.**
155. **For the purposes of the transition provisions in paragraphs 154, 156–180, the date of initial application is the date when an entity first applies those requirements of this Standard and must be the beginning of a reporting period after the issue of this Standard.**

Transition for Classification and Measurement

156. **At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraphs 40(a) or 41(a) on the basis of the facts and circumstances that exist at that date. The resulting classification shall be applied retrospectively irrespective of the entity's management model in prior reporting periods.**
157. **If, at the date of initial application, it is impracticable (as defined in IPSAS 3) for an entity to assess a modified time value of money element in accordance with paragraphs AG68–AG70 on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the requirements related to the modification of the time value of money element in paragraphs AG68–AG70. (See also paragraph 49R of IPSAS 30.)**
158. **If, at the date of initial application, it is impracticable (as defined in IPSAS 3) for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraph AG74(c) on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph AG74. (See also paragraph 49S of IPSAS 30.)**
159. **If an entity measures a hybrid contract at fair value in accordance with paragraphs 41, 43 or 44 but the fair value of the hybrid contract had not been measured in comparative reporting periods, the fair value of the hybrid contract in the comparative reporting periods shall be the sum of the fair values of the components (i.e., the non-derivative host and the embedded derivative) at the end of each comparative reporting period if the entity restates prior periods (see paragraph 169).**
160. **If an entity has applied paragraph 159 then at the date of initial application the entity shall recognize any difference between the fair value of the entire hybrid contract at the date of initial application and the sum of the fair values of the components of the hybrid contract at the date of initial application in the opening accumulated surplus or deficit (or other component of net assets/equity, as appropriate) of the reporting period that includes the date of initial application.**
161. **At the date of initial application an entity may designate:**

- (a) **A financial asset as measured at fair value through surplus or deficit in accordance with paragraph 44; or**
- (b) **An investment in an equity instrument as at fair value through net assets/equity in accordance with paragraph 103.**

Such a designation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

162. At the date of initial application an entity:

- (a) **Shall revoke its previous designation of a financial asset as measured at fair value through surplus or deficit if that financial asset does not meet the condition in paragraph 44.**
- (b) **May revoke its previous designation of a financial asset as measured at fair value through surplus or deficit if that financial asset meets the condition in paragraph 44.**

Such a revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

163. At the date of initial application, an entity:

- (a) **May designate a financial liability as measured at fair value through surplus or deficit in accordance with paragraph 46(a).**
- (b) **Shall revoke its previous designation of a financial liability as measured at fair value through surplus or deficit if such designation was made at initial recognition in accordance with the condition now in paragraph 46(a) and such designation does not satisfy that condition at the date of initial application.**
- (c) **May revoke its previous designation of a financial liability as measured at fair value through surplus or deficit if such designation was made at initial recognition in accordance with the condition now in paragraph 46(a) and such designation satisfies that condition at the date of initial application.**

Such a designation and revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

164. If it is impracticable (as defined in IPSAS 3) for an entity to apply retrospectively the effective interest method, the entity shall treat:

- (a) **The fair value of the financial asset or the financial liability at the end of each comparative period presented as the gross carrying amount of that financial asset or the amortized cost of that financial liability if the entity restates prior periods; and**
- (b) **The fair value of the financial asset or the financial liability at the date of initial application as the new gross carrying amount of that financial asset or the new amortized cost of that financial liability at the date of initial application of this Standard.**

165. If an entity previously accounted at cost (in accordance with IPSAS 29), for an investment in an equity instrument that does not have a quoted price in an active market for an identical instrument (i.e., a Level 1 input) (or for a derivative asset that is linked to and must be settled by delivery of such an equity instrument) it shall measure that instrument at fair value at the

date of initial application. Any difference between the previous carrying amount and the fair value shall be recognized in the opening accumulated surplus or deficit (or other component of net assets/equity, as appropriate) of the reporting period that includes the date of initial application.

166. If an entity previously accounted for a derivative liability that is linked to, and must be settled by, delivery of an equity instrument that does not have a quoted price in an active market for an identical instrument (i.e., a Level 1 input) at cost in accordance with IPSAS 29, it shall measure that derivative liability at fair value at the date of initial application. Any difference between the previous carrying amount and the fair value shall be recognized in the opening net assets/equity of the reporting period that includes the date of initial application.
167. At the date of initial application, an entity shall determine whether the treatment in paragraph 105 would create or enlarge an accounting mismatch in surplus or deficit on the basis of the facts and circumstances that exist at the date of initial application. This Standard shall be applied retrospectively on the basis of that determination.
168. At the date of initial application, an entity is permitted to make the designation in paragraph 6 for contracts that already exist on the date but only if it designates all similar contracts. The change in the net assets resulting from such designations shall be recognized in net assets/equity at the date of initial application.
169. Despite the requirement in paragraph 154, an entity that adopts the classification and measurement requirements of this Standard (which include the requirements related to amortized cost measurement for financial assets and impairment in paragraphs 67–70 and paragraphs 71–90) shall provide the disclosures set out in paragraphs 49L–49O of IPSAS 30 but need not restate prior periods. The entity may restate prior periods if, and only if, it is possible without the use of hindsight. If an entity does not restate prior periods, the entity shall recognize any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening accumulated surplus or deficit (or other component of net assets/equity, as appropriate) of the annual reporting period that includes the date of initial application. However, if an entity restates prior periods, the restated financial statements must reflect all of the requirements in this Standard
170. If an entity prepares interim financial reports, the entity need not apply the requirements in this Standard to interim periods prior to the date of initial application if it is impracticable (as defined in IPSAS 3).

Impairment

171. An entity shall apply the impairment requirements in paragraphs 71–90 retrospectively in accordance with IPSAS 3 subject to paragraphs 169 and 172–174.
172. At the date of initial application, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that a financial instrument was initially recognized (or for loan commitments and financial guarantee contracts at the date that the entity became a party to the irrevocable commitment in accordance with paragraph 76) and compare that to the credit risk at the date of initial application of this Standard.

173. **When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:**
- (a) **The requirements in paragraphs 80 and AG183–AG185; and**
 - (b) **The rebuttable presumption in paragraph 81 for contractual payments that are more than 30 days past due if an entity will apply the impairment requirements by identifying significant increases in credit risk since initial recognition for those financial instruments on the basis of past due information.**
174. **If, at the date of initial application, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, an entity shall recognize a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognized (unless that financial instrument is low credit risk at a reporting date, in which case paragraph 173(a) applies).**

Transition for Hedge Accounting

175. **When an entity first applies this Standard, it may choose as its accounting policy to continue to apply the hedge accounting requirements of IPSAS 29 instead of the requirements in paragraphs 110 - 152 of this Standard. An entity shall apply that policy to all of its hedging relationships. An entity that chooses that policy shall also apply Appendix C of IPSAS 29.**
176. **Except as provided in paragraph 180, an entity shall apply the hedge accounting requirements of this Standard prospectively.**
177. **To apply hedge accounting from the date of initial application of the hedge accounting requirements of this Standard, all qualifying criteria must be met as at that date.**
178. **Hedging relationships that qualified for hedge accounting in accordance with IPSAS 29 that also qualify for hedge accounting in accordance with the criteria of this Standard (see paragraph 126), after taking into account any rebalancing of the hedging relationship on transition (see paragraph 179(b)), shall be regarded as continuing hedging relationships.**
179. **On initial application of the hedge accounting requirements of this Standard, an entity:**
- (a) **May start to apply those requirements from the same point in time as it ceases to apply the hedge accounting requirements of IPSAS 29; and**
 - (b) **Shall consider the hedge ratio in accordance with IPSAS 29 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship, if applicable. Any gain or loss from such a rebalancing shall be recognized in surplus or deficit.**
180. **As an exception to prospective application of the hedge accounting requirements of this Standard, an entity:**
- (a) **Shall apply the accounting for the time value of options in accordance with paragraph 141 retrospectively if, in accordance with IPSAS 29, only the change in an option's intrinsic value was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.**
 - (b) **May apply the accounting for the forward element of forward contracts in accordance with paragraph 142 retrospectively if, in accordance with IPSAS 29, only the change in**

the spot element of a forward contract was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. In addition, if an entity elects retrospective application of this accounting, it shall be applied to all hedging relationships that qualify for this election (i.e., on transition this election is not available on a hedging-relationship-by-hedging-relationship basis). The accounting for foreign currency basis spreads (see paragraph 142) may be applied retrospectively for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.

- (c) Shall apply retrospectively the requirement of paragraph 132 that there is not an expiration or termination of the hedging instrument if:
 - (i) As a consequence of laws or regulations, or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties; and
 - (ii) Other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty.

Application Guidance

This Appendix is an integral part of [draft] IPSAS [X] (ED 62)

Scope

- AG1. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as ‘weather derivatives’.) If those contracts are not *insurance contracts*, they are within the scope of this Standard.
- AG2. This Standard does not change the requirements relating to employee benefit plans that comply with the relevant international or national accounting standard on accounting and reporting by retirement benefit plans and royalty agreements based on the volume of sales or service revenues that are accounted for under IPSAS 9.
- AG3. Sometimes, an entity makes what it views as a ‘strategic investment’ in equity instruments issued by another entity, with the management model of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor or joint venturer entity uses IPSAS 36 *Investments in Associates and Joint Ventures* to determine whether the equity method of accounting shall be applied to such an investment.
- AG4. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise from insurance contracts.

An entity does however apply this Standard to:

- Financial guarantee contracts, except those where the issuer elects to treat such contracts as insurance contracts in accordance with IPSAS 28; and
- Embedded derivatives included in insurance contracts.

An entity may, but is not required to, apply this Standard to other insurance contracts that involve the transfer of financial risk.

- AG5. Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):
- (a) Although a financial guarantee contract meets the definition of an insurance contract in IFRS 4 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, an entity may elect, under certain circumstances, to treat financial guarantee contracts as insurance contracts of financial instruments using IPSAS 28 if the issuer has previously adopted an accounting policy that treated financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or the relevant international or national accounting standard on insurance contracts to such financial guarantee contracts. If this Standard applies, paragraph 57 requires the issuer to recognize a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm’s length

transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through surplus or deficit or unless paragraphs 26–34 and AG32–AG38 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

- (i) The amount determined in accordance with paragraphs 71–90; and
 - (ii) The amount initially recognized less, when appropriate, the cumulative amortization recognized in accordance with the principles of IPSAS 9 (see paragraph 45(c)).
- (b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in this Standard, and are not insurance contracts. Such guarantees are derivatives and the issuer applies this Standard to them.
- (c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies IPSAS 9 in determining when it recognizes the revenue from the guarantee and from the sale of goods.
- AG6. Rights and obligations (assets and liabilities) may arise from non-exchange revenue transactions, for example, an entity may receive cash from a multi-lateral agency to perform certain activities. Where the performance of those activities is subject to conditions, an asset and a liability is recognized simultaneously. Where the asset is a financial asset, it is recognized in accordance with IPSAS 23, and initially measured in accordance with IPSAS 23 and this Standard. A liability that is initially recognized as a result of conditions imposed on the use of an asset is outside the scope of this Standard and is dealt with in IPSAS 23. After initial recognition, if circumstances indicate that recognition of a liability in accordance with IPSAS 23 is no longer appropriate, an entity considers whether a financial liability should be recognized in accordance with this Standard. Other liabilities that may arise from non-exchange revenue transactions are recognized and measured in accordance with this Standard if they meet the definition of a financial liability in IPSAS 28.

Definitions

Derivatives

- AG7. Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000 if six-month interbank offered rate increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.
- AG8. The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g. a forward contract to purchase a fixed rate debt instrument). An entity

may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g. a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard applies to such contracts for an entity's expected purchase, sale or usage requirements if the entity makes a designation in accordance with paragraph 6 (see paragraphs 5–8).

- AG9. One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.
- AG10. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognized as a derivative financial instrument. Instead, this Standard provides for special accounting for such regular way contracts (see paragraphs 11 and AG17–AG20).
- AG11. The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Financial Assets and Liabilities Held for Trading

- AG12. Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.
- AG13. Financial liabilities held for trading include:
- (a) Derivative liabilities that are not accounted for as hedging instruments;
 - (b) Obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);
 - (c) Financial liabilities that are incurred with a management model to repurchase them in the near term (e.g. a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
 - (d) Financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

AG14. The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

Recognition and Derecognition

Initial Recognition

AG15. As a consequence of the principle in paragraph 10, an entity recognizes all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG35). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset (see paragraph AG36).

AG16. The following are examples of applying the principle in paragraph 10:

- (a) Unconditional receivables and payables are recognized as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
- (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognized until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognize an asset (and the entity that places the order does not recognize a liability) at the time of the commitment but, instead, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard in accordance with paragraphs 5–8, its net fair value is recognized as an asset or a liability on the commitment date (see paragraph AG92(c)). In addition, if a previously unrecognized firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognized as an asset or a liability after the inception of the hedge (see paragraphs 134(b) and 135).
- (c) A forward contract that is within the scope of this Standard (see paragraph 2) is recognized as an asset or a liability on the commitment date, instead of on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognized as an asset or liability.
- (d) Option contracts that are within the scope of this Standard (see paragraph 2) are recognized as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

Regular Way Purchase or Sale of Financial Assets

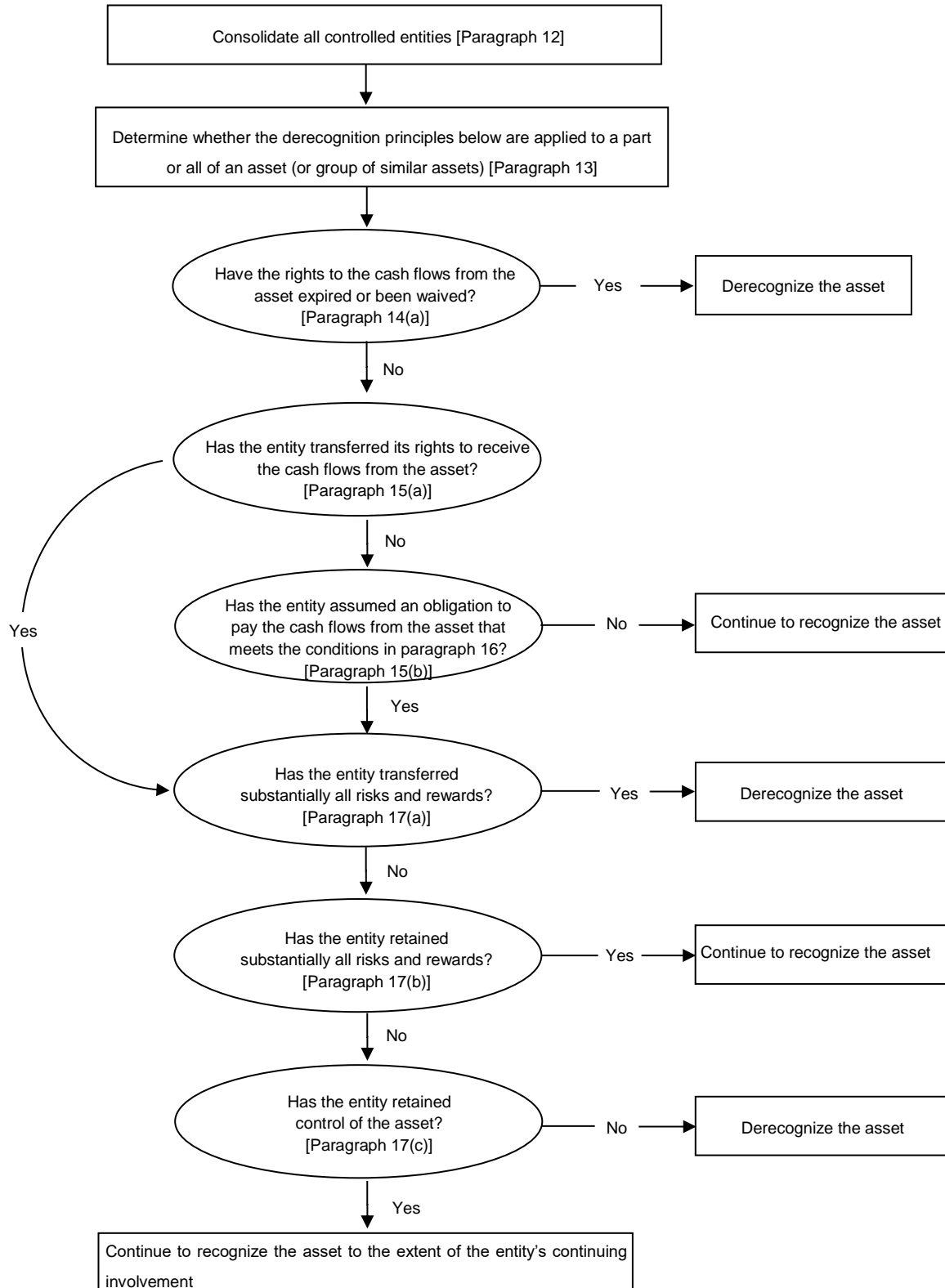
AG17. A regular way purchase or sale of financial assets is recognized using either trade date accounting or settlement date accounting as described in paragraphs AG19 and AG20. An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with this Standard. For this purpose assets that are mandatorily measured at fair value through surplus or deficit form a separate classification from assets

designated as measured at fair value through surplus or deficit. In addition, investments in equity instruments accounted for using the option provided in paragraph 103 form a separate classification.

- AG18. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- AG19. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.
- AG20. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognized for assets measured at amortized cost; it is recognized in surplus or deficit for assets classified as financial assets measured at fair value through surplus or deficit; and it is recognized in net assets/equity for financial assets measured at fair value through net assets/equity in accordance with paragraph 41 and for investments in equity instruments accounted for in accordance with paragraph 103.

Derecognition of Financial Assets

AG21. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognized.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 15(b))

- AG22. The situation described in paragraph 15(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 16 and 17 are met.
- AG23. In applying paragraph 16, the entity could be, for example, the originator of the financial asset, or it could be an economic entity that includes a controlled entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the Transfer of Risks and Rewards of Ownership (paragraph 17)

- AG24. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:
- (a) An unconditional sale of a financial asset;
 - (b) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
 - (c) A sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).
- AG25. Examples of when an entity has retained substantially all the risks and rewards of ownership are:
- (a) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
 - (b) A securities lending agreement;
 - (c) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
 - (d) A sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
 - (e) A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.
- AG26. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognize the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the Transfer of Control

- AG27. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase

the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

AG28. The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

- (a) A contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset, and
- (b) An ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:
 - (i) The transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e., it must be a unilateral ability), and
 - (ii) The transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or "strings" to the transfer (e.g., conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

AG29. That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Transfers that Qualify for Derecognition

AG30. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 24, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognized and the part that continues to be recognized. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognized at fair value.

- AG31. When measuring the fair values of the part that continues to be recognized and the part that is derecognized for the purposes of applying paragraph 24, an entity applies the fair value measurement requirements in paragraphs 64–66 and AG140–AG152.

Transfers that do not Qualify for Derecognition

- AG32. The following is an application of the principle outlined in paragraph 26. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognized because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognized in its entirety and the consideration received is recognized as a liability.

Sale of Future Flows Arising from a Sovereign Right

- AG33. In the public sector, securitization schemes may involve a sale of future flows arising from a sovereign right, such as right to taxation. Consideration received for such sale transactions shall be accounted for in accordance with IPSAS 9. Public Sector entities shall also consider if the securitization arrangement gives rise to financial liabilities as defined in IPSAS 28. Examples of such financial liabilities may include but are not limited to borrowings, financial guarantees, liabilities arising from a servicing or administrative contract, or payables relating to cash collected on behalf of the purchasing entity. Financial liabilities shall be recognized when the entity becomes party to the contractual provisions of the instrument in accordance with paragraph 10 and classified in accordance with paragraph 45 and 46. The financial liabilities shall be initially recognized in accordance with paragraph 57, and subsequently measured in accordance with paragraphs 62 and 63.

Continuing Involvement in Transferred Assets

- AG34. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 27.

All assets

- (a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognized to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognized in surplus or deficit on a time proportion basis (see IPSAS 9) and the carrying value of the asset is reduced by any loss allowance.

Assets Measured at Amortized Cost

- (b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognized and the entity measures the transferred asset at amortized cost, the associated liability is measured at its cost (i.e., the consideration received) adjusted for the amortization of any difference between that cost and the gross carrying amount of the transferred asset at the expiration date of the option. For example,

assume that the gross carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The gross carrying amount of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognized in surplus or deficit using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognized in surplus or deficit.

Assets Measured at Fair Value

- (c) If a call option right retained by an entity prevents a transferred asset from being derecognized and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 ($\text{CU}80 - \text{CU}5$) and the carrying amount of the transferred asset is CU80 (i.e. its fair value).
- (d) If a put option written by an entity prevents a transferred asset from being derecognized and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 ($\text{CU}100 + \text{CU}5$) and the carrying amount of the asset is CU100 (in this case the option exercise price).
- (e) If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognized and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognizes an asset of CU100 (the fair value of the asset) and a liability of CU96 [$(\text{CU}100 + \text{CU}1) - \text{CU}5$]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

All Transfers

- AG35. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognizing both the derivative and either the transferred asset or the liability arising from the transfer would result in recognizing the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognized as a derivative asset.
- AG36. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset. The transferee derecognizes the cash or other consideration paid and recognizes a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may measure its receivable at amortized cost if it meets the criteria in paragraph 40.

Examples

- AG37. The following examples illustrate the application of the derecognition principles of this Standard.
- (a) Repurchase agreements and securities lending. If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its statement of financial position, for example, as a loaned asset or repurchase receivable.
 - (b) Repurchase agreements and securities lending—assets that are substantially the same. If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership.
 - (c) Repurchase agreements and securities lending—right of substitution. If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognized because the transferor retains substantially all the risks and rewards of ownership.
 - (d) Repurchase right of first refusal at fair value. If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognizes the asset because it has transferred substantially all the risks and rewards of ownership.
 - (e) Wash sale transaction. The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to

repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognized.

- (f) Put options and call options that are deeply in the money. If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (g) Put options and call options that are deeply out of the money. A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognized. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money. If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognized. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money. If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognized to the extent of the transferor's continuing involvement (see paragraph AG29). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognized.
- (j) Assets subject to a fair value put or call option or a forward repurchase agreement. A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
- (k) Cash-settled call or put options. An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG29 and (g), (h) and (i) above).

- (l) Removal of accounts provision. A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.
- (m) Clean-up calls. An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.
- (n) Subordinated retained interests and credit guarantees. An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
- (o) Total return swaps. An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
- (p) Interest rate swaps. An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) Amortizing interest rate swaps. An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortizing interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortizes so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognize all of the transferred asset or continues to recognize the transferred asset to the extent of its continuing involvement. Conversely, if the amortization of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the

asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

- (r) Write-off. An entity has no reasonable expectations of recovering the contractual cash flows on a financial asset in its entirety or a portion thereof.

AG38. This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 percent and whose principal amount and amortized cost is CU10,000. It enters into a transaction in which, in return for a payment of CU9,115, the transferee obtains the right to CU9,000 of any collections of principal plus interest thereon at 9.5 percent. The entity retains rights to CU1,000 of any collections of principal plus interest thereon at 10 percent, plus the excess spread of 0.5 percent on the remaining CU9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of CU1,000 until that interest is exhausted. The fair value of the loans at the date of the transaction is CU10,100 and the estimated fair value of the excess spread of 0.5 percent is CU40.

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies the continuing involvement approach.

To apply this Standard, the entity analyzes the transaction as (a) a retention of a fully proportionate retained interest of CU1,000, plus (b) the subordination of that retained interest to provide credit enhancement to the transferee for credit losses.

The entity calculates that CU9,090 (90 percent \times CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90 percent share. The remainder of the consideration received (CU25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 percent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is CU65 (CU25 + CU40).

The entity calculates the gain or loss on the sale of the 90 percent share of cash flows. Assuming that separate fair values of the 90 percent part transferred and the 10 percent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 25 as follows:

	<i>Estimated fair value</i>	<i>Percentage</i>	<i>Allocated carrying amount</i>
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	10,100		10,000

The entity computes its gain or loss on the sale of the 90 percent share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, i.e. CU90 (CU9,090 – CU9,000). The carrying amount of the portion retained by the entity is CU1,000.

In addition, the entity recognizes the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognizes an asset of CU1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of CU1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, i.e. CU1,000 plus the fair value of the subordination of CU65).

The entity uses all of the above information to account for the transaction as follows:

	<i>Debit</i>	<i>Credit</i>
Original asset	—	9,000
Asset recognized for subordination or the residual interest	1,000	—
Asset for the consideration received in the form of excess spread	40	—
Surplus or deficit (gain on transfer)	—	90
Liability	—	1,065
Cash received	9,115	—
Total	10,155	10,155

Immediately following the transaction, the carrying amount of the asset is CU2,040 comprising CU1,000, representing the allocated cost of the portion retained, and CU1,040, representing the entity's additional continuing involvement from the subordination of its retained interest for credit losses (which includes the excess spread of CU40).

In subsequent periods, the entity recognizes the consideration received for the credit enhancement (CU65) on a time proportion basis, accrues interest on the recognized asset using the effective interest method and recognizes any impairment losses on the recognized assets. As an example of the latter, assume that in the following year there is an impairment loss on the underlying loans of CU300. The entity reduces its recognized asset by CU600 (CU300 relating to its retained interest and CU300 relating to the additional continuing involvement that arises from the subordination of its retained interest for impairment losses), and reduces its recognized liability by CU300. The net result is a charge to surplus or deficit for impairment losses of CU300.

Derecognition of Financial Liabilities

AG39. A financial liability (or part of it) is extinguished when the debtor either:

- (a) Discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- (b) Is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

AG40. If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.

AG41. 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.

AG42. If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognize the debt obligation unless the condition in paragraph AG39(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognizes a new debt obligation to the third party.

AG43. If a third party assumes an obligation of an entity, and the entity provides either no or only nominal consideration to that third party in return, an entity applies the derecognition requirements of this Standard as well as paragraphs 84 to 87 of IPSAS 23.

AG44. Lenders will sometimes waive their right to collect debt owed by a public sector entity, for example, a national government may cancel a loan owed by a local government. This waiver of debt would constitute a legal release of the debt owing by the borrower to the lender. Where an entity's obligations have been waived as part of a non-exchange transaction it applies the derecognition requirements of this Standard as well as paragraphs 84 to 87 of IPSAS 23.

AG45. Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognize a new liability if the derecognition criteria in paragraphs 12–34 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognized, and the entity recognizes a new liability relating to the transferred assets.

AG46. For the purpose of paragraph 36, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 percent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or

fees incurred are recognized as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.

- AG47. In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:
- (a) Recognizes a new financial liability based on the fair value of its obligation for the guarantee; and
 - (b) Recognizes a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Classification

Classification of Financial Assets

The Entity's Management Model for Financial Assets

- AG48. Paragraph 39(a) requires an entity to classify financial assets on the basis of the entity's management model for the financial assets, unless paragraph 44 applies. An entity assesses whether its financial assets meet the condition in paragraph 40(a) or the condition in paragraph 41(a) on the basis of the management model as determined by the entity's key management personnel (as defined in IPSAS 20 *Related Party Disclosures*).
- AG49. An entity's management model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular objective. The entity's management model does not depend on management's management models for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one management model for its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realize fair value changes. Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into sub portfolios in order to reflect the level at which an entity manages those financial assets. For example, that may be the case if an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them.
- AG50. An entity's management model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's management model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the management model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realized in a way that is different from the entity's expectations at the date that the entity assessed the management model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements (see IPSAS

3 *Accounting Policies, Changes in Accounting Estimates and Errors*) nor does it change the classification of the remaining financial assets held with that management model (i.e., those assets that the entity recognized in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the management model assessment. However, when an entity assesses the management model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realized in the past, along with all other relevant information.

- AG51. An entity's management model for financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the management model. An entity will need to use judgment when it assesses its management model for financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:
- (a) How the performance of the management model and the financial assets held within that management model are evaluated and reported to the entity's key management personnel;
 - (b) The risks that affect the performance of the management model (and the financial assets held within that management model) and, in particular, the way in which those risks are managed; and
 - (c) How management is compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

A Management Model Whose Objective is to Hold Assets in Order to Collect Contractual Cash Flows

- AG52. Financial assets that are held within a management model whose objective is to hold assets in order to collect contractual cash flows are managed to realize cash flows by collecting contractual payments over the life of the instrument. That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows (instead of managing the overall return on the portfolio by both holding and selling assets). In determining whether cash flows are going to be realized by collecting the financial assets' contractual cash flows, it is necessary to consider the frequency, value and timing of sales in prior periods, the reasons for those sales and expectations about future sales activity. However sales in themselves do not determine the management model and therefore cannot be considered in isolation. Instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realized. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.
- AG53. Although the objective of an entity's management model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's management model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur or are expected to occur in the future.
- AG54. The management model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets' credit risk. To determine whether there has been an increase in the assets' credit risk, the entity considers reasonable and supportable information, including forward looking information. Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a management

model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at minimizing potential credit losses due to credit deterioration are integral to such a management model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk.

- AG55. Sales that occur for other reasons, such as sales made to manage credit concentration risk (without an increase in the assets' credit risk), may also be consistent with a management model whose objective is to hold financial assets in order to collect contractual cash flows. In particular, such sales may be consistent with a management model whose objective is to hold financial assets in order to collect contractual cash flows if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to this assessment. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's management model. In addition, sales may be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows.
- AG56. The following are examples of when the objective of an entity's management model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive. Furthermore, the examples are not intended to discuss all factors that may be relevant to the assessment of the entity's management model nor specify the relative importance of the factors.

Example	Analysis
<p>Example 1</p> <p>An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs.</p> <p>The entity performs credit risk management activities with the objective of minimizing credit losses. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.</p> <p>Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.</p>	<p>Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (i.e., the cash amount that would be realized if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows. Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy. Infrequent sales resulting from unanticipated funding needs (e.g., in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.</p>
<p>Example 2</p> <p>An entity's management model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired.</p> <p>If payment on the loans is not made on a timely basis, the entity attempts to realize the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realizing cash flows by selling them.</p> <p>In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.</p>	<p>The objective of the entity's management model is to hold the financial assets in order to collect the contractual cash flows.</p> <p>The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (e.g., some of the financial assets are credit impaired at initial recognition).</p> <p>Moreover, the fact that the entity enters into derivatives to modify the cash flows of the portfolio does not in itself change the entity's management model.</p>

Example	Analysis
<p>Example 3</p> <p>An entity has a management model with the objective of originating student loans and subsequently selling those loans to a securitization vehicle. The securitization vehicle issues instruments to investors.</p> <p>The originating entity controls the securitization vehicle and thus consolidates it.</p> <p>The securitization vehicle collects the contractual cash flows from the loans and passes them on to its investors.</p> <p>It is assumed for the purposes of this example that the loans continue to be recognized in the consolidated statement of financial position because they are not derecognized by the securitization vehicle.</p>	<p>The consolidated economic entity originated the loans with the objective of holding them to collect the contractual cash flows.</p> <p>However, the originating entity has an objective of realizing cash flows on the loan portfolio by selling the loans to the securitization vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.</p>

Example	Analysis
<p>Example 4</p> <p>A local government entity that issues bonds holds financial assets to meet redemption needs in a 'stress case' scenario (e.g., a run on the government's issued securities). The entity does not anticipate selling these assets except in such scenarios.</p> <p>The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realized.</p> <p>However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realized if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity</p>	<p>The objective of the entity's management model is to hold the financial assets to collect contractual cash flows.</p> <p>The analysis would not change even if during a previous stress case scenario the entity had sales that were significant in value in order to meet its redemption needs. Similarly, recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows.</p> <p>In contrast, if an entity holds financial assets to meet its everyday redemption needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's management model is not to hold the financial assets to collect contractual cash flows.</p> <p>Similarly, if the entity is required by law or regulation to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's management model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.</p>

A Management Model Whose Objective is Achieved by Both Collecting Contractual Cash Flows and Selling Financial Assets

- AG57. An entity may hold financial assets in a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets. In this type of management model, the entity's key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the management model. There are various objectives that may be consistent with this type of management model. For example, the objective of the management model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding. To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.
- AG58. Compared to a management model whose objective is to hold financial assets to collect contractual cash flows, this management model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the management model's objective instead of being only incidental to it. However, there is no threshold for the frequency or value of

sales that must occur in this management model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

- AG59. The following are examples of when the objective of the entity's management model may be achieved by both collecting contractual cash flows and selling financial assets. This list of examples is not exhaustive. Furthermore, the examples are not intended to describe all the factors that may be relevant to the assessment of the entity's management model nor specify the relative importance of the factors.

Example	Analysis
<p>Example 5</p> <p>An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period.</p> <p>The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return.</p> <p>The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.</p>	<p>The objective of the management model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximize the return on the portfolio until the need arises for the invested cash.</p> <p>In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk). The objective of this contrasting management model is to hold financial assets to collect contractual cash flows.</p>

Example	Analysis
<p>Example 6</p> <p>An entity holds financial assets to meet its everyday liquidity needs. The entity seeks to minimize the costs of managing those liquidity needs and therefore actively manages the return on the portfolio. That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets.</p> <p>As a result, the entity holds financial assets to collect contractual cash flows and sells financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future.</p>	<p>The objective of the management model is to maximize the return on the portfolio to meet everyday liquidity needs and the entity achieves that objective by both collecting contractual cash flows and selling financial assets. In other words, both collecting contractual cash flows and selling financial assets are integral to achieving the management model's objective.</p>
<p>Example 7</p> <p>Asocial security fund holds financial assets in order to fund social security liabilities. The fund uses the proceeds from the contractual cash flows on the financial assets to settle social security liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the fund undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.</p>	<p>The objective of the management model is to fund the social security liabilities. To achieve this objective, the entity collects contractual cash flows as they come due and sells financial assets to maintain the desired profile of the asset portfolio. Thus both collecting contractual cash flows and selling financial assets are integral to achieving the management model's objective.</p>

Other Management Models

AG60. Financial assets are measured at fair value through surplus or deficit if they are not held within a management model whose objective is to hold assets to collect contractual cash flows or within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets (but see also paragraph 103). One management model that results in measurement at fair value through surplus or deficit is one in which an entity manages the financial assets with the objective of realizing cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realize those fair values. In this case, the entity's objective will typically result in active buying and selling. Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a

management model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the management model's objective; instead, it is incidental to it.

- AG61. A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 46(b)) is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. For such portfolios, the collection of contractual cash flows is only incidental to achieving the management model's objective. Consequently, such portfolios of financial assets must be measured at fair value through surplus or deficit.

Contractual Cash Flows That are Solely Payments of Principal and Interest on the Principal Amount Outstanding

- AG62. Paragraph 39(b) requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held within a management model whose objective is to hold assets to collect contractual cash flows or within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets, unless paragraph 44 applies. To do so, the condition in paragraphs 40(b) and 41(b) requires an entity to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding.
- AG63. Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs AG67–AG71) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices, commodity prices, a specific profitability or income threshold being reached by the borrower or lender, or the achievement (or otherwise) of specific financial or other ratios, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.
- AG64. In accordance with paragraph 42(a), principal is the fair value of the financial asset at initial recognition. However that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).
- AG65. An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

- AG66. Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts do not meet the condition in paragraphs 40(b) and 41(b) and cannot be subsequently measured at amortized cost or fair value through net assets/equity.

Consideration for the Time Value of Money

- AG67. Time value of money is the element of interest that provides consideration for only the passage of time. That is, the time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the element provides consideration for only the passage of time, an entity applies judgment and considers relevant factors such as the currency in which the financial asset is denominated and the period for which the interest rate is set.
- AG68. However, in some cases, the time value of money element may be modified (i.e., imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment.
- AG69. When assessing a modified time value of money element, the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit risk except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 40(b) and 41(b). To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. The reason for the interest rate being set in this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.
- AG70. When assessing a modified time value of money element, an entity must consider factors that could affect future contractual cash flows. For example, if an entity is assessing a bond with a five-year term and the variable interest rate is reset every six months to a five-year rate, the entity cannot conclude that the contractual cash flows are solely payments of principal and interest on the principal amount outstanding simply because the interest rate curve at the time of the assessment is such that the difference between a five-year interest rate and a six-month interest rate is not

significant. Instead, the entity must also consider whether the relationship between the five-year interest rate and the six-month interest rate could change over the life of the instrument such that the contractual (undiscounted) cash flows over the life of the instrument could be significantly different from the (undiscounted) benchmark cash flows. However, an entity must consider only reasonably possible scenarios instead of every possible scenario. If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 40(b) and 41(b) and therefore cannot be measured at amortized cost or fair value through net assets/equity.

- AG71. In some jurisdictions, the government or a regulatory authority sets interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, despite paragraphs AG67–AG70, a regulated interest rate shall be considered a proxy for the time value of money element for the purpose of applying the condition in paragraphs 40(b) and 41(b) if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

Contractual Terms that Change the Timing or Amount of Contractual Cash Flows

- AG72. If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk. (See also paragraph AG80.)
- AG73. The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:
- (a) A variable interest rate that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin;
 - (b) A contractual term that permits the issuer (i.e., the debtor) to prepay a debt instrument or permits the holder (i.e., the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal

and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract; and

- (c) A contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (i.e., an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

AG74. Despite paragraph AG72, a financial asset that would otherwise meet the condition in paragraphs 40(b) and 41(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortized cost or fair value through net assets/equity (subject to meeting the condition in paragraph 40(a) or the condition in paragraph 41(a)) if:

- (a) The entity acquires or originates the financial asset at a premium or discount to the contractual par amount;
- (b) The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable additional compensation for the early termination of the contract; and
- (c) When the entity initially recognizes the financial asset, the fair value of the prepayment feature is insignificant.

AG75. The following examples illustrate contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
<p>Instrument A</p> <p>Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.</p> <p>However, if the interest payments were indexed to another variable such as the debtor's performance (e.g., the debtor's surplus or deficit) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement (see paragraph AG63).</p>

Instrument	Analysis
<p>Instrument B</p> <p>Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month interbank offered rate for a three-month term or one-month interbank offered rate for a one-month term.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money, for the credit risk associated with the instrument and for other basic lending risks and costs, as well as a profit margin (see paragraph AG63). The fact that the interbank offered rate interest rate is reset during the life of the instrument does not in itself disqualify the instrument.</p> <p>However, if the borrower is able to choose to pay a one-month interest rate that is reset every three months, the interest rate is reset with a frequency that does not match the tenor of the interest rate. Consequently, the time value of money element is modified. Similarly, if an instrument has a contractual interest rate that is based on a term that can exceed the instrument's remaining life (for example, if an instrument with a five-year maturity pays a variable rate that is reset periodically but always reflects a five-year maturity), the time value of money element is modified. That is because the interest payable in each period is disconnected from the interest period.</p> <p>In such cases, the entity must qualitatively or quantitatively assess the contractual cash flows against those on an instrument that is identical in all respects except the tenor of the interest rate matches the interest period to determine if the cash flows are solely payments of principal and interest on the principal amount outstanding. (But see paragraph AG71 for guidance on regulated interest rates.)</p>

Instrument	Analysis
	<p>For example, in assessing a bond with a five-year term that pays a variable rate that is reset every six months but always reflects a five-year maturity, an entity considers the contractual cash flows on an instrument that resets every six months to a six-month interest rate but is otherwise identical.</p> <p>The same analysis would apply if the borrower is able to choose between the lender's various published interest rates (e.g. the borrower can choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate).</p>
<p>Instrument C</p> <p>Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.</p>	<p>The contractual cash flows of both:</p> <ul style="list-style-type: none"> (a) an instrument that has a fixed interest rate and (b) an instrument that has a variable interest rate <p>are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money, for the credit risk associated with the instrument during the term of the instrument and for other basic lending risks and costs, as well as a profit margin. (See paragraph AG63)</p> <p>Consequently, an instrument that is a combination of (a) and (b) (e.g., a bond with an interest rate cap) can have cash flows that are solely payments of principal and interest on the principal amount outstanding. Such a contractual term may reduce cash flow variability by setting a limit on a variable interest rate (e.g. an interest rate cap or floor) or increase the cash flow variability because a fixed rate becomes variable.</p>
<p>Instrument D</p> <p>Instrument D is a full recourse loan and is secured by collateral.</p>	<p>The fact that a full recourse loan is collateralized does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.</p>

Instrument	Analysis
<p>Instrument E</p> <p>Instrument E is issued by a regulated bank and has a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are non-discretionary. However, the issuer is subject to legislation that permits or requires a national resolving authority to impose losses on holders of particular instruments, including Instrument E, in particular circumstances. For example, the national resolving authority has the power to write down the par amount of Instrument E or to convert it into a fixed number of the issuer's ordinary shares if the national resolving authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is 'failing'.</p>	<p>The holder would analyze the contractual terms of the financial instrument to determine whether they give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and thus are consistent with a basic lending arrangement. That analysis would not consider the payments that arise only as a result of the national resolving authority's power to impose losses on the holders of Instrument E. That is because that power, and the resulting payments, are not contractual terms of the financial instrument.</p> <p>In contrast, the contractual cash flows would not be solely payments of principal and interest on the principal amount outstanding if the contractual terms of the financial instrument permit or require the issuer or another entity to impose losses on the holder (e.g., by writing down the par amount or by converting the instrument into a fixed number of the issuer's ordinary shares) as long as those contractual terms are genuine, even if the probability is remote that such a loss will be imposed.</p>

AG76. The following examples illustrate contractual cash flows that are not solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
<p>Instrument F</p> <p>Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer.</p>	<p>The holder would analyze the convertible bond in its entirety.</p> <p>The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement (see paragraph AG63); i.e. the return is linked to the value of the equity of the issuer.</p>
<p>Instrument G</p> <p>Instrument G is a loan that pays an inverse floating interest rate (i.e., the interest rate has an inverse relationship to market interest rates).</p>	<p>The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding.</p> <p>The interest amounts are not consideration for the time value of money on the principal amount outstanding.</p>

Instrument	Analysis
<p>Instrument H</p> <p>Instrument H is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.</p> <p>Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards.</p> <p>Deferred interest does not accrue additional interest.</p>	<p>The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.</p> <p>If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.</p> <p>The fact that Instrument H is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.</p> <p>Also, the fact that Instrument H is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal amount outstanding. Even if the callable amount includes an amount that reasonably compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding. (See also paragraph AG74.)</p>

AG77. In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 40(b), 41(b) and 42 of this Standard.

- AG78. This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the condition in paragraphs 40(b) and 41(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).
- AG79. However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraphs 40(b) and 41(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraphs 40(b) and 41(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.
- AG80. A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.
- AG81. In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralized, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

Contractually Linked Instruments

- AG82. In some types of transactions, an issuer may prioritize payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches.

- AG83. In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:
- (a) The contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g., the interest rate on the tranche is not linked to a commodity index);
 - (b) The underlying pool of financial instruments has the cash flow characteristics set out in paragraphs AG85 and AG86; and
 - (c) The exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, the credit rating of the tranche being assessed for classification is equal to or higher than the credit rating that would apply to a single tranche that funded the underlying pool of financial instruments).
- AG84. An entity must look through until it can identify the underlying pool of instruments that are creating (instead of passing through) the cash flows. This is the underlying pool of financial instruments.
- AG85. The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.
- AG86. The underlying pool of instruments may also include instruments that:
- (a) Reduce the cash flow variability of the instruments in paragraph AG85 and, when combined with the instruments in paragraph AG85, result in cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g., an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in paragraph AG85); or
 - (b) Align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph AG85 to address differences in and only in:
 - (i) Whether the interest rate is fixed or floating;
 - (ii) The currency in which the cash flows are denominated, including inflation in that currency; or
 - (iii) The timing of the cash flows.
- AG87. If any instrument in the pool does not meet the conditions in either paragraph AG85 or paragraph AG86, the condition in paragraph AG83(b) is not met. In performing this assessment, a detailed instrument-by-instrument analysis of the pool may not be necessary. However, an entity must use judgment and perform sufficient analysis to determine whether the instruments in the pool meet the conditions in paragraphs AG85–AG86. (See also paragraph AG80 for guidance on contractual cash flow characteristics that have only a de minimis effect.)
- AG88. If the holder cannot assess the conditions in paragraph AG83 at initial recognition, the tranche must be measured at fair value through surplus or deficit. If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the conditions in paragraphs AG85–AG86, the tranche does not meet the conditions in paragraph AG83 and must be measured at fair value through surplus or deficit. However, if the underlying pool includes instruments that are collateralized by assets that do not meet the conditions in paragraphs AG85–AG86, the ability to

take possession of such assets shall be disregarded for the purposes of applying this paragraph unless the entity acquired the tranche with the management model of controlling the collateral.

Option to Designate a Financial Asset or Financial Liability as at Fair Value Through Surplus or Deficit

- AG89. Subject to the conditions in paragraphs 44 and 46, this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through surplus or deficit provided that doing so results in more relevant information.
- AG90. The decision of an entity to designate a financial asset or financial liability as at fair value through surplus or deficit is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 12 of IPSAS 3 requires the chosen policy to result in the financial statements providing faithfully representative and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of designation of a financial liability as at fair value through surplus or deficit, paragraph 46 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 46, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Designation Eliminates or Significantly Reduces an Accounting Mismatch

- AG91. Measurement of a financial asset or financial liability and classification of recognized changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through surplus or deficit, a financial asset would be classified as subsequently measured at fair value through surplus or deficit and a liability the entity considers related would be subsequently measured at amortized cost (with changes in fair value not recognized). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through surplus or deficit.
- AG92. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through surplus or deficit only if it meets the principle in paragraph 44 or 46(a):
- (a) An entity has liabilities under insurance contracts whose measurement incorporates current information and financial assets that it considers to be related and that would otherwise be measured at either fair value through net assets/equity or amortized cost.
 - (b) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, and that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through surplus or deficit (for example, those that are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met because, for example, the requirements for hedge effectiveness in paragraph 126 are not met.

- (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and none of the financial assets or financial liabilities qualifies for designation as a hedging instrument because they are not measured at fair value through surplus or deficit. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through surplus or deficit eliminates the inconsistency in the timing of the recognition of the gains and losses that would otherwise result from measuring them both at amortized cost and recognizing a gain or loss each time a bond is repurchased.

AG93. In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through surplus or deficit may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through surplus or deficit at its initial recognition and, at that time, any remaining transactions are expected to occur.

AG94. It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through surplus or deficit if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100 and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through surplus or deficit. However, because designation as at fair value through surplus or deficit can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (e.g., changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e., percentage) of a liability.

A Group of Financial Liabilities or Financial Assets and Financial Liabilities is Managed and its Performance is Evaluated on a Fair Value Basis

AG95. An entity may manage and evaluate the performance of a group of financial liabilities or financial assets and financial liabilities in such a way that measuring that group at fair value through surplus or deficit results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, instead of on the nature of its financial instruments.

AG96. For example, an entity may use this condition to designate financial liabilities as at fair value through surplus or deficit if it meets the principle in paragraph 46(b) and the entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a

fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments.

- AG97. As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial liabilities as at fair value through surplus or deficit on the basis of this condition shall so designate all eligible financial liabilities that are managed and evaluated together.
- AG98. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 46(b). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel—clearly demonstrates that its performance is evaluated on this basis, no further documentation is required to demonstrate compliance with paragraph 46(b).

Embedded Derivatives

- AG99. When an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard, paragraph 49 requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently at fair value through surplus or deficit.
- AG100. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.
- AG101. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.
- AG102. Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see IPSAS 28 *Financial Instruments: Presentation*) are accounted for separately from those classified as assets or liabilities. In addition, if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.
- AG103. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 49(a)) in the following examples. In these examples, assuming the conditions in paragraph 49(b) and 49(c) are met, an entity accounts for the embedded derivative separately from the host contract.

- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.
- (b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.
- (c) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (d) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:
 - (i) The option's exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument or the carrying amount of the host insurance contract; or
 - (ii) The exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with IPSAS 28.

- (f) Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

AG104. An example of a hybrid contract is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable

instrument as a financial liability at fair value through surplus or deficit, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 49 because the host contract is a debt instrument under paragraph AG100 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG103(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

AG105. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

AG106. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognized investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.
- (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g., a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.
- (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (for example, a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognized in surplus or deficit.
- (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
 - (i) The functional currency of any substantial party to that contract;

- (ii) The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
 - (iii) A currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local business transactions or external trade).
- (e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.
 - (f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) variable lease payments based on related sales or (iii) variable lease payments based on variable interest rates.
 - (g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.
 - (h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract).

Instruments Containing Embedded Derivatives

AG107. As noted in paragraph AG99, when an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard and with one or more embedded derivatives, paragraph 49 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through surplus or deficit. For that reason this Standard permits the entire hybrid contract to be designated as at fair value through surplus or deficit.

AG108. Such designation may be used whether paragraph 49 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 51 would not justify designating the hybrid contract as at fair value through surplus or deficit in the cases set out in paragraph 51(a) and 51(b) because doing so would not reduce complexity or increase reliability.

Reassessment of Embedded Derivatives

AG109. In accordance with paragraph 49, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity

first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

AG110. Paragraph AG109 does not apply to embedded derivatives in contracts acquired in:

- (a) A public sector combination;
- (b) A combination of entities under common control; or
- (c) The formation of a joint venture as defined in IPSAS 37 *Joint Arrangements* or their possible reassessment at the date of acquisition.

Reclassification of Financial Assets

AG111. Paragraph 54 requires an entity to reclassify financial assets if the entity changes its management model for managing those financial assets. Such changes are expected to be very infrequent. Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's management model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line. Examples of a change in management model include the following:

- (a) A government agency extends loans to small business owners and has a management model to sell the loan portfolios to private entities at a discount due the long collection cycle of these loans. The entity enters into a long term contract with a third party collection service provider, and the loan portfolios are no longer for sale, and are held to collect the contractual cash flows with the aid of the collections service provider.
- (b) A department of government held a portfolio of longer term fixed income securities to collect cash flows in order to finance a planned infrastructure project in the foreseeable future. A change in the government's plan resulted in the cancellation of the project and the portfolio is grouped into the entity's regular investment portfolio that is regularly sold to meet its everyday liquidity needs in funding its various programs.

AG112. A change in the objective of the entity's management model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (i.e., the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former management model after 15 February.

AG113. The following are not changes in management model:

- (a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).
- (b) The temporary disappearance of a particular market for financial assets.

- (c) A transfer of financial assets between parts of the entity with different management models.

Measurement

Non-Exchange Revenue Transactions

AG114. The initial recognition and measurement of assets and liabilities resulting from non-exchange revenue transactions is dealt with in IPSAS 23. Assets resulting from non-exchange revenue transactions can arise out of both contractual and non-contractual arrangements (see IPSAS 28 paragraphs AG20 and AG21). Where these assets arise out of contractual arrangements and otherwise meet the definition of a financial instrument, they are:

- (a) Initially recognized in accordance with IPSAS 23;
- (b) Initially measured:
 - (i) At fair value using the principles in IPSAS 23; and
 - (ii) Taking account of transaction costs that are directly attributable to the acquisition of the financial asset in accordance with paragraph 57 of this Standard, where the asset is subsequently measured other than at fair value through surplus or deficit.

Initial measurement

Initial Measurement of Financial Assets and Financial Liabilities (Paragraph 57–58)

AG115. The fair value of a financial instrument at initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received, see also paragraph AG117). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG145–AG151). For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of revenue unless it qualifies for recognition as some other type of asset.

AG116. If an entity originates a loan that bears an off-market interest rate (e.g., 5 percent when the market rate for similar loans is 8 percent), and receives an upfront fee as compensation, the entity recognizes the loan at its fair value, i.e., net of the fee it receives.

AG117. The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price. If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph AG115, the entity shall account for that instrument at that date as follows:

- (a) At the measurement required by paragraph AG115 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognize the difference between the fair value at initial recognition and the transaction price as a gain or loss.
- (b) In all other cases, at the measurement required by paragraph AG115, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognize that deferred difference as a gain or loss only to the

extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

Concessionary Loans

AG118. Concessionary loans are granted to or received by an entity at below market terms. Below market terms can result from interest and/or principal concessions. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education and housing loans granted to low income families. Entities may receive concessionary loans, for example, from development agencies and other government entities.

AG119. The granting or receiving of a concessionary loan is distinguished from the waiver of debt owing to or by an entity. This distinction is important because it affects whether the below market conditions are considered in the initial recognition or measurement of the loan rather than as part of the subsequent measurement or derecognition.

AG120. The intention of a concessionary loan at the outset is to provide or receive resources at below market terms. A waiver of debt results from loans initially granted or received at market related terms where the intention of either party to the loan has changed subsequent to its initial issue or receipt. For example, a government may lend money to a not-for-profit entity with the intention that the loan be repaid in full on market terms. However, the government may subsequently write-off part of the loan. This is not a concessionary loan as the intention of the loan at the outset was to provide credit to an entity at market related rates. An entity would treat the subsequent write-off of the loan as a waiver of debt and apply the derecognition requirements of [draft] IPSAS [X] (ED 62).

AG121. As concessionary loans are granted or received at below market terms, the transaction price on initial recognition of the loan may not be its fair value. At initial recognition, an entity therefore analyzes the substance of the loan granted or received into its component parts, and accounts for those components using the principles in paragraphs AG122 and AG124 below.

AG122. An entity firstly assesses whether the substance of the concessionary loan is in fact a loan, a grant, a contribution from owners or a combination thereof, by applying the principles in IPSAS 28 and paragraphs 42–58 of IPSAS 23. If an entity has determined that the transaction, or part of the transaction, is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition. An entity determines the fair value of the loan by using the principles in AG140–AG152. Where an entity cannot determine fair value by reference to an active market, it uses a valuation technique. Fair value using a valuation technique could be determined by discounting all future cash receipts using a market related rate of interest for a similar loan (see AG115).

AG123. Any difference between the fair value of the loan and the transaction price (the loan proceeds) is treated as follows:

- (a) Where the loan is received by an entity, the difference is accounted for in accordance with IPSAS 23.
- (b) Where the loan is granted by an entity, the difference is treated as an expense in surplus or deficit at initial recognition, except where the loan is a transaction with owners, in their capacity as owners. Where the loan is a transaction with owners in their capacity as owners, for example, where a controlling entity provides a concessionary loan to a controlled entity,

the difference may represent a capital contribution, i.e., an investment in an entity, rather than an expense.

Illustrative Examples are provided in paragraph IG54 of IPSAS 23 as well as paragraphs IE153 to IE161 accompanying this Standard.

AG124. After initial recognition at fair value, an entity subsequently assesses the classification of concessionary loans in accordance with paragraphs 39-44 and measures concessionary loans in accordance with paragraphs 59–63.

Equity Instruments Arising from Non-Exchange Transactions

AG125. In the public sector, equity investment can be used as a way for an entity to provide financing or subsidized funding to another public sector entity. In such a transaction, there is generally a lack of an active market for such investments (i.e. the equity instrument is unquoted), and there are no or minimal future cash flow expectations from the investment besides a potential redemption by the issuing entity. Cash is provided by the investing entity to the investee generally to further the investee's economic or social objectives. Examples of such investments could include membership shares in a development bank, or equity investment in another public sector entity that provides certain social programs or services (e.g. shelters, subsidized housing, small business assistance...etc.)

AG126. At initial recognition of such transactions, an entity shall analyze the substance of the arrangement and assess whether the cash provided in full or in part, is in substance a grant, with the intention at the outset being provision or receipt of resources by way of a non-exchange transaction. To the extent that the transaction, or component of the transaction, is a non-exchange transaction, any assets or revenues arising from the transaction are accounted for in accordance with IPSAS 23. The entity providing the grant shall recognize the amount as an expense in surplus or deficit at initial recognition.

AG127. To the extent an equity instrument arises from the transaction, or component of the transaction, that is within the scope of this [draft] IPSAS [X] (ED 62), it is to be recognized initially at fair value in accordance with paragraph 57. The equity instrument is to be measured subsequently in accordance with paragraphs 59-61. If the instrument does not have an active market, the entity shall consider valuation techniques and inputs in AG145-AG152) in determining its fair value.

Valuing Financial Guarantees Issued Through a Non-Exchange Transaction

AG128. Only contractual financial guarantees (or guarantees that are in substance, contractual) are within the scope of this Standard (See AG3 and AG4 of IPSAS 28). Non-contractual guarantees are not within the scope of this Standard as they do not meet the definition of a financial instrument. This Standard prescribes recognition and measurement requirements only for the issuer of financial guarantee contracts.

AG129. In paragraph 9, "financial guarantee contract" is defined as "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." Under the requirements of this Standard, financial guarantee contracts, like other financial assets and financial liabilities, are required to be initially recognized at fair value. Paragraphs 64–66 of this Standard provide commentary and guidance on determining fair value and this is complemented by Application Guidance in paragraphs AG140–AG152. Subsequent

measurement for financial guarantee contracts is at the higher of the amount of the loss allowance determined in accordance with paragraphs 71–90 and the amount initially recognized less, when appropriate, cumulative amortization in accordance with IPSAS 9 *Revenue from Exchange Transactions*.

- AG130. In the public sector, guarantees are frequently provided by way of non-exchange transactions, i.e., at no or nominal consideration. This type of guarantee is provided generally to further the entity's economic and social objectives. Such purposes include supporting infrastructure projects, supporting corporate entities at times of economic distress, guaranteeing the bond issues of entities in other tiers of governments and the loans of employees to finance motor vehicles that are to be used for performance of their duties as employees. Where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an exchange transaction and whether the consideration represents a fair value. If the consideration does represent a fair value, entities should recognize the financial guarantee at the amount of the consideration. Subsequent measurement should be at the higher of the amount of the loss allowance determined in accordance with paragraphs 71–90 and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9. Where the entity concludes that the consideration is not a fair value, an entity determines the carrying value at initial recognition in the same way as if no consideration had been paid.
- AG131. At initial recognition, where no fee is charged or where the consideration is not fair value, an entity firstly considers whether there are quoted prices available in an active market for financial guarantee contracts directly equivalent to that entered into. Evidence of an active market includes recent arm's length market transactions between knowledgeable willing parties, and reference to the current fair value of another financial guarantee contract that is substantially the same as that provided at nil or nominal consideration by the issuer. The fact that a financial guarantee contract has been entered into at no consideration by the debtor to the issuer is not, of itself, conclusive evidence of the absence of an active market. Guarantees may be available from commercial issuers, but a public sector entity may agree to enter into a financial guarantee contract for a number of non-commercial reasons. For example, if a debtor is unable to afford a commercial fee, and initiation of a project in fulfillment of one of the entity's social or policy objectives would be put at risk unless a financial guarantee contract is issued, it may approach a public sector entity or government to issue a financial guarantee contract.
- AG132. Where there is no active market for a directly equivalent guarantee contract; the entity considers whether a valuation technique other than observation of an active market is available and provides a reliable measure of fair value. Such a valuation technique may rely on mathematical models which consider financial risk. For example, National Government W guarantees a bond issue of Municipality X. As Municipality X has a government guarantee backing its bond issue, its bonds have a lower coupon than if they were not secured by a government guarantee. This is because the guarantee lowers the risk profile of the bonds for investors. The guarantee fee could be determined by using the credit spread between what the coupon rate would have been had the issue not been backed by a government guarantee and the rate with the guarantee in place. Where a fair value is obtainable either by observation of an active market or through another valuation technique, the entity recognizes the financial guarantee at that fair value in the statement of financial position and recognizes an expense of an equivalent amount in the statement of financial performance. When using a valuation technique that is not based on observation of an active market an entity needs to satisfy itself that the output of any model is reliable and understandable.

AG133. If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition. The entity assesses whether a present obligation has arisen as a result of a past event related to a financial guarantee contract whether it is probable that such a present obligation will result in a cash outflow in accordance with the terms of the contract and whether a reliable estimate can be made of the outflow. It is possible that a present obligation related to a financial guarantee contract will arise at initial recognition where, for example, an entity enters into a financial guarantee contract to guarantee loans to a large number of small enterprises and, based on past experience, is aware that a proportion of these enterprises will default.

Subsequent Measurement

AG134. If a financial instrument that was previously recognized as a financial asset is measured at fair value through surplus or deficit and its fair value decreases below zero, it is a financial liability measured in accordance with paragraph 45. However, hybrid contracts with hosts that are assets within the scope of this Standard are always measured in accordance with paragraph 48.

AG135. The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of a financial asset measured at fair value with changes through net assets/equity in accordance with either paragraph 103 or 41. An entity acquires a financial asset for CU100 plus a purchase commission of CU2. Initially, the entity recognizes the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognizes a loss of CU2 in net assets/equity. If the financial asset is measured at fair value through net assets/equity in accordance with paragraph 41, the transaction costs are amortized to surplus or deficit using the effective interest method.

Investments in Equity Instruments and Contracts on Those Investments

AG136. All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

AG137. Indicators that cost might not be representative of fair value include:

- (a) A significant change in the performance of the investee compared with budgets, plans or milestones.
- (b) Changes in expectation that the investee's technical product milestones will be achieved.
- (c) A significant change in the market for the investee's net assets/equity or its products or potential products.
- (d) A significant change in the global economy or the economic environment in which the investee operates.
- (e) A significant change in the performance of comparable entities, or in the valuations implied by the overall market.

- (f) Internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.
- (g) Evidence from external transactions in the investee's net assets/equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

AG138. The list in paragraph AG137 is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.

AG139. Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Fair Value Measurement Considerations

AG140. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

AG141. This Standard uses the terms "bid price" and "asking price" (sometimes referred to as "current offer price") in the context of quoted market prices, and the term "the bid-ask spread" to include only transaction costs. Other adjustments to arrive at fair value (e.g., for counterparty credit risk) are not included in the term "bid-ask spread."

Active Market: Quoted Price

AG142. A financial instrument is regarded as quoted in an active market if 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. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument (i.e., without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

AG143. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (e.g., a change in the risk-free interest rate following the most recent price quote for a government bond), the fair value reflects the change in conditions by

reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (e.g., because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

AG144. If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

No Active Market: Valuation Technique

AG145. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

AG146. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

AG147. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition, in an exchange transaction, is the transaction price (i.e., the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

AG148. The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. The application of paragraph AG147 may result in no gain or loss being recognized on the initial recognition of a financial asset or financial liability. In such a case, IPSAS 29 requires that a gain

or loss shall be recognized after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

AG149. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (i.e., similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

AG150. The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

AG151. In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

Inputs to Valuation Techniques

AG152. An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

- (a) The time value of money (i.e., interest at the basic or risk-free rate). Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity

may use a well-accepted and readily observable general market rate, such as a swap rate, as the benchmark rate. (If the rate used is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate). In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

- (b) Credit risk. The effect on fair value of credit risk (i.e., the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.
- (c) Foreign currency exchange prices. Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.
- (d) Commodity prices. There are observable market prices for many commodities.
- (e) Equity prices. Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.
- (f) Volatility (i.e., magnitude of future changes in price of the financial instrument or other item). Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.
- (g) Prepayment risk and surrender risk. Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount – see paragraph 66).
- (h) Servicing costs for a financial asset or a financial liability. Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

Amortized Cost Measurement

Effective Interest Method

AG153. In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in

fair value being recognized in surplus or deficit. In those cases, the fees are recognized as revenue or expense when the instrument is initially recognized.

AG154. Fees that are an integral part of the effective interest rate of a financial instrument include:

- (a) Origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.
- (b) Commitment fees received by the entity to originate a loan when the loan commitment is not measured in accordance with paragraph 45(a) and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognized as revenue on expiry.
- (c) Origination fees paid on issuing financial liabilities measured at amortized cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

AG155. Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with IPSAS 9 include:

- (a) Fees charged for servicing a loan;
- (b) Commitment fees to originate a loan when the loan commitment is not measured in accordance with paragraph 45(a) and it is unlikely that a specific lending arrangement will be entered into; and
- (c) Loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

AG156. When applying the effective interest method, an entity generally amortizes any fees, points paid or received, transaction costs and other premiums or discounts that are included in the calculation of the effective interest rate over the expected life of the financial instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the financial instrument. In such a case, the appropriate amortization period is the period to the next such repricing date. For example, if a premium or discount on a floating-rate financial instrument reflects the interest that has accrued on that financial instrument since the interest was last paid, or changes in the market rates since the floating interest rate was reset to the market rates, it will be amortized to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to the market rates. If, however, the premium or discount results from a change in the credit

spread over the floating rate specified in the financial instrument, or other variables that are not reset to the market rates, it is amortized over the expected life of the financial instrument.

AG157. For floating-rate financial assets and floating-rate financial liabilities, periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. If a floating-rate financial asset or a floating-rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or the liability.

AG158. If an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 69 and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortized cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortized cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 136. The adjustment is recognized in surplus or deficit as revenue or expense.

AG159. In some cases a financial asset is considered credit-impaired at initial recognition because the credit risk is very high, and in the case of a purchase it is acquired at a deep discount. An entity is required to include the initial expected credit losses in the estimated cash flows when calculating the credit-adjusted effective interest rate for financial assets that are considered to be purchased or originated credit-impaired at initial recognition. However, this does not mean that a credit-adjusted effective interest rate should be applied solely because the financial asset has high credit risk at initial recognition.

Transaction Costs

AG160. Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Write-off

AG161. Write-offs can relate to a financial asset in its entirety or to a portion of it. For example, an entity plans to enforce the collateral on a financial asset and expects to recover no more than 30 percent of the financial asset from the collateral. If the entity has no reasonable prospects of recovering any further cash flows from the financial asset, it should write off the remaining 70 percent of the financial asset.

Impairment

Collective and Individual Assessment Basis

AG162. In order to meet the objective of recognizing lifetime expected credit losses for significant increases in credit risk since initial recognition, it may be necessary to perform the assessment of significant increases in credit risk on a collective basis by considering information that is indicative of significant increases in credit risk on, for example, a group or sub-group of financial instruments.

This is to ensure that an entity meets the objective of recognizing lifetime expected credit losses when there are significant increases in credit risk, even if evidence of such significant increases in credit risk at the individual instrument level is not yet available.

AG163. Lifetime expected credit losses are generally expected to be recognized before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.

AG164. However, depending on the nature of the financial instruments and the credit risk information available for particular groups of financial instruments, an entity may not be able to identify significant changes in credit risk for individual financial instruments before the financial instrument becomes past due. This may be the case for financial instruments such as retail loans for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument until a borrower breaches the contractual terms. If changes in the credit risk for individual financial instruments are not captured before they become past due, a loss allowance based only on credit information at an individual financial instrument level would not faithfully represent the changes in credit risk since initial recognition.

AG165. In some circumstances an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime expected credit losses on an individual instrument basis. In that case, lifetime expected credit losses shall be recognized on a collective basis that considers comprehensive credit risk information. This comprehensive credit risk information must incorporate not only past due information but also all relevant credit information, including forward-looking macroeconomic information, in order to approximate the result of recognizing lifetime expected credit losses when there has been a significant increase in credit risk since initial recognition on an individual instrument level.

AG166. For the purpose of determining significant increases in credit risk and recognizing a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk characteristics. Examples of shared credit risk characteristics may include, but are not limited to, the:

- (a) Instrument type;
- (b) Credit risk ratings;
- (c) Collateral type;
- (d) Date of initial recognition;
- (e) Remaining term to maturity;
- (f) Industry;
- (g) Geographical location of the borrower; and
- (h) The value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios).

AG167. Paragraph 74 requires that lifetime expected credit losses are recognized on all financial instruments for which there has been significant increases in credit risk since initial recognition. In order to meet this objective, if an entity is not able to group financial instruments for which the credit risk is considered to have increased significantly since initial recognition based on shared credit risk characteristics, the entity should recognize lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly. The aggregation of financial instruments to assess whether there are changes in credit risk on a collective basis may change over time as new information becomes available on groups of, or individual, financial instruments.

Timing of Recognizing Lifetime Expected Credit Losses

AG168. The assessment of whether lifetime expected credit losses should be recognized is based on significant increases in the likelihood or risk of a default occurring since initial recognition (irrespective of whether a financial instrument has been repriced to reflect an increase in credit risk) instead of on evidence of a financial asset being credit-impaired at the reporting date or an actual default occurring. Generally, there will be a significant increase in credit risk before a financial asset becomes credit-impaired or an actual default occurs.

AG169. For loan commitments, an entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default on the contract.

AG170. The significance of a change in the credit risk since initial recognition depends on the risk of a default occurring as at initial recognition. Thus, a given change, in absolute terms, in the risk of a default occurring will be more significant for a financial instrument with a lower initial risk of a default occurring compared to a financial instrument with a higher initial risk of a default occurring.

AG171. The risk of a default occurring on financial instruments that have comparable credit risk is higher the longer the expected life of the instrument; for example, the risk of a default occurring on an AAA-rated bond with an expected life of 10 years is higher than that on an AAA-rated bond with an expected life of five years.

AG172. Because of the relationship between the expected life and the risk of a default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of a default occurring over time. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is identical to the risk of a default occurring on that financial instrument when its expected life in a subsequent period is only five years, that may indicate an increase in credit risk. This is because the risk of a default occurring over the expected life usually decreases as time passes if the credit risk is unchanged and the financial instrument is closer to maturity. However, for financial instruments that only have significant payment obligations close to the maturity of the financial instrument the risk of a default occurring may not necessarily decrease as time passes. In such a case, an entity should also consider other qualitative factors that would demonstrate whether credit risk has increased significantly since initial recognition.

AG173. An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses. An entity may apply different approaches for different financial instruments. An approach that does not include an explicit probability of default as an input per se, such as a credit loss rate approach, can be consistent with the requirements in this Standard, provided that an entity is able

to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses, such as collateral, and considers the following when making the assessment:

- (a) The change in the risk of a default occurring since initial recognition;
- (b) The expected life of the financial instrument; and
- (c) Reasonable and supportable information that is available without undue cost or effort that may affect credit risk.

AG174. The methods used to determine whether credit risk has increased significantly on a financial instrument since initial recognition should consider the characteristics of the financial instrument (or group of financial instruments) and the default patterns in the past for comparable financial instruments. Despite the requirement in paragraph 79, for financial instruments for which default patterns are not concentrated at a specific point during the expected life of the financial instrument, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring. In such cases, an entity may use changes in the risk of a default occurring over the next 12 months to determine whether credit risk has increased significantly since initial recognition, unless circumstances indicate that a lifetime assessment is necessary.

AG175. However, for some financial instruments, or in some circumstances, it may not be appropriate to use changes in the risk of a default occurring over the next 12 months to determine whether lifetime expected credit losses should be recognized. For example, the change in the risk of a default occurring in the next 12 months may not be a suitable basis for determining whether credit risk has increased on a financial instrument with a maturity of more than 12 months when:

- (a) The financial instrument only has significant payment obligations beyond the next 12 months;
- (b) Changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months; or
- (c) Changes in credit-related factors only have an impact on the credit risk of the financial instrument (or have a more pronounced effect) beyond 12 months.

Determining Whether Credit Risk has Increased Significantly since Initial Recognition

AG176. When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect the credit risk on a financial instrument in accordance with paragraph 87(c). An entity need not undertake an exhaustive search for information when determining whether credit risk has increased significantly since initial recognition.

AG177. Credit risk analysis is a multifactor and holistic analysis; whether a specific factor is relevant, and its weight compared to other factors, will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region. An entity shall consider reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed. However, some factors or indicators may not be identifiable on an individual financial instrument level. In such a case, the factors or indicators should be assessed for appropriate portfolios, groups of portfolios or portions of a portfolio of financial instruments to determine whether the requirement in paragraph 73 for the recognition of lifetime expected credit losses has been met.

AG178. The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

- (a) Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.
- (b) Other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher revenue coverage) because of changes in the credit risk of the financial instrument since initial recognition.
- (c) Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:
 - (i) The credit spread;
 - (ii) The credit default swap prices for the borrower;
 - (iii) The length of time or the extent to which the fair value of a financial asset has been less than its amortized cost; and
 - (iv) Other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.
- (d) An actual or expected significant change in the financial instrument's external credit rating.
- (e) An actual or expected internal credit rating downgrade for the borrower or decrease in behavioral scoring used to assess credit risk internally. Internal credit ratings and internal behavioral scoring are more reliable when they are mapped to external ratings or supported by default studies.
- (f) Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.
- (g) An actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of operation or organizational structure (such as the discontinuance of a segment of the entity) that results in a significant change in the borrower's ability to meet its debt obligations.
- (h) Significant increases in credit risk on other financial instruments of the same borrower.
- (i) An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology.
- (j) Significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's

economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.

- (k) A significant change in the quality of the guarantee provided by an entity's owners (or an individual's guarantors) if the shareholder (or guarantors) have an incentive and financial ability to prevent default by capital or cash infusion.
- (l) Significant changes, such as reductions in financial support from a controlling entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitizations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security).
- (m) Expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument.
- (n) Significant changes in the expected performance and behavior of the borrower, including changes in the payment status of borrowers in the economic entity (for example, an increase in the expected number or extent of delayed contractual payments or significant increases in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount).
- (o) Changes in the entity's credit management approach in relation to the financial instrument; i.e., based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.
- (p) Past due information, including the rebuttable presumption as set out in paragraph 81.

AG179. In some cases, the qualitative and non-statistical quantitative information available may be sufficient to determine that a financial instrument has met the criterion for the recognition of a loss allowance at an amount equal to lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, i.e., qualitative factors that are not captured through the internal ratings process and a specific internal rating category at the reporting date, taking into consideration the credit risk characteristics at initial recognition, if both types of information are relevant.

More than 30 Days Past Due Rebuttable Presumption

AG180. The rebuttable presumption in paragraph 81 is not an absolute indicator that lifetime expected credit losses should be recognized, but is presumed to be the latest point at which lifetime expected credit

losses should be recognized even when using forward-looking information (including macroeconomic factors on a portfolio level).

AG181. An entity can rebut this presumption. However, it can do so only when it has reasonable and supportable information available that demonstrates that even if contractual payments become more than 30 days past due, this does not represent a significant increase in the credit risk of a financial instrument. For example when non-payment was an administrative oversight, instead of resulting from financial difficulty of the borrower, or the entity has access to historical evidence that demonstrates that there is no correlation between significant increases in the risk of a default occurring and financial assets on which payments are more than 30 days past due, but that evidence does identify such a correlation when payments are more than 60 days past due.

AG182. An entity cannot align the timing of significant increases in credit risk and the recognition of lifetime expected credit losses to when a financial asset is regarded as credit-impaired or an entity's internal definition of default.

Financial Instruments that have Low Credit Risk at the Reporting Date

AG183. The credit risk on a financial instrument is considered low for the purposes of paragraph 80, if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which an entity operates.

AG184. To determine whether a financial instrument has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed. An external rating of 'investment grade' is an example of a financial instrument that may be considered as having low credit risk. However, financial instruments are not required to be externally rated to be considered to have low credit risk. They should, however, be considered to have low credit risk from a market participant perspective taking into account all of the terms and conditions of the financial instrument.

AG185. Lifetime expected credit losses are not recognized on a financial instrument simply because it was considered to have low credit risk in the previous reporting period and is not considered to have low credit risk at the reporting date. In such a case, an entity shall determine whether there has been a significant increase in credit risk since initial recognition and thus whether lifetime expected credit losses are required to be recognized in accordance with paragraph 73.

Modifications

AG186. In some circumstances, the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset in accordance with this Standard. When the modification of a financial asset results in the derecognition of the existing financial asset

and the subsequent recognition of the modified financial asset, the modified asset is considered a 'new' financial asset for the purposes of this Standard.

AG187. Accordingly the date of the modification shall be treated as the date of initial recognition of that financial asset when applying the impairment requirements to the modified financial asset. This typically means measuring the loss allowance at an amount equal to 12-month expected credit losses until the requirements for the recognition of lifetime expected credit losses in paragraph 73 are met. However, in some unusual circumstances following a modification that results in derecognition of the original financial asset, there may be evidence that the modified financial asset is credit-impaired at initial recognition, and thus, the financial asset should be recognized as an originated credit-impaired financial asset. This might occur, for example, in a situation in which there was a substantial modification of a distressed asset that resulted in the derecognition of the original financial asset. In such a case, it may be possible for the modification to result in a new financial asset which is credit-impaired at initial recognition.

AG188. If the contractual cash flows on a financial asset have been renegotiated or otherwise modified, but the financial asset is not derecognized, that financial asset is not automatically considered to have lower credit risk. An entity shall assess whether there has been a significant increase in credit risk since initial recognition on the basis of all reasonable and supportable information that is available without undue cost or effort. This includes historical and forward-looking information and an assessment of the credit risk over the expected life of the financial asset, which includes information about the circumstances that led to the modification. Evidence that the criteria for the recognition of lifetime expected credit losses are no longer met may include a history of up-to-date and timely payment performance against the modified contractual terms. Typically a borrower would need to demonstrate consistently good payment behavior over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms.

Measurement of Expected Credit Losses

Expected Credit Losses

AG189. Expected credit losses are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

AG190. For financial assets, a credit loss is the present value of the difference between:

- (a) The contractual cash flows that are due to an entity under the contract; and
- (b) The cash flows that the entity expects to receive.

AG191. For undrawn loan commitments, a credit loss is the present value of the difference between:

- (a) The contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan; and
- (b) The cash flows that the entity expects to receive if the loan is drawn down.

- AG192. An entity's estimate of expected credit losses on loan commitments shall be consistent with its expectations of drawdowns on that loan commitment, i.e. it shall consider the expected portion of the loan commitment that will be drawn down within 12 months of the reporting date when estimating 12-month expected credit losses, and the expected portion of the loan commitment that will be drawn down over the expected life of the loan commitment when estimating lifetime expected credit losses.
- AG193. For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.
- AG194. For a financial asset that is credit-impaired at the reporting date, but that is not a purchased or originated credit-impaired financial asset, an entity shall measure the expected credit losses as the difference between the asset's gross carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. Any adjustment is recognized in surplus or deficit as an impairment gain or loss.
- AG195. When measuring a loss allowance for a lease receivable, the cash flows used for determining the expected credit losses should be consistent with the cash flows used in measuring the lease receivable in accordance with IPSAS 13 Leases.
- AG196. An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 87. An example of a practical expedient is the calculation of the expected credit losses on receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs AG212–AG213) for receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 percent if not past due, 2 percent if less than 30 days past due, 3 percent if more than 30 days but less than 90 days past due, 20 percent if 90–180 days past due etc.). Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as other government entities or individuals).

Definition of Default

- AG197. Paragraph 79 requires that when determining whether the credit risk on a financial instrument has increased significantly, an entity shall consider the change in the risk of a default occurring since initial recognition.
- AG198. When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has

reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes shall be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument.

Period over which to estimate expected credit losses

AG199. In accordance with paragraph 89, the maximum period over which expected credit losses shall be measured is the maximum contractual period over which the entity is exposed to credit risk. For loan commitments and financial guarantee contracts, this is the maximum contractual period over which an entity has a present contractual obligation to extend credit.

AG200. However, in accordance with paragraph 90, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For example, revolving credit facilities, such as line of credit provided by a government owned bank, can be contractually withdrawn by the lender with as little as one day's notice. However, in practice lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases, which could be too late to prevent some or all of the expected credit losses. These financial instruments generally have the following characteristics as a result of the nature of the financial instrument, the way in which the financial instruments are managed, and the nature of the available information about significant increases in credit risk:

- (a) The financial instruments do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day);
- (b) The contractual ability to cancel the contract is not enforced in the normal day-to-day management of the financial instrument and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level; and
- (c) The financial instruments are managed on a collective basis.

AG201. When determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions, an entity should consider factors such as historical information and experience about:

- (a) The period over which the entity was exposed to credit risk on similar financial instruments;
- (b) The length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and
- (c) The credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

Probability-weighted Outcome

AG202. The purpose of estimating expected credit losses is neither to estimate a worst-case scenario nor to estimate the best-case scenario. Instead, an estimate of expected credit losses shall always reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs even if the most likely outcome is no credit loss.

AG203. Paragraph 87(a) requires the estimate of expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. In practice, this may not need to be a complex analysis. In some cases, relatively simple modelling may be sufficient, without the need for a large number of detailed simulations of scenarios. For example, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. In those situations, the expected credit losses shall reflect at least two outcomes in accordance with paragraph 88.

AG204. For lifetime expected credit losses, an entity shall estimate the risk of a default occurring on the financial instrument during its expected life. 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring. Thus, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months nor the cash shortfalls that are predicted over the next 12 months.

Time Value of Money

AG205. Expected credit losses shall be discounted to the reporting date, not to the expected default or some other date, using the effective interest rate determined at initial recognition or an approximation thereof. If a financial instrument has a variable interest rate, expected credit losses shall be discounted using the current effective interest rate determined in accordance with paragraph AG157.

AG206. For purchased or originated credit-impaired financial assets, expected credit losses shall be discounted using the credit-adjusted effective interest rate determined at initial recognition.

AG207. Expected credit losses on lease receivables shall be discounted using the same discount rate used in the measurement of the lease receivable in accordance with IPSAS 13.

AG208. The expected credit losses on a loan commitment shall be discounted using the effective interest rate, or an approximation thereof, that will be applied when recognizing the financial asset resulting from the loan commitment. This is because for the purpose of applying the impairment requirements, a financial asset that is recognized following a draw down on a loan commitment shall be treated as a continuation of that commitment instead of as a new financial instrument. The expected credit losses on the financial asset shall therefore be measured considering the initial credit risk of the loan commitment from the date that the entity became a party to the irrevocable commitment.

AG209. Expected credit losses on financial guarantee contracts or on loan commitments for which the effective interest rate cannot be determined shall be discounted by applying a discount rate that reflects the current market assessment of the time value of money and the risks that are specific to the cash flows but only if, and to the extent that, the risks are taken into account by adjusting the discount rate instead of adjusting the cash shortfalls being discounted.

Reasonable and Supportable Information

AG210. For the purpose of this Standard, reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions. Information that is available for financial reporting purposes is considered to be available without undue cost or effort.

AG211. An entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument. The degree of judgment that is required to estimate expected credit losses depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgment required to estimate expected credit losses increases. The estimate of expected credit losses does not require a detailed estimate for periods that are far in the future—for such periods, an entity may extrapolate projections from available, detailed information.

AG212. An entity need not undertake an exhaustive search for information but shall consider all reasonable and supportable information that is available without undue cost or effort and that is relevant to the estimate of expected credit losses, including the effect of expected prepayments. The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, that may be both internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

AG213. Historical information is an important anchor or base from which to measure expected credit losses. However, an entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows. In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered. Estimates of changes in expected credit losses should reflect, and be directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience.

AG214. When using historical credit loss experience in estimating expected credit losses, it is important that information about historical credit loss rates is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit loss rates were observed. Consequently, the method used shall enable each group of financial assets to be associated with information about past credit loss experience in groups of financial assets with similar risk characteristics and with relevant observable data that reflects current conditions.

AG215. Expected credit losses reflect an entity's own expectations of credit losses. However, when considering all reasonable and supportable information that is available without undue cost or effort in estimating expected credit losses, an entity should also consider observable market information about the credit risk of the particular financial instrument or similar financial instruments.

Collateral

AG216. For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognized separately by the entity. The estimate of expected cash shortfalls on a collateralized financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable (i.e. the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realization of the collateral beyond the contractual maturity of the contract should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognized as an asset that is separate from the collateralized financial instrument unless it meets the relevant recognition criteria for an asset in this or other Standards.

Reclassification of Financial Assets

AG217. If an entity reclassifies financial assets in accordance with paragraph 54, paragraph 91 requires that the reclassification is applied prospectively from the reclassification date. Both the amortized cost measurement category and the fair value through net assets/equity measurement category require that the effective interest rate is determined at initial recognition. Both of those measurement categories also require that the impairment requirements are applied in the same way. Consequently, when an entity reclassifies a financial asset between the amortized cost measurement category and the fair value through net assets/equity measurement category:

- (a) The recognition of interest revenue will not change and therefore the entity continues to use the same effective interest rate.
- (b) The measurement of expected credit losses will not change because both measurement categories apply the same impairment approach. However if a financial asset is reclassified out of the fair value through net assets/equity measurement category and into the amortized cost measurement category, a loss allowance would be recognized as an adjustment to the gross carrying amount of the financial asset from the reclassification date. If a financial asset is reclassified out of the amortized cost measurement category and into the fair value through net assets/equity measurement category, the loss allowance would be derecognized (and thus would no longer be recognized as an adjustment to the gross carrying amount) but instead would be recognized as an accumulated impairment amount (of an equal amount) in net assets/equity and would be disclosed from the reclassification date.

AG218. However, an entity is not required to separately recognize interest revenue or impairment gains or losses for a financial asset measured at fair value through surplus or deficit. Consequently, when an entity reclassifies a financial asset out of the fair value through surplus or deficit measurement category, the effective interest rate is determined on the basis of the fair value of the asset at the reclassification date. In addition, for the purposes of applying paragraphs 71–90 to the financial asset from the reclassification date, the date of the reclassification is treated as the date of initial recognition.

Gains and Losses

AG219. Paragraph 103 permits an entity to make an irrevocable election to present in net assets/equity changes in the fair value of an investment in an equity instrument that is not held for trading. This election is made on an instrument-by-instrument (i.e., share-by-share) basis. Amounts presented in net assets/equity shall not be subsequently transferred to surplus or deficit. However, the entity may transfer the cumulative gain or loss within net assets/equity. Dividends or similar distributions on such investments are recognized in surplus or deficit in accordance with paragraph 104 unless the dividend clearly represents a recovery of part of the cost of the investment.

AG220. Unless paragraph 44 applies, paragraph 41 requires that a financial asset is measured at fair value through net assets/equity if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and the asset is held in a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets. This measurement category recognizes information in surplus or deficit as if the financial asset is measured at amortized cost, while the financial asset is measured in the statement of financial position at fair value. Gains or losses, other than those that are recognized in surplus or deficit in accordance with paragraphs 108–109, are recognized in net assets/equity. When these financial assets are derecognized, cumulative gains or losses previously recognized in net assets/equity are reclassified to surplus or deficit. This reflects the gain or loss that would have been recognized in surplus or deficit upon derecognition if the financial asset had been measured at amortized cost.

AG221. An entity applies IPSAS 4 to financial assets and financial liabilities that are monetary items in accordance with IPSAS 4 and denominated in a foreign currency. IPSAS 4 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognized in surplus or deficit. An exception is a monetary item that is designated as a hedging instrument in a cash flow hedge (see paragraph 137), a hedge of a net investment (see paragraph 139) or a fair value hedge of an equity instrument for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103 (see paragraph 134).

AG222. For the purpose of recognizing foreign exchange gains and losses under IPSAS 4, a financial asset measured at fair value through net assets/equity in accordance with paragraph 41 is treated as a monetary item. Accordingly, such a financial asset is treated as an asset measured at amortized cost in the foreign currency. Exchange differences on the amortized cost are recognized in surplus or deficit and other changes in the carrying amount are recognized in accordance with paragraph 108.

AG223. Paragraph 103 permits an entity to make an irrevocable election to present in net assets/equity subsequent changes in the fair value of particular investments in equity instruments. Such an investment is not a monetary item. Accordingly, the gain or loss that is presented in net assets/equity in accordance with paragraph 103 includes any related foreign exchange component.

AG224. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in surplus or deficit.

Liabilities Designated as at Fair Value Through Surplus or Deficit

AG225. When an entity designates a financial liability as at fair value through surplus or deficit, it must determine whether presenting in net assets/equity the effects of changes in the liability's credit risk

- would create or enlarge an accounting mismatch in surplus or deficit. An accounting mismatch would be created or enlarged if presenting the effects of changes in the liability's credit risk in net assets/equity would result in a greater mismatch in surplus or deficit than if those amounts were presented in surplus or deficit.
- AG226. To make that determination, an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in surplus or deficit by a change in the fair value of another financial instrument measured at fair value through surplus or deficit. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument.
- AG227. That determination is made at initial recognition and is not reassessed. For practical purposes the entity need not enter into all of the assets and liabilities giving rise to an accounting mismatch at exactly the same time. A reasonable delay is permitted provided that any remaining transactions are expected to occur. An entity must apply consistently its methodology for determining whether presenting in net assets/equity the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in surplus or deficit. However, an entity may use different methodologies when there are different economic relationships between the characteristics of the liabilities designated as at fair value through surplus or deficit and the characteristics of the other financial instruments. IPSAS 30 requires an entity to provide qualitative disclosures in the notes to the financial statements about its methodology for making that determination.
- AG228. If such a mismatch would be created or enlarged, the entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in surplus or deficit. If such a mismatch would not be created or enlarged, the entity is required to present the effects of changes in the liability's credit risk in net assets/equity.
- AG229. Amounts presented in net assets/equity shall not be subsequently transferred to surplus or deficit. However, the entity may transfer the cumulative gain or loss within equity.
- AG230. The following example describes a situation in which an accounting mismatch would be created in surplus or deficit if the effects of changes in the credit risk of the liability were presented in net assets/equity. A mortgage bank provides loans to customers and funds those loans by selling bonds with matching characteristics (e.g., amount outstanding, repayment profile, term and currency) in the market. The contractual terms of the loan permit the mortgage customer to prepay its loan (i.e. satisfy its obligation to the bank) by buying the corresponding bond at fair value in the market and delivering that bond to the mortgage bank. As a result of that contractual prepayment right, if the credit quality of the bond worsens (and, thus, the fair value of the mortgage bank's liability decreases), the fair value of the mortgage bank's loan asset also decreases. The change in the fair value of the asset reflects the mortgage customer's contractual right to prepay the mortgage loan by buying the underlying bond at fair value (which, in this example, has decreased) and delivering the bond to the mortgage bank. Consequently, the effects of changes in the credit risk of the liability (the bond) will be offset in surplus or deficit by a corresponding change in the fair value of a financial asset (the loan). If the effects of changes in the liability's credit risk were presented in net assets/equity there would be an accounting mismatch in surplus or deficit. Consequently, the mortgage bank is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in surplus or deficit.
- AG231. In the example in paragraph AG230, there is a contractual linkage between the effects of changes in the credit risk of the liability and changes in the fair value of the financial asset (i.e., as a result

of the mortgage customer's contractual right to prepay the loan by buying the bond at fair value and delivering the bond to the mortgage bank). However, an accounting mismatch may also occur in the absence of a contractual linkage.

AG232. For the purposes of applying the requirements in paragraphs 105 and 106, an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk. An accounting mismatch in surplus or deficit would arise only when the effects of changes in the liability's credit risk (as defined in IPSAS 30) are expected to be offset by changes in the fair value of another financial instrument. A mismatch that arises solely as a result of the measurement method (i.e. because an entity does not isolate changes in a liability's credit risk from some other changes in its fair value) does not affect the determination required by paragraphs 105 and 106. For example, an entity may not isolate changes in a liability's credit risk from changes in liquidity risk. If the entity presents the combined effect of both factors in net assets/equity, a mismatch may occur because changes in liquidity risk may be included in the fair value measurement of the entity's financial assets and the entire fair value change of those assets is presented in surplus or deficit. However, such a mismatch is caused by measurement imprecision, not the offsetting relationship described in paragraph AG226 and, therefore, does not affect the determination required by paragraphs 105 and 106.

The Meaning of 'Credit Risk' (paragraphs 105 and 106)

AG233. IPSAS 30 defines credit risk as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. The requirement in paragraph 105(a) relates to the risk that the issuer will fail to perform on that particular liability. It does not necessarily relate to the creditworthiness of the issuer. For example, if an entity issues a collateralized liability and a non-collateralized liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralized liability will be less than the credit risk of the non-collateralized liability. The credit risk for a collateralized liability may be close to zero.

AG234. For the purposes of applying the requirement in paragraph 105(a), credit risk is different from asset-specific performance risk. Asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but instead it is related to the risk that a single asset or a group of assets will perform poorly (or not at all).

AG235. The following are examples of asset-specific performance risk:

- (a) A liability with a unit-linking feature whereby the amount due to investors is contractually determined on the basis of the performance of specified assets. The effect of that unit-linking feature on the fair value of the liability is asset-specific performance risk, not credit risk.
- (b) A liability issued by a structured entity with the following characteristics. The entity is legally isolated so the assets in the entity are ring-fenced solely for the benefit of its investors, even in the event of bankruptcy. The entity enters into no other transactions and the assets in the entity cannot be hypothecated. Amounts are due to the entity's investors only if the ring-fenced assets generate cash flows. Thus, changes in the fair value of the liability primarily reflect changes in the fair value of the assets. The effect of the performance of the assets on the fair value of the liability is asset-specific performance risk, not credit risk.

Determining the Effects of Changes in Credit Risk

AG236. For the purposes of applying the requirement in paragraph 105(a), an entity shall determine the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability either:

- (a) As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see paragraphs AG237 and AG238); or
- (b) Using an alternative method the entity believes more faithfully represents the amount of change in the liability's fair value that is attributable to changes in its credit risk.

AG237. Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates.

AG238. If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount in paragraph AG236(a) can be estimated as follows:

- (a) First, the entity computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.
- (b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).
- (c) The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in net assets/equity in accordance with paragraph 105(a).

AG239. The example in paragraph AG238 assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in observed (benchmark) interest rates are not significant. This method would not be appropriate if changes in fair value arising from other factors are significant. In those cases, an entity is required to use an alternative method that more faithfully measures the effects of changes in the liability's credit risk (see paragraph AG236(b)). For example, if the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be presented in net assets/equity in accordance with paragraph 105(a).

AG240. As with all fair value measurements, an entity's measurement method for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk must make maximum use of relevant observable inputs and minimum use of unobservable inputs.

Hedge Accounting*Hedging Instruments*

Qualifying Instruments

AG241. Derivatives that are embedded in hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments.

AG242. An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

AG243. For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with IPSAS 4.

Written Options

AG244. This Standard does not restrict the circumstances in which a derivative that is measured at fair value through surplus or deficit may be designated as a hedging instrument, except for some written options. A written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability).

Designation of Hedging Instruments

AG245. For hedges other than hedges of foreign currency risk, when an entity designates a non-derivative financial asset or a non-derivative financial liability measured at fair value through surplus or deficit as a hedging instrument, it may only designate the non-derivative financial instrument in its entirety or a proportion of it.

AG246. A single hedging instrument may be designated as a hedging instrument of more than one type of risk, provided that there is a specific designation of the hedging instrument and of the different risk positions as hedged items. Those hedged items can be in different hedging relationships.

Hedged Items

Qualifying Items

AG247. A firm commitment to acquire an operation in a public sector combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.

AG248. An equity method investment cannot be a hedged item in a fair value hedge. This is because the equity method recognizes in surplus or deficit the investor's share of the investee's surplus or deficit, instead of changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge. This is because consolidation recognizes in surplus or deficit the controlled entity's surplus or deficit, instead of changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

AG249. Paragraph 122 permits an entity to designate as hedged items aggregated exposures that are a combination of an exposure and a derivative. When designating such a hedged item, an entity assesses whether the aggregated exposure combines an exposure with a derivative so that it

creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks). In that case, the entity may designate the hedged item on the basis of the aggregated exposure. For example:

- (a) An entity may hedge a given quantity of highly probable oil purchases in 15 months' time against price risk (based on US dollars) using a 15-month futures contract for oil. The highly probable oil purchases and the futures contract for oil in combination can be viewed as a 15-month fixed-amount US dollar foreign currency risk exposure for risk management purposes (i.e., like any fixed-amount US dollar cash outflow in 15 months' time).
- (b) An entity may hedge the foreign currency risk for the entire term of a 10-year fixed-rate debt denominated in a foreign currency. However, the entity requires fixed-rate exposure in its functional currency only for a short to medium term (say two years) and floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (i.e., on a two-year rolling basis) the entity fixes the next two years' interest rate exposure (if the interest level is such that the entity wants to fix interest rates). In such a situation an entity may enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed-rate foreign currency debt into a variable-rate functional currency exposure. This is overlaid with a two-year interest rate swap that—on the basis of the functional currency—swaps variable-rate debt into fixed-rate debt. In effect, the fixed-rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable-rate debt functional currency exposure for risk management purposes.

AG250. When designating the hedged item on the basis of the aggregated exposure, an entity considers the combined effect of the items that constitute the aggregated exposure for the purpose of assessing hedge effectiveness and measuring hedge ineffectiveness. However, the items that constitute the aggregated exposure remain accounted for separately. This means that, for example:

- (a) Derivatives that are part of an aggregated exposure are recognized as separate assets or liabilities measured at fair value; and
- (b) If a hedging relationship is designated between the items that constitute the aggregated exposure, the way in which a derivative is included as part of an aggregated exposure must be consistent with the designation of that derivative as the hedging instrument at the level of the aggregated exposure. For example, if an entity excludes the forward element of a derivative from its designation as the hedging instrument for the hedging relationship between the items that constitute the aggregated exposure, it must also exclude the forward element when including that derivative as a hedged item as part of the aggregated exposure. Otherwise, the aggregated exposure shall include a derivative, either in its entirety or a proportion of it.

AG251. Paragraph 124 states that in consolidated financial statements the foreign currency risk of a highly probable forecast transaction within an economic entity may qualify as a hedged item in a cash flow hedge, provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and that the foreign currency risk will affect consolidated surplus or deficit. For this purpose an entity can be a controlling entity, controlled entity, associate, joint arrangement or branch. If the foreign currency risk of a forecast transaction within the economic entity does not affect consolidated surplus or deficit, the transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management

charges between members of the same economic entity, unless there is a related external transaction. However, when the foreign currency risk of a forecast transaction within an economic entity will affect consolidated surplus or deficit, the transaction within the economic entity can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same economic entity if there is an onward sale of the inventory to a party external to the economic entity. Similarly, a forecast sale of plant and equipment within the economic entity from the entity that manufactured it to an entity that will use the plant and equipment in its operations may affect consolidated surplus or deficit. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognized for the plant and equipment may change if the forecast transaction within the economic entity is denominated in a currency other than the functional currency of the purchasing entity.

AG252. If a hedge of a forecast transaction within an economic entity qualifies for hedge accounting, any gain or loss is recognized in, and taken out of, net assets/equity in accordance with paragraph 137. The relevant period or periods during which the foreign currency risk of the hedged transaction affects surplus or deficit is when it affects consolidated surplus or deficit.

Designation of Hedged Items

AG253. A component is a hedged item that is less than the entire item. Consequently, a component reflects only some of the risks of the item of which it is a part or reflects the risks only to some extent (for example, when designating a proportion of an item).

Risk Components

AG254. To be eligible for designation as a hedged item, a risk component must be a separately identifiable component of the financial or the non-financial item, and the changes in the cash flows or the fair value of the item attributable to changes in that risk component must be reliably measurable.

AG255. When identifying what risk components qualify for designation as a hedged item, an entity assesses such risk components within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market.

AG256. When designating risk components as hedged items, an entity considers whether the risk components are explicitly specified in a contract (contractually specified risk components) or whether they are implicit in the fair value or the cash flows of an item of which they are a part (non-contractually specified risk components). Non-contractually specified risk components can relate to items that are not a contract (for example, forecast transactions) or contracts that do not explicitly specify the component (for example, a firm commitment that includes only one single price instead of a pricing formula that references different underlyings). For example:

- (a) Entity A has a long-term supply contract for natural gas that is priced using a contractually specified formula that references commodities and other factors (for example, gas oil, fuel oil and other components such as transport charges). Entity A hedges the gas oil component in that supply contract using a gas oil forward contract. Because the gas oil component is specified by the terms and conditions of the supply contract it is a contractually specified risk component. Hence, because of the pricing formula, Entity A concludes that the gas oil price exposure is separately identifiable. At the same time, there is a market for gas oil forward contracts. Hence, Entity A concludes that the gas oil price exposure is reliably measurable.

Consequently, the gas oil price exposure in the supply contract is a risk component that is eligible for designation as a hedged item.

- (b) Entity B hedges its future wheat purchases based on its production forecast. Hedging starts up to 15 months before delivery for part of the forecast purchase volume. Entity B increases the hedged volume over time (as the delivery date approaches). Entity B uses two different types of contracts to manage its wheat price risk:
 - (i) Exchange-traded wheat futures contracts; and
 - (ii) Wheat supply contracts for durum wheat from Canada delivered to a specific manufacturing site. These contracts price a tonne of wheat based on the exchange-traded wheat futures contract price plus a fixed price differential plus a variable logistics services charge using a pricing formula. The wheat supply contract is an executory contract in accordance with which Entity B takes actual delivery of wheat.

For deliveries that relate to the current harvest, entering into the wheat supply contracts allows Entity B to fix the price differential between the actual wheat quality purchased (durum wheat from Canada) and the benchmark quality that is the underlying of the exchange-traded futures contract. However, for deliveries that relate to the next harvest, the wheat supply contracts are not yet available, so the price differential cannot be fixed. Entity B uses exchange-traded wheat futures contracts to hedge the benchmark quality component of its wheat price risk for deliveries that relate to the current harvest as well as the next harvest. Entity B determines that it is exposed to three different risks: wheat price risk reflecting the benchmark quality, wheat price risk reflecting the difference (spread) between the price for the benchmark quality coffee and the particular durum wheat from Canada that it actually receives, and the variable logistics costs. For deliveries related to the current harvest, after Entity B enters into a wheat supply contract, the wheat price risk reflecting the benchmark quality is a contractually specified risk component because the pricing formula includes an indexation to the exchange-traded wheat futures contract price. Entity B concludes that this risk component is separately identifiable and reliably measurable. For deliveries related to the next harvest, Entity B has not yet entered into any wheat supply contracts (i.e., those deliveries are forecast transactions). Hence, the wheat price risk reflecting the benchmark quality is a non-contractually specified risk component. Entity B's analysis of the market structure takes into account how eventual deliveries of the particular wheat that it receives are priced. Hence, on the basis of this analysis of the market structure, Entity B concludes that the forecast transactions also involve the wheat price risk that reflects the benchmark quality as a risk component that is separately identifiable and reliably measurable even though it is not contractually specified. Consequently, Entity B may designate hedging relationships on a risk components basis (for the wheat price risk that reflects the benchmark quality) for wheat supply contracts as well as forecast transactions

- (c) Entity C hedges part of its future jet fuel purchases on the basis of its consumption forecast up to 24 months before delivery and increases the volume that it hedges over time. Entity C hedges this exposure using different types of contracts depending on the time horizon of the hedge, which affects the market liquidity of the derivatives. For the longer time horizons (12–24 months) Entity C uses crude oil contracts because only these have sufficient market liquidity. For time horizons of 6–12 months Entity C uses gas oil derivatives because they are

sufficiently liquid. For time horizons up to six months Entity C uses jet fuel contracts. Entity C's analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances is as follows:

- (i) Entity C operates in a geographical area in which Brent is the crude oil benchmark. Crude oil is a raw material benchmark that affects the price of various refined oil products as their most basic input. Gas oil is a benchmark for refined oil products, which is used as a pricing reference for oil distillates more generally. This is also reflected in the types of derivative financial instruments for the crude oil and refined oil products markets of the environment in which Entity C operates, such as:
 - The benchmark gas oil futures contract, which is used as the pricing reference for distillates—for example, jet fuel spread derivatives cover the price differential between jet fuel and that benchmark gas oil; and
 - The benchmark gas oil crack spread derivative (i.e. the derivative for the price differential between crude oil and gas oil—a refining margin), which is indexed to Brent crude oil.
- (ii) The benchmark crude oil futures contract, which is for Brent crude oil;
- (iii) The pricing of refined oil products does not depend on which particular crude oil is processed by a particular refinery because those refined oil products (such as gas oil or jet fuel) are standardized products.

Hence, Entity C concludes that the price risk of its jet fuel purchases includes a crude oil price risk component based on Brent crude oil and a gas oil price risk component, even though crude oil and gas oil are not specified in any contractual arrangement. Entity C concludes that these two risk components are separately identifiable and reliably measurable even though they are not contractually specified. Consequently, Entity C may designate hedging relationships for forecast jet fuel purchases on a risk components basis (for crude oil or gas oil). This analysis also means that if, for example, Entity C used crude oil derivatives based on West Texas Intermediate (WTI) crude oil, changes in the price differential between Brent crude oil and WTI crude oil would cause hedge ineffectiveness.

- (d) Entity D holds a fixed-rate debt instrument. This instrument is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate (for example, an interbank offered rate) and variable-rate instruments in that environment are typically indexed to that benchmark rate. Interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate, irrespective of the spread of debt instruments to that benchmark rate. The price of fixed-rate debt instruments varies directly in response to changes in the benchmark rate as they happen. Entity D concludes that the benchmark rate is a component that can be separately identified and reliably measured. Consequently, Entity D may designate hedging relationships for the fixed-rate debt instrument on a risk component basis for the benchmark interest rate risk.

AG257. When designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. For example, the qualifying criteria apply, including that the hedging relationship must meet the hedge effectiveness requirements, and any hedge ineffectiveness must be measured and recognized.

AG258. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a 'one-sided risk'). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, the entity designates only cash flow losses that result from an increase in the price above the specified level. The hedged risk does not include the time value of a purchased option, because the time value is not a component of the forecast transaction that affects surplus or deficit.

AG259. There is a rebuttable presumption that unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable and hence cannot be designated as a risk component of a financial instrument. However, in limited cases, it is possible to identify a risk component for inflation risk that is separately identifiable and reliably measurable because of the particular circumstances of the inflation environment and the relevant debt market.

AG260. For example, an entity issues debt in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. This means that for the respective currency, inflation is a relevant factor that is separately considered by the debt markets. In those circumstances the inflation risk component could be determined by discounting the cash flows of the hedged debt instrument using the term structure of zero-coupon real interest rates (i.e., in a manner similar to how a risk-free (nominal) interest rate component can be determined). Conversely, in many cases an inflation risk component is not separately identifiable and reliably measurable. For example, an entity issues only nominal interest rate debt in an environment with a market for inflation-linked bonds that is not sufficiently liquid to allow a term structure of zero-coupon real interest rates to be constructed. In this case the analysis of the market structure and of the facts and circumstances does not support the entity concluding that inflation is a relevant factor that is separately considered by the debt markets. Hence, the entity cannot overcome the rebuttable presumption that inflation risk that is not contractually specified is not separately identifiable and reliably measurable. Consequently, an inflation risk component would not be eligible for designation as the hedged item. This applies irrespective of any inflation hedging instrument that the entity has actually entered into. In particular, the entity cannot simply impute the terms and conditions of the actual inflation hedging instrument by projecting its terms and conditions onto the nominal interest rate debt.

AG261. A contractually specified inflation risk component of the cash flows of a recognized inflation-linked bond (assuming that there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable, as long as other cash flows of the instrument are not affected by the inflation risk component.

Components of a Nominal Amount

AG262. There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component. The type of component changes the accounting outcome. An entity shall designate the component for accounting purposes consistently with its risk management objective.

AG263. An example of a component that is a proportion is 50 percent of the contractual cash flows of a loan.

AG264. A layer component may be specified from a defined, but open, population, or from a defined nominal amount. Examples include:

- (a) Part of a monetary transaction volume, for example, the next FC10 cash flows from sales denominated in a foreign currency after the first FC20 in March 201X;³
- (b) A part of a physical volume, for example, the bottom layer, measuring 5 million cubic meters, of the natural gas stored in location XYZ;
- (c) A part of a physical or other transaction volume, for example, the first 100 barrels of the oil purchases in June 201X or the first 100 MWh of electricity sales in June 201X; or
- (d) A layer from the nominal amount of the hedged item, for example, the last CU80 million of a CU100 million firm commitment, the bottom layer of CU20 million of a CU100 million fixed-rate bond or the top layer of CU30 million from a total amount of CU100 million of fixed-rate debt that can be prepaid at fair value (the defined nominal amount is CU100 million).

AG265. If a layer component is designated in a fair value hedge, an entity shall specify it from a defined nominal amount. To comply with the requirements for qualifying fair value hedges, an entity shall remeasure the hedged item for fair value changes (i.e., remeasure the item for fair value changes attributable to the hedged risk). The fair value hedge adjustment must be recognized in surplus or deficit no later than when the item is derecognized. Consequently, it is necessary to track the item to which the fair value hedge adjustment relates. For a layer component in a fair value hedge, this requires an entity to track the nominal amount from which it is defined. For example, in paragraph AG264(d), the total defined nominal amount of CU100 million must be tracked in order to track the bottom layer of CU20 million or the top layer of CU30 million.

AG266. A layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the prepayment option's fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.

Relationship Between Components and the Total Cash Flows of an Item

AG267. If a component of the cash flows of a financial or a non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item. However, all of the cash flows of the entire item may be designated as the hedged item and hedged for only one particular risk (for example, only for those changes that are attributable to changes in a market related interest rate or a benchmark commodity price).

AG268. For example, in the case of a financial liability whose effective interest rate is below a market related interest rate, an entity cannot designate:

- (a) A component of the liability equal to interest at the market rate (plus the principal amount in case of a fair value hedge); and
- (b) A negative residual component.

AG269. However, in the case of a fixed-rate financial liability whose effective interest rate is (for example) 100 basis points below the market rate, an entity can designate as the hedged item the change in the value of that entire liability (i.e., principal plus interest at the market rate minus 100 basis points)

³ In this Standard monetary amounts are denominated in 'currency units' (CU) and 'foreign currency units' (FC).

that is attributable to changes in the market rate. If a fixed-rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a risk component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day when it first designates the hedged item. For example, assume that an entity originates a fixed-rate financial asset of CU100 that has an effective interest rate of 6 percent at a time when the market rate is 4 percent. It begins to hedge that asset some time later when the market rate has increased to 8 percent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates the related the market rate interest rate risk as the hedged item, the effective yield of the asset based on its then fair value of CU90 would have been 9.5 percent. Because the market rate is less than this effective yield, the entity can designate a the market rate component of 8 percent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (i.e., CU90) and the amount repayable on maturity (i.e., CU100).

AG270. If a variable-rate financial liability bears interest of (for example) three-month interbank offered rate minus 20 basis points (with a floor at zero basis points), an entity can designate as the hedged item the change in the cash flows of that entire liability (i.e., three-month interbank offered rate minus 20 basis points—including the floor) that is attributable to changes in interbank offered rate. Hence, as long as the three-month interbank offered rate forward curve for the remaining life of that liability does not fall below 20 basis points, the hedged item has the same cash flow variability as a liability that bears interest at three-month interbank offered rate with a zero or positive spread. However, if the three-month interbank offered rate forward curve for the remaining life of that liability (or a part of it) falls below 20 basis points, the hedged item has a lower cash flow variability than a liability that bears interest at three-month interbank offered rate with a zero or positive spread.

AG271. A similar example of a non-financial item is a specific type of crude oil from a particular oil field that is priced off the relevant benchmark crude oil. If an entity sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at the benchmark crude oil price minus CU10 with a floor of CU15, the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in the benchmark crude oil price. Hence, as long as the forward price (for each delivery) does not fall below CU25, the hedged item has the same cash flow variability as a crude oil sale at the benchmark crude oil price (or with a positive spread). However, if the forward price for any delivery falls below CU25, the hedged item has a lower cash flow variability than a crude oil sale at the benchmark crude oil price (or with a positive spread).

Qualifying Criteria for Hedge Accounting

Hedge Effectiveness

AG272. Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item.

AG273. When designating a hedging relationship and on an ongoing basis, an entity shall analyze the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis (including any updates in accordance with paragraph AG311 arising from rebalancing a hedging relationship) is the basis for the entity's assessment of meeting the hedge effectiveness requirements.

AG274. For the avoidance of doubt, the effects of replacing the original counterparty with a clearing counterparty and making the associated changes as described in paragraph 132 shall be reflected in the measurement of the hedging instrument and therefore in the assessment of hedge effectiveness and the measurement of hedge effectiveness.

Economic Relationship Between the Hedged Item and the Hedging Instrument

AG275. The requirement that an economic relationship exists means that the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk. Hence, there must be an expectation that the value of the hedging instrument and the value of the hedged item will systematically change in response to movements in either the same underlying or underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged (for example, Brent and WTI crude oil).

AG276. If the underlyings are not the same but are economically related, there can be situations in which the values of the hedging instrument and the hedged item move in the same direction, for example, because the price differential between the two related underlyings changes while the underlyings themselves do not move significantly. That is still consistent with an economic relationship between the hedging instrument and the hedged item if the values of the hedging instrument and the hedged item are still expected to typically move in the opposite direction when the underlyings move.

AG277. The assessment of whether an economic relationship exists includes an analysis of the possible behavior of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective. The mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists.

The Effect of Credit Risk

AG278. Because the hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item, hedge effectiveness is determined not only by the economic relationship between those items (i.e., the changes in their underlyings) but also by the effect of credit risk on the value of both the hedging instrument and the hedged item. The effect of credit risk means that even if there is an economic relationship between the hedging instrument and the hedged item, the level of offset might become erratic. This can result from a change in the credit risk of either the hedging instrument or the hedged item that is of such a magnitude that the credit risk dominates the value changes that result from the economic relationship (i.e., the effect of the changes in the underlyings). A level of magnitude that gives rise to dominance is one that would result in the loss (or gain) from credit risk frustrating the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant. Conversely, if during a particular period there is little change in the underlyings, the fact that even small credit risk-related changes in the value of the hedging instrument or the hedged item might affect the value more than the underlyings does not create dominance.

AG279. An example of credit risk dominating a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralized derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, the effect of the changes in the counterparty's credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas changes in the value of the hedged item depend largely on the commodity price changes.

Hedge Ratio

AG280. In accordance with the hedge effectiveness requirements, the hedge ratio of the hedging relationship must be the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. Hence, if an entity hedges less than 100 percent of the exposure on an item, such as 85 percent, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from 85 percent of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 85 percent. Similarly, if, for example, an entity hedges an exposure using a nominal amount of 40 units of a financial instrument, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from that quantity of 40 units (i.e., the entity must not use a hedge ratio based on a higher quantity of units that it might hold in total or a lower quantity of units) and the quantity of the hedged item that it actually hedges with those 40 units.

AG281. However, the designation of the hedging relationship using the same hedge ratio as that resulting from the quantities of the hedged item and the hedging instrument that the entity actually uses shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would in turn create hedge ineffectiveness (irrespective of whether recognized or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. Hence, for the purpose of designating a hedging relationship, an entity must adjust the hedge ratio that results from the quantities of the hedged item and the hedging instrument that the entity actually uses if that is needed to avoid such an imbalance.

AG282. Examples of relevant considerations in assessing whether an accounting outcome is inconsistent with the purpose of hedge accounting are:

- (a) Whether the intended hedge ratio is established to avoid recognizing hedge ineffectiveness for cash flow hedges, or to achieve fair value hedge adjustments for more hedged items with the aim of increasing the use of fair value accounting, but without offsetting fair value changes of the hedging instrument; and
- (b) Whether there is a commercial reason for the particular weightings of the hedged item and the hedging instrument, even though that creates hedge ineffectiveness. For example, an entity enters into and designates a quantity of the hedging instrument that is not the quantity that it determined as the best hedge of the hedged item because the standard volume of the hedging instruments does not allow it to enter into that exact quantity of hedging instrument (a 'lot size issue'). An example is an entity that hedges 1,000 tonnes of oil purchases with standard oil futures contracts that have a contract size of 1,000 barrels. The entity could only use either seven or eight contracts (equivalent to 980 tonnes and 1,120 tonnes respectively) to hedge the purchase volume of 1,000 tonnes. In that case, the entity designates the hedging relationship using the hedge ratio that results from the number of coffee futures contracts that it actually uses, because the hedge ineffectiveness resulting from the mismatch

in the weightings of the hedged item and the hedging instrument would not result in an accounting outcome that is inconsistent with the purpose of hedge accounting.

Frequency of Assessing Whether the Hedge Effectiveness Requirements are Met

AG283. An entity shall assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

Methods for Assessing Whether the Hedge Effectiveness Requirements are Met

AG284. This Standard does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity shall use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Depending on those factors, the method can be a qualitative or a quantitative assessment.

AG285. For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging instrument and the hedged item have values that will generally move in the opposite direction because of the same risk and hence that an economic relationship exists between the hedged item and the hedging instrument (see paragraphs AG275–AG277).

AG286. The fact that a derivative is in or out of the money when it is designated as a hedging instrument does not in itself mean that a qualitative assessment is inappropriate. It depends on the circumstances whether hedge ineffectiveness arising from that fact could have a magnitude that a qualitative assessment would not adequately capture.

AG287. Conversely, if the critical terms of the hedging instrument and the hedged item are not closely aligned, there is an increased level of uncertainty about the extent of offset. Consequently, the hedge effectiveness during the term of the hedging relationship is more difficult to predict. In such a situation it might only be possible for an entity to conclude on the basis of a quantitative assessment that an economic relationship exists between the hedged item and the hedging instrument (see paragraphs AG275–AG277). In some situations a quantitative assessment might also be needed to assess whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements (see paragraphs AG280–AG282). An entity can use the same or different methods for those two different purposes.

AG288. If there are changes in circumstances that affect hedge effectiveness, an entity may have to change the method for assessing whether a hedging relationship meets the hedge effectiveness requirements in order to ensure that the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness, are still captured.

AG289. An entity's risk management is the main source of information to perform the assessment of whether a hedging relationship meets the hedge effectiveness requirements. This means that the management information (or analysis) used for decision-making purposes can be used as a basis for assessing whether a hedging relationship meets the hedge effectiveness requirements.

AG290. An entity's documentation of the hedging relationship includes how it will assess the hedge effectiveness requirements, including the method or methods used. The documentation of the hedging relationship shall be updated for any changes to the methods (see paragraph AG288).

Accounting for Qualifying Hedging Relationships

AG291. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed-rate debt instrument arising from changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

AG292. The purpose of a cash flow hedge is to defer the gain or loss on the hedging instrument to a period or periods in which the hedged expected future cash flows affect surplus or deficit. An example of a cash flow hedge is the use of a swap to change floating rate debt (whether measured at amortized cost or fair value) to fixed-rate debt (i.e., a hedge of a future transaction in which the future cash flows being hedged are the future interest payments). Conversely, a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value through surplus or deficit, is an example of an item that cannot be the hedged item in a cash flow hedge, because any gain or loss on the hedging instrument that would be deferred could not be appropriately reclassified to surplus or deficit during a period in which it would achieve offset. For the same reason, a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value with changes in fair value presented in net assets/equity also cannot be the hedged item in a cash flow hedge.

AG293. A hedge of a firm commitment (for example, a hedge of the change in fuel price relating to an unrecognized contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, in accordance with paragraph 130, a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Measurement of Hedge Ineffectiveness

AG294. When measuring hedge ineffectiveness, an entity shall consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

AG295. To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item (this is commonly referred to as a 'hypothetical derivative'), and, for example for a hedge of a forecast transaction, would be calibrated using the hedged price (or rate) level. For example, if the hedge was for a two-sided risk at the current market level, the hypothetical derivative would represent a hypothetical forward contract that is calibrated to a value of nil at the time of designation of the hedging relationship. If the hedge was for example for a one-sided risk, the hypothetical derivative would represent the intrinsic value of a hypothetical option that at the time of designation of the hedging relationship is at the money if the hedged price level is the current market level, or out of the money if the hedged price level is above (or, for a hedge of a long position, below) the current market level. Using a hypothetical derivative is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach. Hence, using a 'hypothetical derivative' is not a method in its own right but a mathematical expedient that can only be used to calculate the value of the hedged item.

Consequently, a 'hypothetical derivative' cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item). An example is debt denominated in a foreign currency (irrespective of whether it is fixed-rate or variable-rate debt). When using a hypothetical derivative to calculate the change in the value of such debt or the present value of the cumulative change in its cash flows, the hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a charge (for example, cross-currency interest rate swaps).

AG296. The change in the value of the hedged item determined using a hypothetical derivative may also be used for the purpose of assessing whether a hedging relationship meets the hedge effectiveness requirements.

Rebalancing the Hedging Relationship and Changes to the Hedge Ratio

AG297. Rebalancing refers to the adjustments made to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedged item or of a hedging instrument for a different purpose do not constitute rebalancing for the purpose of this Standard.

AG298. Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs AG299–AG311. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognized immediately before adjusting the hedging relationship.

AG299. Adjusting the hedge ratio allows an entity to respond to changes in the relationship between the hedging instrument and the hedged item that arise from their underlyings or risk variables. For example, a hedging relationship in which the hedging instrument and the hedged item have different but related underlyings changes in response to a change in the relationship between those two underlyings (for example, different but related reference indices, rates or prices). Hence, rebalancing allows the continuation of a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio.

AG300. For example, an entity hedges an exposure to Foreign Currency A using a currency derivative that references Foreign Currency B and Foreign Currencies A and B are pegged (i.e., their exchange rate is maintained within a band or at an exchange rate set by a central bank or other authority). If the exchange rate between Foreign Currency A and Foreign Currency B were changed (i.e., a new band or rate was set), rebalancing the hedging relationship to reflect the new exchange rate would ensure that the hedging relationship would continue to meet the hedge effectiveness requirement for the hedge ratio in the new circumstances. In contrast, if there was a default on the currency derivative, changing the hedge ratio could not ensure that the hedging relationship would continue to meet that hedge effectiveness requirement. Hence, rebalancing does not facilitate the continuation of a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that cannot be compensated for by adjusting the hedge ratio.

AG301. Not every change in the extent of offset between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows constitutes a change in the relationship between the hedging instrument and the hedged item. An entity analyzes the sources of hedge

ineffectiveness that it expected to affect the hedging relationship during its term and evaluates whether changes in the extent of offset are:

- (a) Fluctuations around the hedge ratio, which remains valid (i.e., continues to appropriately reflect the relationship between the hedging instrument and the hedged item); or
- (b) An indication that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item.

An entity performs this evaluation against the hedge effectiveness requirement for the hedge ratio, i.e., to ensure that the hedging relationship does not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognized or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. Hence, this evaluation requires judgment.

AG302. Fluctuation around a constant hedge ratio (and hence the related hedge ineffectiveness) cannot be reduced by adjusting the hedge ratio in response to each particular outcome. Hence, in such circumstances, the change in the extent of offset is a matter of measuring and recognizing hedge ineffectiveness but does not require rebalancing.

AG303. Conversely, if changes in the extent of offset indicate that the fluctuation is around a hedge ratio that is different from the hedge ratio that is currently used for that hedging relationship, or that there is a trend leading away from that hedge ratio, hedge ineffectiveness can be reduced by adjusting the hedge ratio, whereas retaining the hedge ratio would increasingly produce hedge ineffectiveness. Hence, in such circumstances, an entity must evaluate whether the hedging relationship reflects an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognized or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. If the hedge ratio is adjusted, it also affects the measurement and recognition of hedge ineffectiveness because, on rebalancing, the hedge ineffectiveness of the hedging relationship must be determined and recognized immediately before adjusting the hedging relationship in accordance with paragraph AG298.

AG304. Rebalancing means that, for hedge accounting purposes, after the start of a hedging relationship an entity adjusts the quantities of the hedging instrument or the hedged item in response to changes in circumstances that affect the hedge ratio of that hedging relationship. Typically, that adjustment should reflect adjustments in the quantities of the hedging instrument and the hedged item that it actually uses. However, an entity must adjust the hedge ratio that results from the quantities of the hedged item or the hedging instrument that it actually uses if:

- (a) The hedge ratio that results from changes to the quantities of the hedging instrument or the hedged item that the entity actually uses would reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting; or
- (b) An entity would retain quantities of the hedging instrument and the hedged item that it actually uses, resulting in a hedge ratio that, in new circumstances, would reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (i.e., an entity must not create an imbalance by omitting to adjust the hedge ratio).

AG305. Rebalancing does not apply if the risk management objective for a hedging relationship has changed. Instead, hedge accounting for that hedging relationship shall be discontinued (despite that an entity might designate a new hedging relationship that involves the hedging instrument or hedged item of the previous hedging relationship as described in paragraph AG318).

AG306. If a hedging relationship is rebalanced, the adjustment to the hedge ratio can be effected in different ways:

- (a) The weighting of the hedged item can be increased (which at the same time reduces the weighting of the hedging instrument) by:
 - (i) Increasing the volume of the hedged item; or
 - (ii) Decreasing the volume of the hedging instrument.
- (b) The weighting of the hedging instrument can be increased (which at the same time reduces the weighting of the hedged item) by:
 - (i) Increasing the volume of the hedging instrument; or
 - (ii) Decreasing the volume of the hedged item.

Changes in volume refer to the quantities that are part of the hedging relationship. Hence, decreases in volumes do not necessarily mean that the items or transactions no longer exist, or are no longer expected to occur, but that they are not part of the hedging relationship. For example, decreasing the volume of the hedging instrument can result in the entity retaining a derivative, but only part of it might remain a hedging instrument of the hedging relationship. This could occur if the rebalancing could be effected only by reducing the volume of the hedging instrument in the hedging relationship, but with the entity retaining the volume that is no longer needed. In that case, the undesignated part of the derivative would be accounted for at fair value through surplus or deficit (unless it was designated as a hedging instrument in a different hedging relationship).

AG307. Adjusting the hedge ratio by increasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item related to the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the value of the hedged item also include the change in the value of the additional volume of the hedged item. These changes are measured starting from, and by reference to, the date of rebalancing instead of the date on which the hedging relationship was designated. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price of CU80 (the forward price at inception of the hedging relationship) and added a volume of 10 tonnes on rebalancing when the forward price was CU90, the hedged item after rebalancing would comprise two layers: 100 tonnes hedged at CU80 and 10 tonnes hedged at CU90.

AG308. Adjusting the hedge ratio by decreasing the volume of the hedging instrument does not affect how the changes in the value of the hedged item are measured. The measurement of the changes in the fair value of the hedging instrument related to the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and reduces that volume by 10 tonnes on rebalancing, a nominal amount of 90 tonnes of the hedging instrument volume would remain (see paragraph AG306 for the

consequences for the derivative volume (i.e., the 10 tonnes) that is no longer a part of the hedging relationship).

AG309. Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect how the changes in the value of the hedged item are measured. The measurement of the changes in the fair value of the hedging instrument related to the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the fair value of the hedging instrument also include the changes in the value of the additional volume of the hedging instrument. The changes are measured starting from, and by reference to, the date of rebalancing instead of the date on which the hedging relationship was designated. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and added a volume of 10 tonnes on rebalancing, the hedging instrument after rebalancing would comprise a total derivative volume of 110 tonnes. The change in the fair value of the hedging instrument is the total change in the fair value of the derivatives that make up the total volume of 110 tonnes. These derivatives could (and probably would) have different critical terms, such as their forward rates, because they were entered into at different points in time (including the possibility of designating derivatives into hedging relationships after their initial recognition).

AG310. Adjusting the hedge ratio by decreasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item related to the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedged item was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price of CU80 and reduces that volume by 10 tonnes on rebalancing, the hedged item after rebalancing would be 90 tonnes hedged at CU80. The 10 tonnes of the hedged item that are no longer part of the hedging relationship would be accounted for in accordance with the requirements for the discontinuation of hedge accounting (see paragraphs 132–133 and AG312–AG318).

AG311. When rebalancing a hedging relationship, an entity shall update its analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its (remaining) term (see paragraph AG273). The documentation of the hedging relationship shall be updated accordingly.

Discontinuation of Hedge Accounting

AG312. Discontinuation of hedge accounting applies prospectively from the date on which the qualifying criteria are no longer met.

AG313. An entity shall not de-designate and thereby discontinue a hedging relationship that:

- (a) Still meets the risk management objective on the basis of which it qualified for hedge accounting (i.e., the entity still pursues that risk management objective); and
- (b) Continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).

AG314. For the purposes of this Standard, an entity's risk management strategy is distinguished from its risk management objectives. The risk management strategy is established at the highest level at which an entity determines how it manages its risk. Risk management strategies typically identify the risks to which the entity is exposed and set out how the entity responds to them. A risk

management strategy is typically in place for a longer period and may include some flexibility to react to changes in circumstances that occur while that strategy is in place (for example, different interest rate or commodity price levels that result in a different extent of hedging). This is normally set out in a general document that is cascaded down through an entity through policies containing more specific guidelines. In contrast, the risk management objective for a hedging relationship applies at the level of a particular hedging relationship. It relates to how the particular hedging instrument that has been designated is used to hedge the particular exposure that has been designated as the hedged item. Hence, a risk management strategy can involve many different hedging relationships whose risk management objectives relate to executing that overall risk management strategy. For example:

- (a) An entity has a strategy of managing its interest rate exposure on debt funding that sets ranges for the overall entity for the mix between variable-rate and fixed-rate funding. The strategy is to maintain between 20 percent and 40 percent of the debt at fixed rates. The entity decides from time to time how to execute this strategy (i.e., where it positions itself within the 20 percent to 40 percent range for fixed-rate interest exposure) depending on the level of interest rates. If interest rates are low the entity fixes the interest for more debt than when interest rates are high. The entity's debt is CU100 of variable-rate debt of which CU30 is swapped into a fixed-rate exposure. The entity takes advantage of low interest rates to issue an additional CU50 of debt to finance a major investment, which the entity does by issuing a fixed-rate bond. In the light of the low interest rates, the entity decides to set its fixed interest-rate exposure to 40 percent of the total debt by reducing by CU20 the extent to which it previously hedged its variable-rate exposure, resulting in CU60 of fixed-rate exposure. In this situation the risk management strategy itself remains unchanged. However, in contrast the entity's execution of that strategy has changed and this means that, for CU20 of variable-rate exposure that was previously hedged, the risk management objective has changed (i.e., at the hedging relationship level). Consequently, in this situation hedge accounting must be discontinued for CU20 of the previously hedged variable-rate exposure. This could involve reducing the swap position by a CU20 nominal amount but, depending on the circumstances, an entity might retain that swap volume and, for example, use it for hedging a different exposure or it might become part of a trading book. Conversely, if an entity instead swapped a part of its new fixed-rate debt into a variable-rate exposure, hedge accounting would have to be continued for its previously hedged variable-rate exposure.
- (b) Some exposures result from positions that frequently change, for example, the interest rate risk of an open portfolio of debt instruments. The addition of new debt instruments and the derecognition of debt instruments continuously change that exposure (i.e., it is different from simply running off a position that matures). This is a dynamic process in which both the exposure and the hedging instruments used to manage it do not remain the same for long. Consequently, an entity with such an exposure frequently adjusts the hedging instruments used to manage the interest rate risk as the exposure changes. For example, debt instruments with 24 months' remaining maturity are designated as the hedged item for interest rate risk for 24 months. The same procedure is applied to other time buckets or maturity periods. After a short period of time, the entity discontinues all, some or a part of the previously designated hedging relationships for maturity periods and designates new hedging relationships for maturity periods on the basis of their size and the hedging instruments that exist at that time. The discontinuation of hedge accounting in this situation reflects that those hedging relationships are established in such a way that the entity looks

at a new hedging instrument and a new hedged item instead of the hedging instrument and the hedged item that were designated previously. The risk management strategy remains the same, but there is no risk management objective that continues for those previously designated hedging relationships, which as such no longer exist. In such a situation, the discontinuation of hedge accounting applies to the extent to which the risk management objective has changed. This depends on the situation of an entity and could, for example, affect all or only some hedging relationships of a maturity period, or only part of a hedging relationship.

- (c) An entity has a risk management strategy whereby it manages the foreign currency risk of forecast sales and the resulting receivables. Within that strategy the entity manages the foreign currency risk as a particular hedging relationship only up to the point of the recognition of the receivable. Thereafter, the entity no longer manages the foreign currency risk on the basis of that particular hedging relationship. Instead, it manages together the foreign currency risk from receivables, payables and derivatives (that do not relate to forecast transactions that are still pending) denominated in the same foreign currency. For accounting purposes, this works as a 'natural' hedge because the gains and losses from the foreign currency risk on all of those items are immediately recognized in surplus or deficit. Consequently, for accounting purposes, if the hedging relationship is designated for the period up to the payment date, it must be discontinued when the receivable is recognized, because the risk management objective of the original hedging relationship no longer applies. The foreign currency risk is now managed within the same strategy but on a different basis. Conversely, if an entity had a different risk management objective and managed the foreign currency risk as one continuous hedging relationship specifically for that forecast sales amount and the resulting receivable until the settlement date, hedge accounting would continue until that date.

AG315. The discontinuation of hedge accounting can affect:

- (a) A hedging relationship in its entirety; or
- (b) A part of a hedging relationship (which means that hedge accounting continues for the remainder of the hedging relationship).

AG316. A hedging relationship is discontinued in its entirety when, as a whole, it ceases to meet the qualifying criteria. For example:

- (a) The hedging relationship no longer meets the risk management objective on the basis of which it qualified for hedge accounting (i.e., the entity no longer pursues that risk management objective);
- (b) The hedging instrument or instruments have been sold or terminated (in relation to the entire volume that was part of the hedging relationship); or
- (c) There is no longer an economic relationship between the hedged item and the hedging instrument or the effect of credit risk starts to dominate the value changes that result from that economic relationship.

AG317. A part of a hedging relationship is discontinued (and hedge accounting continues for its remainder) when only a part of the hedging relationship ceases to meet the qualifying criteria. For example:

- (a) On rebalancing of the hedging relationship, the hedge ratio might be adjusted in such a way that some of the volume of the hedged item is no longer part of the hedging relationship (see paragraph AG310); hence, hedge accounting is discontinued only for the volume of the hedged item that is no longer part of the hedging relationship; or
- (b) When the occurrence of some of the volume of the hedged item that is (or is a component of) a forecast transaction is no longer highly probable, hedge accounting is discontinued only for the volume of the hedged item whose occurrence is no longer highly probable. However, if an entity has a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur, the entity's ability to predict forecast transactions accurately is called into question when predicting similar forecast transactions. This affects the assessment of whether similar forecast transactions are highly probable (see paragraph 121) and hence whether they are eligible as hedged items.

AG318. An entity can designate a new hedging relationship that involves the hedging instrument or hedged item of a previous hedging relationship for which hedge accounting was (in part or in its entirety) discontinued. This does not constitute a continuation of a hedging relationship but is a restart. For example:

- (a) A hedging instrument experiences such a severe credit deterioration that the entity replaces it with a new hedging instrument. This means that the original hedging relationship failed to achieve the risk management objective and is hence discontinued in its entirety. The new hedging instrument is designated as the hedge of the same exposure that was hedged previously and forms a new hedging relationship. Hence, the changes in the fair value or the cash flows of the hedged item are measured starting from, and by reference to, the date of designation of the new hedging relationship instead of the date on which the original hedging relationship was designated.
- (b) A hedging relationship is discontinued before the end of its term. The hedging instrument in that hedging relationship can be designated as the hedging instrument in another hedging relationship (for example, when adjusting the hedge ratio on rebalancing by increasing the volume of the hedging instrument or when designating a whole new hedging relationship).

Accounting for the Time Value of Options

AG319. An option can be considered as being related to a time period because its time value represents a charge for providing protection for the option holder over a period of time. However, the relevant aspect for the purpose of assessing whether an option hedges a transaction or time-period related hedged item are the characteristics of that hedged item, including how and when it affects surplus or deficit. Hence, an entity shall assess the type of hedged item (see paragraph 141(a)) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

- (a) The time value of an option relates to a transaction related hedged item if the nature of the hedged item is a transaction for which the time value has the character of costs of that transaction. An example is when the time value of an option relates to a hedged item that results in the recognition of an item whose initial measurement includes transaction costs (for example, an entity hedges a commodity purchase, whether it is a forecast transaction or a firm commitment, against the commodity price risk and includes the transaction costs in the

initial measurement of the inventory). As a consequence of including the time value of the option in the initial measurement of the particular hedged item, the time value affects surplus or deficit at the same time as that hedged item. Similarly, an entity that hedges a sale of a commodity, whether it is a forecast transaction or a firm commitment, would include the time value of the option as part of the cost related to that sale (hence, the time value would be recognized in surplus or deficit in the same period as the revenue from the hedged sale).

- (b) The time value of an option relates to a time-period related hedged item if the nature of the hedged item is such that the time value has the character of a cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of a transaction cost in accordance with (a)). For example, if commodity inventory is hedged against a fair value decrease for six months using a commodity option with a corresponding life, the time value of the option would be allocated to surplus or deficit (i.e., amortized on a systematic and rational basis) over that six-month period. Another example is a hedge of a net investment in a foreign operation that is hedged for 18 months using a foreign-exchange option, which would result in allocating the time value of the option over that 18-month period.

AG320. The characteristics of the hedged item, including how and when the hedged item affects surplus or deficit, also affect the period over which the time value of an option that hedges a time-period related hedged item is amortized, which is consistent with the period over which the option's intrinsic value can affect surplus or deficit in accordance with hedge accounting. For example, if an interest rate option (a cap) is used to provide protection against increases in the interest expense on a floating rate bond, the time value of that cap is amortized to surplus or deficit over the same period over which any intrinsic value of the cap would affect surplus or deficit:

- (a) If the cap hedges increases in interest rates for the first three years out of a total life of the floating rate bond of five years, the time value of that cap is amortized over the first three years; or
- (b) If the cap is a forward start option that hedges increases in interest rates for years two and three out of a total life of the floating rate bond of five years, the time value of that cap is amortized during years two and three.

AG321. The accounting for the time value of options in accordance with paragraph 141 also applies to a combination of a purchased and a written option (one being a put option and one being a call option) that at the date of designation as a hedging instrument has a net nil time value (commonly referred to as a 'zero-cost collar'). In that case, an entity shall recognize any changes in time value in net assets/equity, even though the cumulative change in time value over the total period of the hedging relationship is nil. Hence, if the time value of the option relates to:

- (a) A transaction related hedged item, the amount of time value at the end of the hedging relationship that adjusts the hedged item or that is reclassified to surplus or deficit (see paragraph 141(b)) would be nil.
- (b) A time-period related hedged item, the amortization expense related to the time value is nil.

AG322. The accounting for the time value of options in accordance with paragraph 141 applies only to the extent that the time value relates to the hedged item (aligned time value). The time value of an option relates to the hedged item if the critical terms of the option (such as the nominal amount, life and underlying) are aligned with the hedged item. Hence, if the critical terms of the option and the

hedged item are not fully aligned, an entity shall determine the aligned time value, i.e., how much of the time value included in the premium (actual time value) relates to the hedged item (and therefore should be treated in accordance with paragraph 141). An entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.

AG323. If the actual time value and the aligned time value differ, an entity shall determine the amount that is accumulated in a separate component of equity in accordance with paragraph 141 as follows:

- (a) If, at inception of the hedging relationship, the actual time value is higher than the aligned time value, the entity shall:
 - (i) Determine the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and
 - (ii) Account for the differences in the fair value changes between the two time values in surplus or deficit.
- (b) If, at inception of the hedging relationship, the actual time value is lower than the aligned time value, the entity shall determine the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:
 - (i) The actual time value; and
 - (ii) The aligned time value.

Any remainder of the change in fair value of the actual time value shall be recognized in surplus or deficit.

Accounting for the Forward Element of Forward Contracts and Foreign Currency Basis Spreads of Financial Instruments

AG324. A forward contract can be considered as being related to a time period because its forward element represents charges for a period of time (which is the tenor for which it is determined). However, the relevant aspect for the purpose of assessing whether a hedging instrument hedges a transaction or time-period related hedged item are the characteristics of that hedged item, including how and when it affects surplus or deficit. Hence, an entity shall assess the type of hedged item (see paragraphs 141(a) and 142) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

- (a) The forward element of a forward contract relates to a transaction related hedged item if the nature of the hedged item is a transaction for which the forward element has the character of costs of that transaction. An example is when the forward element relates to a hedged item that results in the recognition of an item whose initial measurement includes transaction costs (for example, an entity hedges an inventory purchase denominated in a foreign currency, whether it is a forecast transaction or a firm commitment, against foreign currency risk and includes the transaction costs in the initial measurement of the inventory). As a consequence of including the forward element in the initial measurement of the particular hedged item, the forward element affects surplus or deficit at the same time as that hedged item. Similarly, an entity that hedges a sale of a commodity denominated in a foreign currency against foreign currency risk, whether it is a forecast transaction or a firm commitment, would include the forward element as part of the cost that is related to that sale (hence, the forward element

would be recognized in surplus or deficit in the same period as the revenue from the hedged sale).

- (b) The forward element of a forward contract relates to a time-period related hedged item if the nature of the hedged item is such that the forward element has the character of a cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of a transaction cost in accordance with (a)). For example, if commodity inventory is hedged against changes in fair value for six months using a commodity forward contract with a corresponding life, the forward element of the forward contract would be allocated to surplus or deficit (i.e., amortized on a systematic and rational basis) over that six-month period. Another example is a hedge of a net investment in a foreign operation that is hedged for 18 months using a foreign-exchange forward contract, which would result in allocating the forward element of the forward contract over that 18-month period.

AG325. The characteristics of the hedged item, including how and when the hedged item affects surplus or deficit, also affect the period over which the forward element of a forward contract that hedges a time-period related hedged item is amortized, which is over the period to which the forward element relates. For example, if a forward contract hedges the exposure to variability in three-month interest rates for a three-month period that starts in six months' time, the forward element is amortized during the period that spans months seven to nine.

AG326. The accounting for the forward element of a forward contract in accordance with paragraph 142 also applies if, at the date on which the forward contract is designated as a hedging instrument, the forward element is nil. In that case, an entity shall recognize any fair value changes attributable to the forward element in net assets/equity, even though the cumulative fair value change attributable to the forward element over the total period of the hedging relationship is nil. Hence, if the forward element of a forward contract relates to:

- (a) A transaction related hedged item, the amount in respect of the forward element at the end of the hedging relationship that adjusts the hedged item or that is reclassified to surplus or deficit (see paragraphs 141(b) and 142) would be nil.
- (b) A time-period related hedged item, the amortization amount related to the forward element is nil.

AG327. The accounting for the forward element of forward contracts in accordance with paragraph 142 applies only to the extent that the forward element relates to the hedged item (aligned forward element). The forward element of a forward contract relates to the hedged item if the critical terms of the forward contract (such as the nominal amount, life and underlying) are aligned with the hedged item. Hence, if the critical terms of the forward contract and the hedged item are not fully aligned, an entity shall determine the aligned forward element, i.e., how much of the forward element included in the forward contract (actual forward element) relates to the hedged item (and therefore should be treated in accordance with paragraph 141(c)). An entity determines the aligned forward element using the valuation of the forward contract that would have critical terms that perfectly match the hedged item.

AG328. If the actual forward element and the aligned forward element differ, an entity shall determine the amount that is accumulated in a separate component of equity in accordance with paragraph 142 as follows:

- (a) If, at inception of the hedging relationship, the absolute amount of the actual forward element is higher than that of the aligned forward element the entity shall:
 - (i) Determine the amount that is accumulated in a separate component of equity on the basis of the aligned forward element; and
 - (ii) Account for the differences in the fair value changes between the two forward Elements in surplus or deficit.
- (b) If, at inception of the hedging relationship, the absolute amount of the actual forward element is lower than that of the aligned forward element, the entity shall determine the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:
 - (i) The absolute amount of the actual forward element; and
 - (ii) The absolute amount of the aligned forward element.

Any remainder of the change in fair value of the actual forward element shall be recognized in surplus or deficit.

AG329. When an entity separates the foreign currency basis spread from a financial instrument and excludes it from the designation of that financial instrument as the hedging instrument (see paragraph 116(b)), the application guidance in paragraphs AG324–AG328 applies to the foreign currency basis spread in the same manner as it is applied to the forward element of a forward contract.

Hedge of a Group of Items

Hedge of a Net Position

Eligibility for Hedge Accounting and Designation of a Net Position

AG330. A net position is eligible for hedge accounting only if an entity hedges on a net basis for risk management purposes. Whether an entity hedges in this way is a matter of fact (not merely of assertion or documentation). Hence, an entity cannot apply hedge accounting on a net basis solely to achieve a particular accounting outcome if that would not reflect its risk management approach. Net position hedging must form part of an established risk management strategy. Normally this would be approved by key management personnel as defined in IPSAS 20.

AG331. For example, Entity A, whose functional currency is its local currency, has a firm commitment to pay FC150,000 for advertising expenses in nine months' time and a firm commitment to sell finished goods for FC150,000 in 15 months' time. Entity A enters into a foreign currency derivative that settles in nine months' time under which it receives FC100 and pays CU70. Entity A has no other exposures to FC. Entity A does not manage foreign currency risk on a net basis. Hence, Entity A cannot apply hedge accounting for a hedging relationship between the foreign currency derivative and a net position of FC100 (consisting of FC150,000 of the firm purchase commitment—i.e., advertising services—and FC149,900 (of the FC150,000) of the firm sale commitment) for a nine-month period.

AG332. If Entity A did manage foreign currency risk on a net basis and did not enter into the foreign currency derivative (because it increases its foreign currency risk exposure instead of reducing it), then the entity would be in a natural hedged position for nine months. Normally, this hedged position would not be reflected in the financial statements because the transactions are recognized in different

reporting periods in the future. The nil net position would be eligible for hedge accounting only if the conditions in paragraph 148 are met.

AG333. When a group of items that constitute a net position is designated as a hedged item, an entity shall designate the overall group of items that includes the items that can make up the net position. An entity is not permitted to designate a non-specific abstract amount of a net position. For example, an entity has a group of firm sale commitments in nine months' time for FC100 and a group of firm purchase commitments in 18 months' time for FC120. The entity cannot designate an abstract amount of a net position up to FC20. Instead, it must designate a gross amount of purchases and a gross amount of sales that together give rise to the hedged net position. An entity shall designate gross positions that give rise to the net position so that the entity is able to comply with the requirements for the accounting for qualifying hedging relationships.

Application of the Hedge Effectiveness Requirements to a Hedge of a Net Position

AG334. When an entity determines whether the hedge effectiveness requirements of paragraph 126(c) are met when it hedges a net position, it shall consider the changes in the value of the items in the net position that have a similar effect as the hedging instrument in conjunction with the fair value change on the hedging instrument. For example, an entity has a group of firm sale commitments in nine months' time for FC100 and a group of firm purchase commitments in 18 months' time for FC120. It hedges the foreign currency risk of the net position of FC20 using a forward exchange contract for FC20. When determining whether the hedge effectiveness requirements of paragraph 126(c) are met, the entity shall consider the relationship between:

- (a) The fair value change on the forward exchange contract together with the foreign currency risk related changes in the value of the firm sale commitments; and
- (b) The foreign currency risk related changes in the value of the firm purchase commitments.

AG335. Similarly, if in the example in paragraph AG334 the entity had a nil net position it would consider the relationship between the foreign currency risk related changes in the value of the firm sale commitments and the foreign currency risk related changes in the value of the firm purchase commitments when determining whether the hedge effectiveness requirements of paragraph 126(c) are met.

Cash Flow Hedges that Constitute a Net Position

AG336. When an entity hedges a group of items with offsetting risk positions (i.e., a net position), the eligibility for hedge accounting depends on the type of hedge. If the hedge is a fair value hedge, then the net position may be eligible as a hedged item. If, however, the hedge is a cash flow hedge, then the net position can only be eligible as a hedged item if it is a hedge of foreign currency risk and the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect surplus or deficit and also specifies their nature and volume.

AG337. For example, an entity has a net position that consists of a bottom layer of FC100 of sales and a bottom layer of FC150 of purchases. Both sales and purchases are denominated in the same foreign currency. In order to sufficiently specify the designation of the hedged net position, the entity specifies in the original documentation of the hedging relationship that sales can be of Product A or Product B and purchases can be of Machinery Type A, Machinery Type B and Raw Material A. The entity also specifies the volumes of the transactions by each nature. The entity documents that the bottom layer of sales (FC100) is made up of a forecast sales volume of the first FC70 of Product

A and the first FC30 of Product B. If those sales volumes are expected to affect surplus or deficit in different reporting periods, the entity would include that in the documentation, for example, the first FC70 from sales of Product A that are expected to affect surplus or deficit in the first reporting period and the first FC30 from sales of Product B that are expected to affect surplus or deficit in the second reporting period. The entity also documents that the bottom layer of the purchases (FC150) is made up of purchases of the first FC60 of Machinery Type A, the first FC40 of Machinery Type B and the first FC50 of Raw Material A. If those purchase volumes are expected to affect surplus or deficit in different reporting periods, the entity would include in the documentation a disaggregation of the purchase volumes by the reporting periods in which they are expected to affect surplus or deficit (similarly to how it documents the sales volumes). For example, the forecast transaction would be specified as:

- (a) The first FC60 of purchases of Machinery Type A that are expected to affect surplus or deficit from the third reporting period over the next ten reporting periods;
- (b) The first FC40 of purchases of Machinery Type B that are expected to affect surplus or deficit from the fourth reporting period over the next 20 reporting periods; and
- (c) The first FC50 of purchases of Raw Material A that are expected to be received in the third reporting period and sold, i.e., affect surplus or deficit, in that and the next reporting period.

Specifying the nature of the forecast transaction volumes would include aspects such as the depreciation pattern for items of property, plant and equipment of the same kind, if the nature of those items is such that the depreciation pattern could vary depending on how the entity uses those items. For example, if the entity uses items of Machinery Type A in two different production processes that result in straight-line depreciation over ten reporting periods and the units of production method respectively, its documentation of the forecast purchase volume for Machinery Type A would disaggregate that volume by which of those depreciation patterns will apply.

AG338. For a cash flow hedge of a net position, the amounts determined in accordance with paragraph 137 shall include the changes in the value of the items in the net position that have a similar effect as the hedging instrument in conjunction with the fair value change on the hedging instrument. However, the changes in the value of the items in the net position that have a similar effect as the hedging instrument are recognized only once the transactions that they relate to are recognized, such as when a forecast sale is recognized as revenue. For example, an entity has a group of highly probable forecast sales in nine months' time for FC100 and a group of highly probable forecast purchases in 18 months' time for FC120. It hedges the foreign currency risk of the net position of FC20 using a forward exchange contract for FC20. When determining the amounts that are recognized in the cash flow hedge reserve in accordance with paragraph 137(a)–137(b), the entity compares:

- (a) The fair value change on the forward exchange contract together with the foreign currency risk related changes in the value of the highly probable forecast sales; with
- (b) The foreign currency risk related changes in the value of the highly probable forecast purchases.

However, the entity recognizes only amounts related to the forward exchange contract until the highly probable forecast sales transactions are recognized in the financial statements, at which time the gains or losses on those forecast transactions are recognized (i.e., the change in the value

attributable to the change in the foreign exchange rate between the designation of the hedging relationship and the recognition of revenue).

AG339. Similarly, if in the example the entity had a nil net position it would compare the foreign currency risk related changes in the value of the highly probable forecast sales with the foreign currency risk related changes in the value of the highly probable forecast purchases. However, those amounts are recognized only once the related forecast transactions are recognized in the financial statements.

Layers of Groups of Items Designated as the Hedged Item

AG340. For the same reasons noted in paragraph AG265, designating layer components of groups of existing items requires the specific identification of the nominal amount of the group of items from which the hedged layer component is defined.

AG341. A hedging relationship can include layers from several different groups of items. For example, in a hedge of a net position of a group of assets and a group of liabilities, the hedging relationship can comprise, in combination, a layer component of the group of assets and a layer component of the group of liabilities.

Presentation of Hedging Instrument Gains or Losses

AG342. If items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of surplus or deficit and net assets/equity. The presentation of hedging gains or losses in that statement depends on the group of items.

AG343. If the group of items does not have any offsetting risk positions (for example, a group of foreign currency expenses that affect different line items in the statement of surplus or deficit and net assets/equity that are hedged for foreign currency risk) then the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items. This apportionment shall be done on a systematic and rational basis and shall not result in the grossing up of the net gains or losses arising from a single hedging instrument.

AG344. If the group of items does have offsetting risk positions (for example, a group of sales and expenses denominated in a foreign currency hedged together for foreign currency risk) then an entity shall present the hedging gains or losses in a separate line item in the statement of surplus or deficit and net assets/equity. Consider, for example, a hedge of the foreign currency risk of a net position of foreign currency sales of FC100 and foreign currency expenses of FC80 using a forward exchange contract for FC20. The gain or loss on the forward exchange contract that is reclassified from the cash flow hedge reserve to surplus or deficit (when the net position affects surplus or deficit) shall be presented in a separate line item from the hedged sales and expenses. Moreover, if the sales occur in an earlier period than the expenses, the sales revenue is still measured at the spot exchange rate in accordance with IPSAS 4. The related hedging gain or loss is presented in a separate line item, so that surplus or deficit reflects the effect of hedging the net position, with a corresponding adjustment to the cash flow hedge reserve. When the hedged expenses affect surplus or deficit in a later period, the hedging gain or loss previously recognized in the cash flow hedge reserve on the sales is reclassified to surplus or deficit and presented as a separate line item from those that include the hedged expenses, which are measured at the spot exchange rate in accordance with IPSAS 4.

AG345. For some types of fair value hedges, the objective of the hedge is not primarily to offset the fair value change of the hedged item but instead to transform the cash flows of the hedged item. For example, an entity hedges the fair value interest rate risk of a fixed-rate debt instrument using an interest rate swap. The entity's hedge objective is to transform the fixed-interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationship by accruing the net interest accrual on the interest rate swap in surplus or deficit. In the case of a hedge of a net position (for example, a net position of a fixed-rate asset and a fixed-rate liability), this net interest accrual must be presented in a separate line item in the statement of surplus or deficit and net assets/equity. This is to avoid the grossing up of a single instrument's net gains or losses into offsetting gross amounts and recognizing them in different line items (for example, this avoids grossing up a net interest receipt on a single interest rate swap into gross interest revenue and gross interest expense).

Effective Date and Transition

Transition

Financial Assets Held for Trading

AG346. At the date of initial application of this Standard, an entity must determine whether the objective of the entity's management model for managing any of its financial assets meets the condition in paragraph 40(a) or the condition in paragraph 41(a) or if a financial asset is eligible for the election in paragraph 103. For that purpose, an entity shall determine whether financial assets meet the definition of held for trading as if the entity had purchased the assets at the date of initial application.

Impairment

AG347. On transition, an entity should seek to approximate the credit risk on initial recognition by considering all reasonable and supportable information that is available without undue cost or effort. An entity is not required to undertake an exhaustive search for information when determining, at the date of transition, whether there have been significant increases in credit risk since initial recognition. If an entity is unable to make this determination without undue cost or effort paragraph 174 applies.

AG348. In order to determine the loss allowance on financial instruments initially recognized (or loan commitments or financial guarantee contracts to which the entity became a party to the contract) prior to the date of initial application, both on transition and until the derecognition of those items an entity shall consider information that is relevant in determining or approximating the credit risk at initial recognition. In order to determine or approximate the initial credit risk, an entity may consider internal and external information, including portfolio information, in accordance with paragraphs AG162–AG167.

AG349. An entity with little historical information may use information from internal reports and statistics (that may have been generated when deciding whether to launch a new product), information about similar products or peer group experience for comparable financial instruments, if relevant.

Appendix B – Hedges of a Net Investment in a Foreign Operation

This Appendix is an integral part of [draft] IPSAS [X] (ED 62).

Introduction

- B1. Many reporting entities have investments in foreign operations (as defined in IPSAS 4, paragraph 10). Such foreign operations may be controlled entities, associates, joint ventures or branches. IPSAS 4 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognize foreign exchange differences directly in net assets/equity until it disposes of the foreign operation.
- B2. Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements. This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint venters are accounted for using the equity method and financial statements that include a branch or joint operations as defined in IPSAS 37. The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.
- B3. [draft] IPSAS [X] (ED 62) requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognized directly in net assets/equity and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.
- B4. This appendix applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with [draft] IPSAS [X] (ED 62). It should not be applied by analogy to other types of hedge accounting. This appendix refers to such an entity as a controlling entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a controlling entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.
- B5. This appendix provides guidance on:
 - (a) Identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation, given that an entity with many foreign operations may be exposed to a number of foreign currency risks. It specifically addresses:
 - (i) Whether the controlling entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the controlling entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the controlling entity's consolidated financial statements and the functional currency of the foreign operation; and

- (ii) If the controlling entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate controlling entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate controlling entity (i.e., whether the fact that the net investment in the foreign operation is held through an intermediate controlling entity affects the economic risk to the ultimate controlling entity).
- (b) Where in an economic entity the hedging instrument can be held. It specifically addresses:
 - (i) [draft] IPSAS [X] (ED 62) allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This appendix addresses whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.
 - (ii) This appendix also addresses where, within an economic entity, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting i.e., whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity within the economic entity, regardless of its functional currency, can hold the hedging instrument.
- (c) How an entity should determine what amount of the gain or loss recognized in net assets/equity should be recognized directly in surplus or deficit for both the hedging instrument and the hedged item as IPSAS 4 and [draft] IPSAS [X] (ED 62) require cumulative amounts recognized directly in net assets/equity relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be recognized directly when the controlling entity disposes of the foreign operation. It specifically addresses:
 - (i) When a foreign operation that was hedged is disposed of, what amounts from the controlling entity's foreign currency translation reserve in respect of the hedging instrument and of that foreign operation should be recognized in surplus or deficit in the controlling entity's consolidated financial statements; and
 - (ii) Whether the method of consolidation affects the determination of the amounts to be recognized in surplus or deficit.

Application of [draft] IPSAS [X] (ED 62) to Hedges of a Net Investment in a Foreign Operation

Nature of the Hedged Risk and Amount of the Hedged Item for which a Hedging Relationship may be Designated

- B6. Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the controlling entity's functional currency.
- B7. In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the controlling entity. The

carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a controlling entity depends on whether any lower level controlling entity of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the controlling entity's consolidated financial statements.

- B8. The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any controlling entity (the immediate, intermediate or ultimate controlling entity) of that foreign operation. The fact that the net investment is held through an intermediate controlling entity does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate controlling entity.
- B9. An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one controlling entity within the economic entity (e.g., both a direct and an indirect controlling entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate controlling entity. A hedging relationship designated by one controlling entity in its consolidated financial statements need not be maintained by another higher level controlling entity. However, if it is not maintained by the higher level controlling entity, the hedge accounting applied by the lower level controlling entity must be reversed before the higher level controlling entity's hedge accounting is recognized.
- B10. A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the economic entity, as long as the designation, documentation and effectiveness requirements of [draft] IPSAS [X] (ED 62) paragraph 126 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the economic entity should be clearly documented because of the possibility of different designations at different levels of the economic entity.
- B11. For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the controlling entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognized in surplus or deficit, directly in net assets/equity, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognized in surplus or deficit or directly in net assets/equity. As part of the application of hedge accounting, the total effective portion of the change is included directly in net assets/equity. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

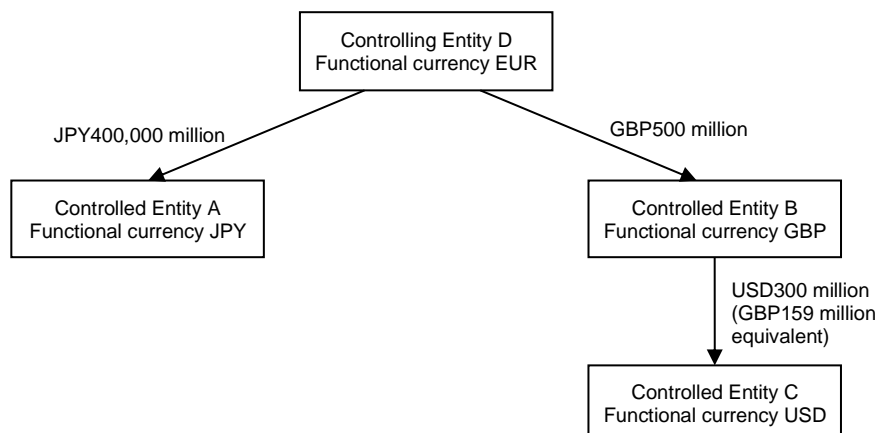
Disposal of a Hedged Foreign Operation

- B12. When a foreign operation that was hedged is disposed of, the amount reclassified to surplus or deficit from the foreign currency translation reserve in the consolidated financial statements of the controlling entity in respect of the hedging instrument is the amount that [draft] IPSAS [X] (ED 62) paragraph 140 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.

- B13. The amount recognized in surplus or deficit upon transfer from the foreign currency translation reserve in the consolidated financial statements of a controlling entity in respect of the net investment in that foreign operation in accordance with IPSAS 4 paragraph 57 is the amount included in that controlling entity's foreign currency translation reserve in respect of that foreign operation. In the ultimate controlling entity's consolidated financial statements, the aggregate net amount recognized in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate controlling entity uses the direct or the step-by-step method of consolidation, this may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation.
- B14. The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate controlling entity. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate controlling entity(ies) and then translated into the functional currency of the ultimate controlling entity (or the presentation currency if different).
- B15. The use of the step-by-step method of consolidation may result in a different amount being recognized in surplus or deficit from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by IPSAS 4. However, it is an accounting policy choice that should be followed consistently for all net investments.

Example

- B16. The following example illustrates the application of the preceding paragraphs using the entity structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with [draft] IPSAS [X] (ED 62), although this testing is not discussed. Controlling Entity D, being the ultimate controlling entity, presents its consolidated financial statements in its functional currency of euro (EUR). Each of the controlled entities i.e., Controlled Entity A, Controlled Entity B and Controlled Entity C, is wholly owned. Controlling Entity D £500 million net investment in Controlled Entity B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Controlled Entity B's US\$300 million net investment in Controlled Entity C (functional currency US dollars (USD)). In other words, Controlled Entity B's net assets other than its investment in Controlled Entity C are £341 million.



Nature of Hedged Risk for which a Hedging Relationship may be Designated (paragraphs B6–B9)

B17. Controlling Entity D can hedge its net investment in each of Controlled Entities A, B and C for the foreign exchange risk between their respective functional currencies (Japanese yen (JPY), pounds sterling and US dollars) and euro. In addition, Controlled Entity D can hedge the USD/GBP foreign exchange risk between the functional currencies of Controlled Entity B and Controlled Entity C. In its consolidated financial statements, Controlled Entity B can hedge its net investment in Controlled Entity C for the foreign exchange risk between their functional currencies of US dollars and pounds sterling. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Controlling Entity D could designate the forward foreign exchange risk.

Amount of Hedged item for which a Hedging Relationship may be Designated (paragraphs B6–B9)

B18. Controlling Entity D wishes to hedge the foreign exchange risk from its net investment in Controlled Entity C. Assume that Controlled Entity A has an external borrowing of US\$300 million. The net assets of Controlled Entity A at the start of the reporting period are ¥400,000 million including the proceeds of the external borrowing of US\$300 million.

B19. The hedged item can be an amount of net assets equal to or less than the carrying amount of Controlling Entity D's net investment in Controlled Entity C (US\$300 million) in its consolidated financial statements. In its consolidated financial statements Controlling Entity D can designate the US\$300 million external borrowing in Controlled Entity A as a hedge of the EUR/USD spot foreign exchange risk associated with its net investment in the US\$300 million net assets of Controlled Entity C. In this case, both the EUR/USD foreign exchange difference on the US\$300 million external borrowing in Controlled Entity A and the EUR/USD foreign exchange difference on the US\$300 million net investment in Controlled Entity C are included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements after the application of hedge accounting.

B20. In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Controlled Entity A would be recognized in Controlling Entity D's consolidated financial statements as follows:

- USD/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit; and
- JPY/EUR spot foreign exchange rate change directly in net assets/equity.

Instead of the designation in paragraph B19, in its consolidated financial statements Controlling Entity D can designate the US\$300 million external borrowing in Controlled Entity A as a hedge of the GBP/USD spot foreign exchange risk between Controlled Entity C and Controlled Entity B. In this case, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Entity A would instead be recognized in Controlled Entity D's consolidated financial statements as follows:

- The GBP/USD spot foreign exchange rate change in the foreign currency translation reserve relating to Controlled Entity C;
- GBP/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit; and
- JPY/EUR spot foreign exchange rate change directly in net assets/equity.

B21. Controlling Entity D cannot designate the US\$300 million external borrowing in Controlled Entity A as a hedge of both the EUR/USD spot foreign exchange risk and the GBP/USD spot foreign

exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Controlled Entity B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the economic entity comprising Controlled Entity B and Controlled Entity C.

Where in an Economic Entity can the Hedging Instrument be Held (paragraphs B10 and B11)?

B22. As noted in paragraph B20, the total change in value in respect of foreign exchange risk of the US\$300 million external borrowing in Controlled Entity A would be recorded in both surplus or deficit (USD/JPY spot risk) and directly in net assets/equity (EUR/JPY spot risk) in Controlling Entity D's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in paragraph B19 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Controlling Entity D against the US dollar functional currency of Controlled Entity C, in accordance with the hedge documentation. The method of consolidation (i.e., direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts Recognized in Surplus or Deficit on Disposal of a Foreign Operation (paragraphs B12 and B13)

B23. When Controlled Entity C is disposed of, the amounts are recognized in surplus or deficit in Controlling Entity D's consolidated financial statements upon transfer from its foreign currency translation reserve (FCTR) are:

- (a) In respect of the US\$300 million external borrowing of Controlled Entity A, the amount that [draft] IPSAS [X] (ED 62) requires to be identified, i.e., the total change in value in respect of foreign exchange risk that was recognized directly in net assets/equity as the effective portion of the hedge; and
- (b) In respect of the US\$300 million net investment in Controlled Entity C, the amount determined by the entity's consolidation method. If Controlling Entity D uses the direct method, its FCTR in respect of Controlled Entity C will be determined directly by the EUR/USD foreign exchange rate. If Controlling Entity D uses the step-by-step method, its FCTR in respect of Controlled Entity C will be determined by the FCTR recognized by Controlled Entity B reflecting the GBP/USD foreign exchange rate, translated to Controlling Entity D's functional currency using the EUR/GBP foreign exchange rate. Controlling Entity D's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be recognized in surplus or deficit when it disposes of Controlled Entity C to be the amount that it would have recognized if it had always used the direct method, depending on its accounting policy.

Hedging More Than One Foreign Operation (paragraphs B7, B9, and B11)

B24. The following examples illustrate that in the consolidated financial statements of Controlling Entity D, the risk that can be hedged is always the risk between its functional currency (euro) and the functional currencies of Controlled Entities B and C. No matter how the hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements when both foreign operations are hedged are US\$300 million for EUR/USD risk and £341 million for EUR/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Controlling Entity D's consolidated surplus or

deficit. Of course, it would be possible for Controlling Entity D to designate US\$300 million only for changes in the USD/GBP spot foreign exchange rate or £500 million only for changes in the GBP/EUR spot foreign exchange rate.

Entity D Holds Both USD and GBP Hedging Instruments

- B25. Controlling Entity D may wish to hedge the foreign exchange risk in relation to its net investment in Controlled Entity B as well as that in relation to Controlled Entity C. Assume that Controlling Entity D holds suitable hedging instruments denominated in US dollars and pounds sterling that it could designate as hedges of its net investments in Controlled Entity B and Controlled Entity C. The designations Controlling Entity D can make in its consolidated financial statements include, but are not limited to, the following:
- (a) US\$300 million hedging instrument designated as a hedge of the US\$300 million of net investment in Controlled Entity C with the risk being the spot foreign exchange exposure (EUR/USD) between Controlling Entity D and Controlled Entity C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between Controlling Entity D and Controlled Entity B.
 - (b) US\$300 million hedging instrument designated as a hedge of the US\$300 million of net investment in Controlled Entity C with the risk being the spot foreign exchange exposure (GBP/USD) between Controlled Entity B and Controlled Entity C and up to £500 million hedging instrument designated as a hedge of £500 million of the net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between Controlling Entity D and Controlled Entity B.
- B26. The EUR/USD risk from Controlling Entity D's net investment in Controlled Entity C is a different risk from the EUR/GBP risk from Controlling Entity D's net investment in Controlled Entity B. However, in the case described in paragraph B25(a), by its designation of the USD hedging instrument it holds, Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in Controlled Entity C. If Controlling Entity D also designated a GBP instrument it holds as a hedge of its £500 million net investment in Controlled Entity B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in Controlled Entity C, would be hedged twice for GBP/EUR risk in Controlling Entity D's consolidated financial statements.
- B27. In the case described in paragraph B25(b), if Controlling Entity D designates the hedged risk as the spot foreign exchange exposure (GBP/USD) between Controlled Entity B and Controlled Entity C, only the GBP/USD part of the change in the value of its US\$300 million hedging instrument is included in Controlling Entity D's foreign currency translation reserve relating to Controlled Entity C. The remainder of the change (equivalent to the GBP/EUR change on £159 million) is included in Controlling Entity D's consolidated surplus or deficit, as in paragraph B20. Because the designation of the USD/GBP risk between Controlled entities B and C does not include the GBP/EUR risk, Controlled Entity D is also able to designate up to £500 million of its net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (GBP/EUR) between Controlling Entity D and Controlled Entity B.

Entity B Holds the USD Hedging Instrument

- B28. Assume that Controlled Entity B holds US\$300 million of external debt, the proceeds of which were transferred to Controlling Entity D by an inter-entity loan denominated in pounds sterling. Because

both its assets and liabilities increased by £159 million, Controlled Entity B's net assets are unchanged. Controlled Entity B could designate the external debt as a hedge of the GBP/USD risk of its net investment in Controlled Entity C in its consolidated financial statements. Controlling Entity D could maintain Controlled Entity B's designation of that hedging instrument as a hedge of its US\$300 million net investment in Controlled Entity C for the GBP/USD risk (see paragraph B9) and Controlling Entity D could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in Controlled Entity B. The first hedge, designated by Controlled Entity B, would be assessed by reference to Controlled Entity B's functional currency (pounds sterling) and the second hedge, designated by Controlling Entity D, would be assessed by reference to Controlling Entity D's functional currency (euro). In this case, only the GBP/USD risk from Controlling Entity D's net investment in Controlled Entity C has been hedged in Controlling Entity D's consolidated financial statements by the USD hedging instrument, not the entire EUR/USD risk. Therefore, the entire EUR/GBP risk from Controlling Entity D's £500 million net investment in Controlled Entity B may be hedged in the consolidated financial statements of Controlling Entity D.

- B29. However, the accounting for Controlled Entity D's £159 million loan payable to Controlled Entity B must also be considered. If Controlling Entity D's loan payable is not considered part of its net investment in Controlled Entity B because it does not satisfy the conditions in IPSAS 4 paragraph 18, the GBP/EUR foreign exchange difference arising on translating it would be included in Controlling Entity D's consolidated surplus or deficit. If the £159 million loan payable to Controlled Entity B is considered part of Controlling Entity D's net investment, that net investment would be only £341 million and the amount Controlling Entity D could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.
- B30. If Controlling Entity D reversed the hedging relationship designated by Controlled Entity B, Controlling Entity D could designate the US\$300 million external borrowing held by Controlled Entity B as a hedge of its US\$300 million net investment in Controlled Entity C for the EUR/USD risk and designate the GBP hedging instrument it holds itself as a hedge of only up to £341 million of the net investment in Controlled Entity B. In this case the effectiveness of both hedges would be computed by reference to Controlling Entity D's functional currency (euro). Consequently, both the USD/GBP change in value of the external borrowing held by Controlled Entity B and the GBP/EUR change in value of Controlling Entity D's loan payable to Controlled Entity B (equivalent to USD/EUR in total) would be included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements. Because Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in Controlled Entity C, it can hedge only up to £341 million for the EUR/GBP risk of its net investment in Controlled Entity B.

Appendix C: Extinguishing Financial Liabilities with Equity Instruments

This appendix is an integral part of [draft] IPSAS [X] (ED 62).

Introduction

- C1. A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'.

Scope

- C2. This appendix addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability. It does not address the accounting by the creditor.
- C3. An entity shall not apply this appendix to transactions in situations where:
- (a) The creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder.
 - (b) The creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity.
 - (c) Extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability.
- C4. This appendix addresses the following issues:
- (a) Are an entity's equity instruments issued to extinguish all or part of a financial liability 'consideration paid' in accordance with paragraph 37 of [draft] IPSAS [X] (ED 62)?
 - (b) How should an entity initially measure the equity instruments issued to extinguish such a financial liability?
 - (c) How should an entity account for any difference between the carrying amount of the financial liability extinguished and the initial measurement amount of the equity instruments issued?

Consensus

- C5. The issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraph 37 of [draft] IPSAS [X] (ED 62). An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished in accordance with paragraph 35 of [draft] IPSAS [X] (ED 62).
- C6. When equity instruments issued to a creditor to extinguish all or part of a financial liability are recognized initially, an entity shall measure them at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured.
- C7. If the fair value of the equity instruments issued cannot be reliably measured then the equity instruments shall be measured to reflect the fair value of the financial liability extinguished. In

measuring the fair value of a financial liability extinguished that includes a demand feature (e.g. a demand deposit), paragraph 66 of [draft] IPSAS [X] (ED 62) is not applied.

- C8. If only part of the financial liability is extinguished, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid does relate to a modification of the terms of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding. The entity shall consider all relevant facts and circumstances relating to the transaction in making this allocation.
- C9. The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognized in surplus or deficit, in accordance with paragraph 37 of [draft] IPSAS [X] (ED 62). The equity instruments issued shall be recognized initially and measured at the date the financial liability (or part of that liability) is extinguished.
- C10. When only part of the financial liability is extinguished, consideration shall be allocated in accordance with paragraph C8. The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability as required by paragraph 36 of [draft] IPSAS [X] (ED 62).
- C11. An entity shall disclose a gain or loss recognized in accordance with paragraphs C9 and C10 as a separate line item in surplus or deficit or in the notes.

Amendments to Other IPSASs

Amendments to IPSAS 1, *Presentation of Financial Statements*

Paragraphs 7, 79, 82, 101, 102 and 138 are amended and paragraphs 125A, 125B, 125C and 153K are added. New text is underlined and deleted text is struck through.

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Definitions

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7. **Net assets/equity is the residual interest in the assets of the entity after deducting all its liabilities.**

The components of net assets/equity are contributed capital, accumulated surpluses or deficits, reserves, and non-controlling interests. Types of reserves include:

- (a) Changes in revaluation surplus (see IPSAS 17, *Property, Plant and Equipment* and IPSAS 31, *Intangible Assets*);
- (b) Remeasurements of defined benefit plans (see IPSAS 39, *Employee Benefits*);
- (c) Gains and losses arising from translating the financial statements of a foreign operation (see IPSAS 4, *The Effects of Changes in Foreign Exchange Rates*);
- (d) Gains and losses from investments in equity instruments designated at fair value through net assets/equity in accordance with paragraph 103 of [draft] IPSAS [X] (ED 62), *Financial Instruments*;
- (e) Gains and losses on financial assets measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62);
- (f) The effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through net assets/equity in accordance with paragraph 103 of [draft] IPSAS [X] (ED 62) (see paragraphs 110-152 of [draft] IPSAS [X] (ED 62));
- (g) For particular liabilities designated as at fair value through surplus or deficit, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 105 of [draft] IPSAS [X] (ED 62));
- (h) Changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value (see paragraphs 110-152 of [draft] IPSAS [X] (ED 62)); and
- (i) Changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign

currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (see paragraphs 110-152 of [draft] IPSAS [X] (ED 62)).

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Statement of Financial Position

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Current Assets

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79. Current assets include assets (such as taxes receivable, user charges receivable, fines and regulatory fees receivable, inventories and accrued investment revenue) that are either realized, consumed or sold, as part of the normal operating cycle even when they are not expected to be realized within twelve months after the reporting date. Current assets also include assets held primarily for the purpose of trading (examples include some financial assets that meet the definition of classified as held for trading in accordance with [draft] IPSAS [X] (ED 62), *Financial Instruments* IPSAS 29, *Financial Instruments: Recognition and Measurement*) and the current portion of non-current financial assets.

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82. Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting date or held primarily for the purpose of being traded. Examples are some financial liabilities that meet the definition of classified as held for trading in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29, bank overdrafts, and the current portion of non-current financial liabilities, dividends or similar distributions payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (i.e., are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting date are non-current liabilities, subject to paragraphs 85 and 86.

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Statement of Financial Performance

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101. Other IPSASs deal with items that may meet definitions of revenue or expense set out in this Standard, but are usually excluded from surplus or deficit. Examples include revaluation surpluses (see IPSAS 17), particular (a) gains and losses arising on translating the financial statements of a foreign operation (see IPSAS 4), and (b) gains or losses on remeasuring available-for-sale financial assets measured at fair value through net assets/equity (guidance on measurement of financial assets can be found in [draft] IPSAS [X] (ED 62) IPSAS 29).

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Information to be Presented on the Face of the Statement Financial Performance

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102. As a minimum, the face of the statement of financial performance shall include line items that present the following amounts for the period:

- (a) Revenue, presenting separately:
 - (i) Interest revenue calculated using the effective interest method; and
 - (ii) Gains and losses arising from the derecognition of financial assets measured at amortized cost;
- (b) Finance costs;
- (ba) Impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with paragraphs 71-90 of [draft] IPSAS [X] (ED 62);
- (c) Share of the surplus or deficit of associates and joint ventures accounted for using the equity method;
- (ca) If a financial asset is reclassified out of the amortized cost measurement category so that it is measured at fair value through surplus or deficit, any gain or loss arising from a difference between the previous amortized cost of the financial asset and its fair value at the reclassification date (as defined in [draft] IPSAS [X] (ED 62));
- (cb) If a financial asset is reclassified out of the fair value through net asset/equity measurement category so that it is measured at fair value through surplus or deficit, any cumulative gain or loss previously recognized in net assets/equity that is reclassified to surplus or deficit;
- (d) Pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to discontinuing operations; and
- (e) Surplus or deficit.

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Statement of Changes in Net Assets/Equity

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125A. Other IPSASs specify whether and when amounts previously recognized in net assets/equity are reclassified to surplus or deficit. Such reclassifications are referred to in this Standard as reclassification adjustments. A reclassification adjustment is included with the related component of net assets/equity in the period that the adjustment is reclassified to surplus or deficit. These amounts may have been recognized in net assets/equity as unrealized gains in the current or previous periods. Those unrealized gains must be deducted from net assets/equity in the period in which the realized gains are reclassified to surplus or deficit to avoid including them in the statement of changes in net assets/equity twice.

125B. Reclassification adjustments arise, for example, on disposal of a foreign operation (see IPSAS 4) and when some hedged forecast cash flows affect surplus or deficit (see paragraph 137(d) of [draft] IPSAS [X] (ED 62) in relation to cash flow hedges).

125C. Reclassification adjustments do not arise on changes in revaluation surplus recognized in accordance with IPSAS 17 or IPSAS 31 or on remeasurements of defined benefit plans recognized in accordance with IPSAS 39. These components are recognized in net assets/equity and are not reclassified to surplus or deficit in subsequent periods. Changes in revaluation surplus may be

transferred to accumulated surpluses or deficits in subsequent periods as the asset is used or when it is derecognized (see IPSAS 17 or IPSAS 31). In accordance with [draft] IPSAS [X] (ED 62), reclassification adjustments do not arise if a cash flow hedge or the accounting for the time value of an option (or the forward element of a forward contract or the foreign currency basis spread of a financial instrument) result in amounts that are removed from the cash flow hedge reserve or a separate component of net assets/equity, respectively, and included directly in the initial cost or other carrying amount of an asset or a liability. These amounts are directly transferred to assets or liabilities.

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Disclosure of Accounting Policies

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138. In the process of applying the entity's accounting policies, management makes various judgments, apart from those involving estimations, that can significantly affect the amounts recognized in the financial statements. For example, management makes judgments in determining:

- Whether assets are investment properties;
- Whether agreements for the provision of goods and/or services that involve the use of dedicated assets are leases;
- Whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; ~~and~~
- Whether the substance of the relationship between the reporting entity and other entities indicates that these other entities are controlled by the reporting entity; and,
- Whether the contractual terms of a financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

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Effective Date

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153K. Paragraphs 7, 79, 82, 101, 102 and 138 were amended and paragraphs 125A, 125B and 125C were added by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

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Amendments to IPSAS 4, *The Effects of Changes in Foreign Exchange Rates*

Paragraph 3, 4, 5, 31 and 61 are amended and paragraph 71C is added. New text is underlined and deleted text is struck through.

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Scope

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3. An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard:
 - (a) In accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of [draft] IPSAS [X] (ED 62), *Financial Instruments* IPSAS 29, *Financial Instruments: Recognition and Measurement*;
 - (b) In translating the financial performance and financial position of foreign operations that are included in the financial statements of the entity by consolidation, or by the equity method; and
 - (c) In translating an entity's financial performance and financial position into a presentation currency.
4. [Draft] IPSAS [X] (ED 62) IPSAS 29 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Standard. However, those foreign currency derivatives that are not within the scope of [draft] IPSAS [X] (ED 62) IPSAS 29 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard. In addition, this Standard applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency.
5. This Standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. [draft] IPSAS [X] (ED 62) IPSAS 29 applies to hedge accounting.

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Recognition of Exchange Differences

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31. As noted in paragraph 5, this Standard does not deal with hedge accounting for foreign currency items. Guidance in relation to hedge accounting, including the criteria for when to use hedge accounting, can be found in [draft] IPSAS [X] (ED 62) IPSAS 29.

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Disclosure

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61. The entity shall disclose:
 - (a) The amount of exchange differences recognized in surplus or deficit, except for those arising on financial instruments measured at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29; and
 - (b) Net exchange differences classified in a separate component of net assets/equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

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Effective Date

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71C. Paragraphs 3, 4, 5, 31 and 61 were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

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Amendments to IPSAS 9, Revenue from Exchange Transactions

Paragraph 10 is amended and paragraph 41C is added. New text is underlined and deleted text is struck through.

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Scope

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10. This Standard does not deal with revenues arising from:
- (a) Lease agreements (see IPSAS 13, *Leases*);
 - (b) Dividends or similar distributions arising from investments that are accounted for under the equity method (see IPSAS 36, *Investments in Associates and Joint Ventures*);
 - (c) Gains from the sale of property, plant, and equipment (which are dealt with in IPSAS 17, *Property, Plant, and Equipment*);
 - (d) Insurance contracts within the scope of the relevant international or national accounting standard dealing with insurance contracts;
 - (e) Changes in the fair value of financial assets and financial liabilities or their disposal (see [draft] IPSAS [X] (ED 62), *Financial Instruments* ~~guidance on the recognition and measurement of financial instruments can be found in IPSAS 29, *Financial Instruments: Recognition and Measurement*~~);
 - (f) Changes in the value of other current assets;
 - (g) Initial recognition, and from changes in the fair value of biological assets related to agricultural activity (see IPSAS 27, *Agriculture*);
 - (g) Initial recognition of agricultural produce (see IPSAS 27); and
 - (h) The extraction of mineral ores.

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Effective Date

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41C. Paragraph 10 was amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply this amendment for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendment for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

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Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 9.

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Rendering of Services

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Financial Service Fees

IG12. The recognition of revenue for financial service fees depends on (a) the purposes for which the fees are assessed, and (b) the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective yield of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act.

(a) **Fees that are an integral part of the effective interest rate of a financial instrument**

Such fees are generally treated as an adjustment to the effective interest rate. However, when the financial instrument is measured at fair value with the change in fair value recognized in surplus or deficit, the fees are recognized as revenue when the instrument is initially recognized.

- (i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ is classified as a financial asset "at fair value through surplus or deficit"*

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related transaction costs (as defined in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~), are deferred and recognized as an adjustment to the effective interest rate.

- (ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related transaction costs (as defined in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~), is deferred and recognized as an

adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognized as revenue on expiry. Loan commitments that are within the scope of [draft] IPSAS [X] (ED 62) IPSAS-29 are accounted for as derivatives and measured at fair value.

(iii) *Origination fees received on issuing financial liabilities measured at amortized cost*

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as “at fair value through surplus or deficit,” the origination fees received are included, with the related transaction costs (as defined in [draft] IPSAS [X] (ED 62) IPSAS-29) incurred, in the initial carrying amount of the financial liability and recognized as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

(b) **Fees earned as services are provided**

(i) *Fees charged for servicing a loan*

Fees charged by an entity for servicing a loan are recognized as revenue as the services are provided.

(ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of [draft] IPSAS [X] (ED 62) IPSAS-29*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of [draft] IPSAS [X] (ED 62) IPSAS-29, the commitment fee is recognized as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of [draft] IPSAS [X] (ED 62) IPSAS-29 are accounted for as derivatives and measured at fair value.

(iii) *Investment management fees*

Fees charged for managing investments are recognized as revenue as the services are provided.

Incremental costs that are directly attributable to securing an investment management contract are recognized as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in [draft] IPSAS [X] (ED 62) IPSAS-29, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortized as the entity recognizes the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of equity securities. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.

(c) Fees that are earned on the execution of a significant act

The fees are recognized as revenue when the significant act has been completed, as in the examples below.

(i) Commission on the allotment of shares to a client

The commission is recognized as revenue when the shares have been allotted.

(ii) Placement fees for arranging a loan between a borrower and an investor

The fee is recognized as revenue when the loan has been arranged.

(iii) Loan syndication fees

A syndication fee received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants) is compensation for the service of syndication. Such a fee is recognized as revenue when the syndication has been completed.

...

Amendments to IPSAS 12, *Inventories*

Paragraph 2 is amended and paragraph 51C is added. New text is underlined and deleted text is struck through.

...

Scope

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2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for all inventories except:**

- (a) **Work-in-progress arising under construction contracts, including directly related service contracts (see IPSAS 11, *Construction Contracts*);**
- (b) **Financial instruments (see IPSAS 28, *Financial Instruments: Presentation* and [draft] IPSAS [X] (ED 62), *Financial Instruments*, ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~);**
- (c) **Biological assets related to agricultural activity and agricultural produce at the point of harvest (see IPSAS 27, *Agriculture*); and**
- (d) **Work-in-progress of services to be provided for no or nominal consideration directly in return from the recipients.**

...

Effective Date

...

51C. Paragraph 2 was amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply this amendment for annual financial statements covering periods

beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendment for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Amendments to IPSAS 14, *Events After the Reporting Date*

Paragraph 11 is amended and paragraph 32F is added. New text is underlined and deleted text is struck through.

...

Adjusting Events after the Reporting Date

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11. The following are examples of adjusting events after the reporting date that require an entity to adjust the amounts recognized in its financial statements, or to recognize items that were not previously recognized:
 - (a) The settlement after the reporting date of a court case that confirms that the entity had a present obligation at the reporting date. The entity adjusts any previously recognized provision related to this court case in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, or recognizes a new provision. The entity does not merely disclose a contingent liability because the settlement provides additional evidence that would be considered in accordance with paragraph 24 in IPSAS 19.
 - (b) The receipt of information after the reporting date indicating that an asset was impaired at the reporting date, or that the amount of a previously recognized impairment loss for that asset needs to be adjusted. For example:
 - (i) The bankruptcy of a debtor that occurs after the reporting date usually confirms that the debtor was credit-impaired at the end of the reporting period ~~a loss already existed at the reporting date on a receivable account, and that the entity needs to adjust the carrying amount of the reporting period receivable account;~~ and
 - (ii) The sale of inventories after the reporting date may give evidence about their net realizable value at the reporting date;
 - (c) The determination after the reporting date of the cost of assets purchased, or the proceeds from assets sold, before the reporting date;
 - (d) The determination after the reporting date of the amount of revenue collected during the reporting period to be shared with another government under a revenue-sharing agreement in place during the reporting period;
 - (e) The determination after the reporting date of performance bonus payments to be made to staff if the entity had a present legal or constructive obligation at the reporting date to make such payments as a result of events before that date; and
 - (f) The discovery of fraud or errors that show that the financial statements were incorrect.

...

Effective Date

...

32F. Paragraph 11 was amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply this amendment for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendment for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Amendments to IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*

Paragraph 4 is amended and paragraph 111D is added. New text is underlined and deleted text is struck through.

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Scope

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4. This Standard does not apply to financial instruments (including guarantees) that are within the scope of [draft] IPSAS [X] (ED 62), *Financial Instruments*, IPSAS 29, *Financial Instruments: Recognition and Measurement*.

...

Effective Date

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111D. Paragraph 4 was amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply this amendment for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendment for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

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Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 19.

...

A Single Guarantee

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IG 14. ~~During 2004, a provincial government gives a guarantee of certain borrowings of a private sector operator providing public services for a fee, whose financial condition at that time is sound. During 2005, the financial condition of the operator deteriorates and, at June 30, 2005, the operator files for protection from its creditors.~~

~~This contract meets the definition of a financial guarantee contract in IPSAS 29, except those where the issuer elects to treat such contracts as insurance contracts in accordance with the relevant international or national accounting standard dealing with insurance contracts. The following is an example of an accounting policy that complies with the requirements in IPSAS 29 for financial guarantee contracts within the scope of IPSAS 29.~~

Analysis

~~(a) At December 31, 2004~~

~~Present obligation as a result of a past obligating event — The obligating event is the giving of the guarantee, which gives rise to a legal obligation.~~

~~An outflow of resources embodying economic benefits or service potential in settlement — No outflow of benefits is probable at December 31, 2004.~~

Conclusion

~~The guarantee is recognized at fair value.~~

Analysis

~~(b) At December 31, 2005~~

~~Present obligation as a result of a past obligating event — The obligating event is the giving of the guarantee, which gives rise to a legal obligation.~~

~~An outflow of resources embodying economic benefits or service potential in settlement — At December 31, 2005, it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation.~~

Conclusion

~~The guarantee is subsequently measured at the higher of (a) the best estimate of the obligation (see paragraphs 22, 31 and 109), and (b) the amount initially recognized less, when appropriate, cumulative amortization in accordance with IPSAS 9, *Revenue from Exchange Transactions*.~~

...

Amendments to IPSAS 21, *Impairment of Non-Cash Generating Assets*

Paragraphs 2, 9 and 13 are amended and paragraph 82G is added. New text is underlined and deleted text is struck through.

...

Scope

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2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for impairment of non-cash-generating assets, except:**
 - (a) **Inventories (see IPSAS 12, *Inventories*);**
 - (b) **Assets arising from construction contracts (see IPSAS 11, *Construction Contracts*);**

- (c) **Financial assets that are included in the scope of [draft] IPSAS [X] (ED 62), *Financial Instruments*, ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~;**
- (d) **Investment property that is measured using the fair value model (see IPSAS 16, *Investment Property*);**
- (e) **Non-cash-generating property, plant, and equipment that is measured at revalued amounts (see IPSAS 17, *Property, Plant, and Equipment*);**
- (f) **Non-cash-generating intangible assets that are measured at revalued amounts (see IPSAS 31, *Intangible Assets*); and**
- (g) **Other assets in respect of which accounting requirements for impairment are included in another IPSAS.**

...

9. This Standard does not apply to financial assets that are included in the scope of IPSAS 28, *Financial Instruments: Presentation*. Impairment of these assets is dealt with in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~.

...

13. Investments in:

- (a) Controlled entities, as defined in IPSAS 35, *Consolidated Financial Statements*;
- (b) Associates, as defined in IPSAS 36, *Investments in Associates and Joint Ventures*; and
- (c) Joint arrangements, as defined in IPSAS 37, *Joint Arrangements*;

are financial assets that are excluded from the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~. Where such investments are classified as cash-generating assets, they are dealt with under IPSAS 26. Where these assets are non-cash-generating assets, they are dealt with under this Standard.

...

Effective Date

...

- 82G. Paragraphs 2, 9 and 13 were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Amendments to IPSAS 23, Revenue from Non-Exchange Transactions (Taxes and Transfers)

Paragraph 105A is amended and paragraph 124F is added. New text is underlined and deleted text is struck through.

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Scope

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105A. Concessionary loans are loans received by an entity at below market terms. The portion of the loan that is repayable, along with any interest payments, is an exchange transaction and is accounted for in accordance with [draft] IPSAS [X] (ED 62), Financial Instruments, ~~IPSAS 29, Financial Instruments: Recognition and Measurement~~. An entity considers whether any difference between the transaction price (loan proceeds) and the fair value of the loan on initial recognition (see [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~) is non-exchange revenue that should be accounted for in accordance with this Standard.

...

Effective Date

...

124F. Paragraph 105A was amended by [draft] IPSAS [X] (ED 62), Financial Instruments issued in Month YYYY. An entity shall apply this amendment for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendment for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 23.

...

Concessionary Loans (paragraphs 105A to 105B)

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IG54. An entity receives CU6 million funding from a multi-lateral development agency to build 10 schools over the next 5 years. The funding is provided on the following conditions:

- CU1 million of the funding need not be repaid, provided that the schools are built.
- CU5 million of the funding is to be repaid as follows:
 - Year 1: no capital to be repaid
 - Year 2: 10 percent of the capital to be repaid
 - Year 3: 20 percent of the capital to be repaid
 - Year 4: 30 percent of the capital to be repaid
 - Year 5: 40 percent of the capital to be repaid
- Interest is charged at 5 percent per annum over the period of the loan (assume interest is paid annually in arrears). The market rate of interest for a similar loan is 10 percent.

- To the extent that schools have not been built, the funding provided should be returned to the donor (assume that the donor has effective monitoring systems in place and has a past history of requiring any unspent funds to be returned).
- The entity built the following schools over the period of the loan:
 - Year 1: 1 school completed
 - Year 2: 3 schools completed
 - Year 3: 5 schools completed
 - Year 4: 10 schools completed

Analysis

The entity has effectively received a grant of CU1 million and a loan of CU5 million (Note: An entity would consider whether the substance of the CU1 million is a contribution from owners or revenue; assume for purposes of this example that the CU1 million is revenue). It has also received an additional grant of CU784,550 (which is the difference between the proceeds of the loan of CU5 million and the present value of the contractual cash flows of the loan, discounted using the market related rate of interest of 10%).

The grant of CU1 million + CU784,550 is accounted for in accordance with this Standard and, the loan with its related contractual interest and capital payments, in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29.

1. On initial recognition, the entity will recognize the following:

Dr	Bank	CU6,000,000	
	Cr	Loan	CU4,215,450
	Cr	Liability	CU1,784,550

2. Year 1: the entity will recognize the following:

Dr	Liability	CU178,455	
	Cr	Non-exchange revenue	CU178,455

(1/10 of the schools built X CU1,784,550)

(Note: The journal entries for the repayment of interest and capital and interest accruals, have not been reflected in this example as it is intended to illustrate the recognition of revenue arising from concessionary loans. Comprehensive examples are included in the Illustrative Examples to [draft] IPSAS [X] (ED 62) IPSAS 29).

3. Year 2: the entity will recognize the following (assuming that the entity subsequently measures the concessionary loan at amortized cost):

Dr	Liability	CU356,910	
	Cr	Non-exchange revenue	CU356,910

3/10 schools built X CU1,784,500 – CU178,455 already recognized)

4. Year 3: the entity will recognize the following:

Dr	Liability	CU356,910	
	Cr	Non-exchange revenue	CU356,910

(5/10 schools built X CU1,784,550 – CU535,365 already recognized)

5. Year 4: the entity will recognize the following:

Dr	Liability	CU892,275	
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Cr	Non-exchange revenue	CU892,275	
(All schools built, CU1,784,550 – CU892,275)			
If the concessionary loan was granted with no conditions, the entity would recognize the following on initial recognition:			
Dr	Bank	CU6,000,000	
Cr	Loan		CU4,215,450
Cr	Non-exchange revenue		CU1,784,550

Interaction Between Measurement Requirements of IPSAS 23 and [draft] IPSAS [X] (ED 62)

Background

- IG55. An individual donates shares in listed Entity X to public sector Entity A on January 1, 20X8. At that date, the shares in Entity X have a fair value of CU1,000,000. At December 31, 20X8, the fair value of the shares is CU900,000. As part of the arrangement, Entity A incurs the transfer duty to have the shares transferred into its name. These costs amount to CU10,000.
- IG56. Listed Entity X provides telecommunications infrastructure and related services to the public. During 20X9, new technology was introduced into the telecommunications industry, making the infrastructure and equipment used by Entity X almost obsolete. This resulted in a permanent decline in the value of listed Entity X. The value of the impairment loss as at December 31, 20X9 is CU700,000. Entity A measures investments in shares at fair value through net assets/equity when the shares are not held for trading. Assume that the arrangement is a contractual arrangement, no present obligations arise from the donation and that the entity's reporting period ends on December 31, 20X8.

Analysis

- IG57. As Entity A received the shares as a donation, it uses IPSAS 23 to initially recognize the shares acquired and the related non-exchange revenue. However, because Entity A has acquired a financial asset, it considers the initial measurement requirements of IPSAS 23 and [draft] IPSAS [X] (ED 62).
- IG58. IPSAS 23 prescribes that assets acquired as part of a non-exchange revenue transaction are initially measured at fair value, while [draft] IPSAS [X] (ED 62) prescribes that financial assets are initially measured at fair value and, depending on their classification, transaction costs may or may not be included. As the entity has a policy of measuring investments in shares at fair value through net assets/equity, the transaction costs of CU10,000 are added to the value of the shares of CU1,000,000 on initial measurement.
- IG59. The subsequent measurement and derecognition of the shares is addressed in IPSAS 29. The entity measures investments in shares at fair value through net assets/equity which means that the shares are measured at a fair value with any subsequent changes in fair value recognized in net assets/equity. Dividends are however recognized in surplus or deficit.

The journal entries at initial acquisition and at the reporting dates are as follows:

1. Acquisition of shares through donation

Dr	Investment in Entity X	1,010,000	-
Cr	Non-exchange revenue		1,000,000
Cr	Bank (Transfer costs paid)	-	10,000

2. Subsequent measurement at December 31, 20X8

Dr	<u>Net assets/equity (fair value adjustment of investment)</u>	<u>110,000</u>	-
	Cr	<u>Investment in Entity X</u>	-
			<u>110,000</u>

3. Subsequent measurement at December 31, 20X9

Dr	<u>Impairment loss (net assets/equity)</u>	<u>700,000</u>	-
	Cr	<u>Investment in Entity X</u>	-
			<u>700,000</u>

...

Amendments to IPSAS 26, *Impairment of Cash Generating Assets*

Paragraphs 2, 9 and 12 are amended and paragraph 126J is added. New text is underlined and deleted text is struck through.

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Scope

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2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for the impairment of cash-generating assets, except for:**

- (a) **Inventories (see IPSAS 12, *Inventories*);**
- (b) **Assets arising from construction contracts (see IPSAS 11, *Construction Contracts*);**
- (c) **Financial assets that are within the scope of [draft] IPSAS [X] (ED 62), *Financial Instruments*, ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~;**
- (d) ...

...

9. This Standard does not apply to any financial assets that are included in the scope of IPSAS 28, *Financial Instruments: Presentation*. Impairment of these assets is dealt with in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~.

...

12. Investments in:

- (a) Controlled entities, as defined in IPSAS 35, *Consolidated Financial Statements*;
- (b) Associates, as defined in IPSAS 36, *Investments in Associates and Joint Ventures*; and
- (c) Joint arrangements, as defined in IPSAS 37, *Joint Arrangements*,

are financial assets that are excluded from the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~. Where such investments are in the nature of cash-generating assets, they are dealt with under this Standard. Where these assets are in the nature of non-cash-generating assets, they are dealt with under IPSAS 21.

...

Effective Date

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126J. Paragraphs 2, 9 and 12 were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Amendments to IPSAS 28, Financial Instruments: Presentation

Paragraphs 2, 3, 4, 9, 10, 14, 28, 36, 47, 48, AG2 and AG55 are amended, paragraph AG63 was deleted and paragraphs 60D, AG63A, AG63B, AG63C, AG63D, AG63E and AG63F were added. New text is underlined and deleted text is struck through.

Objective

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2. The principles in this Standard complement the principles for recognizing and measuring financial assets and financial liabilities in [draft] IPSAS [X] (ED 62), *Financial Instruments*, 29, ~~*Financial Instruments: Recognition and Measurement*~~, and for disclosing information about them in IPSAS 30, *Financial Instruments: Disclosures*.

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Scope

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3. An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard to all types of financial instruments except:
 - (a) Those interests in controlled entities, associates or joint ventures that are accounted for in accordance with IPSAS 35, *Consolidated Financial Statements*, IPSAS 34, *Separate Financial Statements*, IPSAS 36, *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 35, IPSAS 35, or IPSAS 36 require or permits an entity to account for an interest in a controlled entity, associate, or joint venture using [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in controlled entities, associates, or joint ventures.
 - (b) Employers' rights and obligations under employee benefit plans, to which IPSAS 39, *Employee Benefits* applies.
 - (c) Obligations arising from insurance contracts. However, this Standard applies to:
 - (i) Derivatives that are embedded in insurance contracts if [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ requires the entity to account for them separately; and
 - (ii) Financial guarantee contracts, if the issuer applies [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ in recognizing and measuring the contracts, but shall apply the

relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them.

In addition to (i) and (ii) above, an entity may apply this Standard to insurance contracts which involve the transfer of financial risk.

- (d) Financial instruments that are within the scope of the international or national accounting standard dealing with insurance contracts because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 13–37 and AG49–AG60 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see [draft] IPSAS [X] (ED 62) IPSAS 29).
 - (e) Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share-based payments applies, except for:
 - (i) Contracts within the scope of paragraphs 4–6 of this Standard, to which this Standard applies; or
 - (ii) Paragraphs 38 and 39 of this Standard, which shall be applied to treasury shares purchased, sold, issued, or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements.
4. This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through surplus or deficit in accordance with paragraph 6 of [draft] IPSAS [X] (ED 62) *Financial Instruments*.

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Definitions

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9. A financial liability is 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 unfavorable 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, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16, 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 paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.**

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 15 and 16 or paragraphs 17 and 18.

10. The following terms are defined in paragraph 9 of [draft] IPSAS [X] (ED 62) or paragraph 10 of IPSAS 29 and are used in this Standard with the meaning specified in those ~~that~~ Standards.

- Amortized cost of a financial asset or financial liability;
- ~~Available for sale financial assets;~~
- Derecognition ~~Derecognizing~~;
- Derivative;
- Effective interest method;
- Financial guarantee contract;
- Financial ~~asset or financial~~ liability at fair value through surplus or deficit;
- Firm commitment;
- Forecast transaction;
- Hedge effectiveness;
- Hedged item;
- Hedging instrument;
- ~~Held-to-maturity investments;~~
- ~~Loans and receivables;~~
- Held for trading;
- Regular way purchase or sale; and
- Transaction costs.

...

14. When an issuer applies the definitions in paragraph 9 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

- (a) The instrument includes no 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 unfavorable to the issuer.
- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
 - (i) A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 15 and 16 or paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraph 15 and 16 or paragraphs 17 and 18.

...

28. With the exception of the circumstances described in paragraphs 15 and 16 or paragraphs 17 and 18, a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (e.g., for the present value of the forward repurchase price, option exercise price, or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognized initially under [draft] IPSAS [X] (ED 62) IPSAS-29, its fair value (the present value of the redemption amount) is reclassified from net assets/equity. Subsequently, the financial liability is measured in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to net assets/equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (e.g., a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

...

36. ~~[draft] IPSAS [X] (ED 62) IPSAS 29~~ deals with the measurement of financial assets and financial liabilities. Equity instruments evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated into its components, the net assets/equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument is included in the liability component unless it forms part of the component of net assets/equity (such as an equity conversion option). The sum of the carrying amounts assigned to the liability and the net assets/equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognizing the components of the instrument separately.

...

Offsetting a Financial Asset and a Financial Liability (see also paragraphs AG63 and AG64)

...

47. **A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:**
- (a) **Currently has a legally enforceable right to set off the recognized amounts; and**
 - (b) **Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.**

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see [draft] IPSAS [X] (ED 62) IPSAS 29, paragraph 33 38).

48. This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity. An entity shall disclose the information required in paragraphs 17B-17E in IPSAS 30, *Financial Instruments: Disclosures*, for recognized financial instruments that are within the scope of paragraph 17A of IPSAS 30.

...

Effective date

...

- 60D. Paragraphs 2, 3, 4, 9, 10, 14, 28, 36, 47, 48, AG2 and AG55 were amended, paragraph AG63 was deleted and paragraphs AG63A, AG63B, AG63C, AG63D, AG63E and AG63F were added by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Application Guidance

This Appendix is an integral part of IPSAS 28.

...

AG2. The Standard does not deal with the recognition or measurement of financial instruments. Requirements about the recognition and measurement of financial assets and financial liabilities are set out in [draft] IPSAS [X] (ED 62) IPSAS 29.

...

Compound Financial Instruments (paragraphs 33–37)

AG55. Paragraph 33 applies only to issuers of non-derivative compound financial instruments. Paragraph 33 does not deal with compound financial instruments from the perspective of holders. [Draft] IPSAS [X] (ED 62) IPSAS 29 deals with the classification and measurement separation of financial assets that are embedded derivatives from the perspective of holders of compound financial instruments from the holder's perspective that contain the features of both debt and equity instruments.

...

Offsetting a Financial Asset and a Financial Liability (paragraphs 47–55)

AG63. ~~To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognized amounts. An entity may have a conditional right to set off recognized amounts, such as in a master netting agreement or in some forms of non-recourse debt, but such rights are enforceable only on the occurrence of some future event, usually a default of the counterparty. Thus, such an arrangement does not meet the conditions for offset.~~

Criterion that an Entity 'Currently has a Legally Enforceable Right to Set Off the Recognized Amounts' (paragraph 47(a))

AG63A. A right of set-off may be currently available or it may be contingent on a future event (for example, the right may be triggered or exercisable only on the occurrence of some future event, such as the default, insolvency or bankruptcy of one of the counterparties). Even if the right of set-off is not contingent on a future event, it may only be legally enforceable in the normal course of operations, or in the event of default, or in the event of insolvency or bankruptcy, of one or all of the counterparties.

AG63B. To meet the criterion in paragraph 47(a), an entity must currently have a legally enforceable right of set-off. This means that the right of set-off:

- (a) Must not be contingent on a future event; and
- (b) Must be legally enforceable in all of the following circumstances:
 - (i) The normal course of operations;
 - (ii) The event of default; and
 - (iii) The event of insolvency or bankruptcy of the entity and all of the counterparties.

AG63C. The nature and extent of the right of set-off, including any conditions attached to its exercise and whether it would remain in the event of default or insolvency or bankruptcy, may vary from one

legal jurisdiction to another. Consequently, it cannot be assumed that the right of set-off is automatically available outside of the normal course of operations. For example, the bankruptcy or insolvency laws of a jurisdiction may prohibit, or restrict, the right of set-off in the event of bankruptcy or insolvency in some circumstances.

AG63D. The laws applicable to the relationships between the parties (for example, contractual provisions, the laws governing the contract, or the default, insolvency or bankruptcy laws applicable to the parties) need to be considered to ascertain whether the right of set-off is enforceable in the normal course of operations, in an event of default, and in the event of insolvency or bankruptcy, of the entity and all of the counterparties (as specified in paragraph AG63B(b)).

Criterion that an Entity 'Intends Either to Settle on a Net Basis, or to Realize the Asset and Settle the Liability Simultaneously' (paragraph 47(b))

AG63E. To meet the criterion in paragraph 47(b) an entity must intend either to settle on a net basis or to realize the asset and settle the liability simultaneously. Although the entity may have a right to settle net, it may still realize the asset and settle the liability separately.

AG63F. If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion in paragraph 47(b). This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle. For example, a gross settlement system that has all of the following characteristics would meet the net settlement criterion in paragraph 47(b):

- (a) Financial assets and financial liabilities eligible for set-off are submitted at the same point in time for processing;
- (b) Once the financial assets and financial liabilities are submitted for processing, the parties are committed to fulfil the settlement obligation;
- (c) There is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing (unless the processing fails—see (d) below);
- (d) Assets and liabilities that are collateralized with securities will be settled on a securities transfer or similar system (for example, delivery versus payment), so that if the transfer of securities fails, the processing of the related receivable or payable for which the securities are collateral will also fail (and vice versa);
- (e) Any transactions that fail, as outlined in (d), will be re-entered for processing until they are settled;
- (f) Settlement is carried out through the same settlement institution (for example, a settlement bank, a central bank or a central securities depository); and
- (g) An intraday credit facility is in place that will provide sufficient overdraft amounts to enable the processing of payments at the settlement date for each of the parties, and it is virtually certain that the intraday credit facility will be honored if called upon.

...

In Appendix B paragraphs B19 and B21 are amended to read as follows:

...

Appendix B – Members' Shares in Co-operative Entities and Similar Instruments

...

Before the Governing Charter is Amended

B19. Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity measures ~~determines~~ the fair value of such financial liabilities in accordance with ~~as required by~~ paragraph 66 of [draft] IPSAS [X] (ED 62) ~~52 of IPSAS 29~~, which states: "The fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand ..." Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

...

After the Governing Charter is Amended

B21. Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 percent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on January 1, 20X3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 66 of [draft] IPSAS [X] (ED 62) ~~52 of IPSAS 28~~. It therefore transfers on January 1, 20X3 from net assets/equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity instruments. In this example the entity does not recognize a gain or loss on the transfer.

...

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 28.

...

Scope

BC5. IAS 32 excludes all insurance contracts from the scope of IAS 32, except for financial guarantee contracts where the issuer applies IFRS 9, Financial Instruments ~~IAS 39, Financial Instruments: Recognition and Measurement~~ in recognizing and measuring such contracts. The scope of IPSAS 28 also excludes all insurance contracts, except that:

- Financial guarantee contracts are to be treated as financial instruments unless an entity elects to treat such contracts as insurance contracts in accordance with the relevant international or national accounting standard dealing with insurance contracts; and
- Contracts that are insurance contracts but involve the transfer of financial risk may be treated as financial instruments in accordance with IPSAS 28, ~~IPSAS 29 and IPSAS 30 and [draft] IPSAS [X] (ED 62)~~.

...

Illustrative Examples

These examples accompany, but are not part of, IPSAS 28.

Accounting for Contracts on Equity Instruments of an Entity

IE1. The following examples illustrate the application of paragraphs 13–32 and [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ to the accounting for contracts on an entity's own equity instruments. In these examples, monetary amounts are denominated in "currency units" (CU).

...

IE5. Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of Entity A's shares. Similarly to (a) and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has an obligation to pay CU104,000 in cash to Entity B (CU104 × 1,000) and Entity B has an obligation to deliver 1,000 of Entity A's outstanding shares to Entity A in one year. Entity A records the following journal entries.

February 1, 20X2

Dr	Net assets/equity	CU100,000	
	Cr	Liability	CU100,000

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, paragraph AG115 AG82).

December 31, 20X2

Dr	Interest expense	CU3,660	
	Cr	Liability	CU3,660

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

January 31, 20X3

Dr	Interest expense	CU340	
	Cr	Liability	CU340

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

Entity A delivers CU104,000 in cash to Entity B and Entity B delivers 1,000 of Entity A's shares to Entity A.

Dr	Liability	CU104,000	
	Cr	Cash	CU104,000

To record the settlement of the obligation to redeem Entity A's own shares for cash.

...

Amendments to IPSAS 29, *Financial Instruments: Recognition and Measurement*

Paragraphs 2, 9, 10, 80, 98, 99, 101, 102, 107, 108, 109, 111, 112, 113, AG128, AG157 and AG161 are amended, paragraphs 1, 3, 4, 5, 6, 11-79, 88, AG1-AG126 and AG129 are deleted and paragraphs 125G and AG156A are added.

Objective

...

1. ~~The objective of this Standard is to establish principles for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in IPSAS 28, *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in IPSAS 30, *Financial Instruments: Disclosures*.~~
2. **This Standard shall be applied by all entities to all types of financial instruments within the scope of [draft] IPSAS [X] (ED 62), *Financial Instruments* if, and to the extent that, except:**
 - (a) **[draft] IPSAS [X] (ED 62) permits the hedge accounting requirements of this Standard to be applied; and Those interests in controlled entities, associates and joint ventures that are accounted for in accordance with IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements* IPSAS 36, *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 34, IPSAS 35 or IPSAS 36 require or permit an entity to account for an interest in a controlled entity, associate, or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a controlled entity, associate, or joint venture unless the derivative meets the definition of an equity instrument of the entity in IPSAS 28.**
 - (b) **The financial instrument is part of a hedging relationship that qualifies for hedge accounting in accordance with this Standard. Rights and obligations under leases to which IPSAS 13, *Leases* applies. However:**
 - (i) ~~Lease receivables recognized by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 17–39, 67, 68, 72, and Appendix A paragraphs AG51–AG67 and AG117–AG126);~~
 - (ii) ~~Finance lease payables recognized by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 41–44 and Appendix A paragraphs AG72–AG80); and~~
 - (iii) ~~Derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 11–15 and Appendix A paragraphs AG40–AG46).~~
 - (c) ~~Employers' rights and obligations under employee benefit plans, to which IPSAS 39, *Employee Benefits* applies.~~
 - (d) ~~Financial instruments issued by the entity that meet the definition of an equity instrument in IPSAS 28 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 15 and 16 or 17 and~~

~~18 of IPSAS 28. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.~~

~~(e) Rights and obligations arising under:~~

- ~~(i) An insurance contract, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 10; or~~
- ~~(ii) A contract that is within the scope of the relevant international or national accounting standard dealing with insurance contracts because it contains a discretionary participation feature.~~

~~This Standard applies to a derivative that is embedded in an insurance contract if the derivative is not itself an insurance contract (see paragraphs 11–15 and Appendix A paragraphs AG40–AG46 of this Standard). An entity applies this Standard to financial guarantee contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them. Notwithstanding (i) above, an entity may apply this Standard to other insurance contracts which involve the transfer of financial risk.~~

- ~~(f) Any forward contracts between an acquirer and seller to buy or sell an acquired operation that will result in a public sector combination at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.~~
- ~~(g) Loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 17–44 and Appendix A paragraphs AG51–AG80).~~
- ~~(h) Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share based payment applies, except for contracts within the scope of paragraphs 4–6 of this Standard, to which this Standard applies.~~
- ~~(i) Rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognizes as a provision in accordance with IPSAS 19, or for which, in an earlier period, it recognized a provision in accordance with IPSAS 19.~~
- ~~(j) The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions, to which IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* applies.~~
- ~~(k) Rights and obligations under service concession arrangements to which IPSAS 32, *Service Concession Assets: Grantor* applies. However, financial liabilities recognized by a grantor under the financial liability model are subject to the derecognition provisions of this Standard (see paragraphs 41–44 and Appendix A paragraphs AG72–AG80).~~

~~3. The following loan commitments are within the scope of this Standard:~~

- ~~(a) Loan commitments that the entity designates as financial liabilities at fair value through surplus or deficit. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.~~
 - ~~(b) Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in installments (e.g., a mortgage construction loan that is paid out in installments in line with the progress of construction).~~
 - ~~(c) Commitments to provide a loan at a below-market interest rate. Paragraph 49(d) specifies the subsequent measurement of liabilities arising from these loan commitments.~~
- ~~4. This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.~~
- ~~5. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:~~
- ~~(a) When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;~~
 - ~~(b) When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);~~
 - ~~(c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and~~
 - ~~(d) When the non-financial item that is the subject of the contract is readily convertible to cash.~~
- ~~A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements and, accordingly, whether they are within the scope of this Standard.~~
- ~~6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.~~

...

Definitions

9. The terms defined in IPSAS 28 and [draft] IPSAS [X] (ED 62) are used in this Standard with the meanings specified in paragraph 9 of IPSAS 28 and paragraph 9 of [draft] IPSAS [X] (ED 62). IPSAS 28 and [draft] IPSAS [X] (ED 62) defines the following terms:

- Amortized cost of a financial asset or financial liability;
- Derecognition;
- Derivative;
- Effective interest method;
- Effective interest rate;
- Equity instrument;
- Financial asset;
- Financial instrument;
- Financial liability;
- Firm commitment;
- Forecast transaction;

and provides guidance on applying those definitions.

10. The following terms are used in this Standard with the meanings specified:

Definition of a derivative

~~A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–6) with all three of the following characteristics:~~

- ~~(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (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 of contracts that would be expected to have a similar response to changes in market factors; and~~
- ~~(c) It is settled at a future date.~~

Definitions of four categories of financial instruments

~~A financial asset or financial liability at fair value through surplus or deficit is 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:~~
 - ~~(i) It is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;~~

- ~~(ii) On initial recognition it is 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) It is 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 surplus or deficit. An entity may use this designation only when permitted by paragraph 13 or 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 recognizing 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 IPSAS 20, *Related Party Disclosures*), for example the entity’s governing body and chief executive officer.~~

~~In IPSAS 30, paragraphs 11–13 and AG4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through surplus or deficit, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through surplus or deficit is consistent with the entity’s documented risk management or investment strategy.~~

~~Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 48(c) and Appendix A paragraphs AG113 and AG114), shall not be designated as at fair value through surplus or deficit.~~

~~It should be noted that paragraphs 50, 51, 52, and Appendix A paragraphs AG101–AG115, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.~~

~~Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG29–AG38) other than:~~

- ~~(a) Those that the entity upon initial recognition designates as at fair value through surplus or deficit;~~
- ~~(b) Those that the entity designates as available for sale; and~~
- ~~(c) Those that meet the definition of loans and receivables.~~

~~An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than~~

~~insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:~~

- ~~(a) Are so close to maturity or the financial asset's call date (e.g., less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;~~
- ~~(b) Occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or~~
- ~~(c) Are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.~~

~~Loans and receivables are 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 shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through surplus or deficit;~~
- ~~(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 shall be classified as available for sale.~~

~~An interest acquired in a pool of assets that are not loans or receivables (e.g., an interest in a mutual fund or a similar fund) is not a loan or receivable.~~

~~Available-for-sale financial assets are those non-derivative 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 surplus or deficit.~~

~~Definition of a financial guarantee contract~~

~~A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.~~

~~Definitions relating to recognition and measurement~~

~~The amortized cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.~~

~~The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest revenue or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall 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 (see IPSAS 9, *Revenue from Exchange Transactions*), 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 cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).~~

~~**Derecognition** is the removal of a previously recognized financial asset or financial liability from an entity's statement of financial position.~~

~~A **regular way purchase or sale** is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.~~

~~**Transaction costs** are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG26). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.~~

Definitions relating to hedge accounting

~~A **firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.~~

~~A **forecast transaction** is an uncommitted but anticipated future transaction.~~

A **hedging instrument** is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) 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 (paragraphs 81–86 and Appendix A paragraphs AG127–AG130 elaborate on the definition of a hedging instrument).

A **hedged item** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 87–94 and Appendix A paragraphs AG131–AG141 elaborate on the definition of hedged items).

Hedge effectiveness is the degree to which 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 (see Appendix A paragraphs AG145–AG156).

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately.

Embedded Derivatives

11-79. [Deleted]

Hedging

80. If an entity applies [draft] IPSAS [X] (ED 62) and has not chosen as its accounting policy to continue to apply the hedge accounting requirements of this Standard (see paragraph 173 of [draft] IPSAS [X] (ED 62)), it shall apply the hedge accounting requirements in paragraphs 110-

152 of [draft] IPSAS [X] (ED 62). However, for a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities, an entity may, in accordance with paragraph 112 of [draft] IPSAS [X] (ED 62), apply the hedge accounting requirements in this Standard instead of those in [draft] IPSAS [X] (ED 62). In that case the entity must also apply the specific requirements for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs 91, 100 and AG157–AG175). If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 95–98 and Appendix A paragraphs AG142–AG144, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 99–113.

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88. ~~Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held-to-maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.~~

...

98. **A hedging relationship qualifies for hedge accounting under paragraphs 99–113 if, and only if, all of the following conditions are met.**
- (a) **At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.**
 - (b) **The hedge is expected to be highly effective (see Appendix A paragraphs AG145–AG156) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.**
 - (c) **For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect surplus or deficit.**
 - (d) **The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 50 and 51 and Appendix A paragraphs AG139–AG151 for guidance on determining fair value).**
 - (e) **The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.**

Fair Value Hedges

99. **If a fair value hedge meets the conditions in paragraph 98 during the period, it shall be accounted for as follows:**

- (a) The gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with IPSAS 4 (for a non-derivative hedging instrument) shall be recognized in surplus or deficit; and
- (b) The gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized in surplus or deficit. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in surplus or deficit applies if the hedged item is a an available-for-sale financial asset measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62).

...

101. If only particular risks attributable to a hedged item are hedged, recognized changes in the fair value of the hedged item unrelated to the hedged risk are recognized as set out in paragraph 98 of [draft] IPSAS [X] (ED 62) 64.

102. An entity shall discontinue prospectively the hedge accounting specified in paragraph 99 if:

- (a) The hedging instrument expires or is sold, terminated or exercised. For (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy.); Additionally, for this purpose there is not an expiration or termination of the hedging instrument if:
 - (i) As a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organization' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organization or a client of a clearing member of a clearing organization, that are acting as counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties this paragraph shall apply only if each of those parties effects clearing with the same central counterparty.
 - (ii) Other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.
- (b) The hedge no longer meets the criteria for hedge accounting in paragraph 98; or
- (c) The entity revokes the designation.

...

107. More specifically, a cash flow hedge is accounted for as follows:

- (a) The separate component of net assets/equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
 - (i) The cumulative gain or loss on the hedging instrument from inception of the hedge; and
 - (ii) The cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;
- (b) Any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognized in surplus or deficit; and
- (c) If an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 83, 84, and 98(a)), that excluded component of gain or loss is recognized in accordance with paragraph 98 of [draft] IPSAS [X] (ED 62) 64.

...

Cash Flow Hedges

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- 108. **If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognized directly in net assets/equity in accordance with paragraph 106 shall be reclassified into surplus or deficit as a reclassification adjustment in the same period or periods during which the hedged forecast cash flows affect surplus or deficit (such as in the periods that interest revenue or interest expense is recognized). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify into surplus or deficit as a reclassification adjustment the amount that is not expected to be recovered.**
- 109. **If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:**
 - (a) **It reclassifies the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106 into surplus or deficit as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affects surplus or deficit (such as in the periods that depreciation or inventories are recognized as an expense). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify from net assets/equity into surplus or deficit as a reclassification adjustment the amount that is not expected to be recovered.**
 - (b) **It removes the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106, and includes them in the initial cost or other carrying amount of the asset or liability.**

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111. For cash flow hedges other than those covered by paragraphs 108 and 109, amounts that had been recognized directly in net assets/equity shall be recognized in surplus or deficit as a reclassification adjustment in the same period or periods during which the hedged forecast cash flows affects surplus or deficit (e.g., when a forecast sale occurs).
112. In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 106–111:
- (a) The hedging instrument expires or is sold, terminated or exercised ~~(for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy)~~. In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. For the purpose of this subparagraph, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy. Additionally, for the purpose of this subparagraph there is not an expiration or termination of the hedging instrument if:
 - (i) As a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organization' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organization or a client of a clearing member of a clearing organization, that are acting as counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties this paragraph shall apply only if each of those parties effects clearing with the same central counterparty.
 - (ii) Other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.
 - (b) The hedge no longer meets the criteria for hedge accounting in paragraph 98. In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109, or 111 applies.
 - (c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that has been recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall be recognized in surplus or deficit as a reclassification adjustment. A forecast

transaction that is no longer highly probable (see paragraph 98(c)) may still be expected to occur.

- (d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 108, 109, or 111 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized directly in net assets/equity shall be recognized in surplus or deficit as a reclassification adjustment.

113. Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IPSAS 4), shall be accounted for similarly to cash flow hedges:

- (a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) shall be recognized directly in net assets/equity through the statement of changes in net assets/equity (see IPSAS 1); and
- (b) The ineffective portion shall be recognized in surplus or deficit.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognized directly in net assets/equity shall be recognized in surplus or deficit as a reclassification adjustment in accordance with paragraphs 56–57 of IPSAS 4 on disposal of the foreign operation.

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Effective Date

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125G. Paragraphs 2, 9, 10, 80, 98, 99, 101, 102, 107, 108, 109, 111, 112, 113, AG128, AG157 and AG161 were amended, paragraph AG156A was added and paragraphs 1, 3, 4, 5, 6, 11-79, 88, AG1-AG126 and AG129 were deleted by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

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Application Guidance

This Appendix is an integral part of IPSAS 29.

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AG1-AG126. [Deleted] ...

Qualifying Instruments

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AG128. A financial asset measured ~~held-to-maturity investment~~ carried at amortized cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG129. ~~An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 48(c) and 49) cannot be designated as a hedging instrument.~~

Qualifying Items (paragraphs 87–89)

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AG134. If a hedge of a forecast transaction within the economic entity qualifies for hedge accounting, any gain or loss that is recognized directly in net assets/equity in accordance with paragraph 106(a) shall be reclassified into surplus or deficit as a reclassification adjustment in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated surplus or deficit.

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Assessing Hedge Effectiveness

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AG156A. For the avoidance of doubt, the effects of replacing the original counterparty with a clearing counterparty and making the associated changes as described in paragraphs 102(a)(ii) and 112(a)(ii) shall be reflected in the measurement of the hedging instrument and therefore in the assessment of hedge effectiveness and the measurement of hedge effectiveness.

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

AG157. For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)–(i) and paragraphs AG158–AG175 below.

- (a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios ~~(e.g., the entity may group its available-for-sale assets into a separate portfolio)~~, in which case it applies the guidance below to each portfolio separately.
- (b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.
- (c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG169(b).

- (d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g., a swap rate).
- (e) The entity designates one or more hedging instruments for each repricing time period.
- (f) Using the designations made in (c)–(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.
- (g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognizes the change in fair value of the hedged item as a gain or loss in surplus or deficit and in one of two line items in the statement of financial position as described in paragraph 100. The change in fair value need not be allocated to individual assets or liabilities.
- (h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognizes it as a gain or loss in surplus or deficit. The fair value of the hedging instrument(s) is recognized as an asset or liability in the statement of financial position.
- (i) Any ineffectiveness will be recognized in surplus or deficit as the difference between the change in fair value referred to in (g) and that referred to in (h) (effectiveness is measured using the same materiality considerations as in other IPSASs).

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AG161. As an example of the designation set out in paragraph AG157(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates as the hedged item assets in the amount of CU20 (a portion of the assets is designated as the Standard permits an entity to designate any amount of the available qualifying assets or liabilities, i.e., in this example any amount of the assets between CU0 and CU100). The designation is expressed as an "amount of a currency" (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn – i.e., all of the CU100 of assets in the above example – must be:

- (a) Items whose fair value changes in response to changes in the interest rate being hedged; and
- (b) Items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because [draft] IPSAS [X] (ED 62) paragraph 52 of the Standard specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an

amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG169(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 percent ($CU30 / (CU100 - CU40) = 50$ percent) of the liabilities with no demand feature.

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Appendix B is removed. Guidance is included in paragraphs AG109 and AG110 of [draft] IPSAS [X] (ED 62).

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Appendix B: Reassessment of Embedded Derivatives

B1-B7. [Deleted]

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Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 29.

Sections A-G

[Deleted]

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Illustrative Examples

These examples accompany, but are not part of, IPSAS 29.

Sections A-G

IE32-IE50. [Deleted]

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Amendments to IPSAS 30, *Financial Instruments: Presentation*

Paragraphs 2, 3, 4, 5, 8, 11, 12, 13, 14, 18, 24, 34, 35, 36, 37, 41, 43, 45, AG1, AG5, AG9, AG10, AG24, and AG29 are amended, paragraphs 16, 17, 20, 26, 27, 28 and 44 are deleted and several headings and paragraphs 5A, 13A, 14A, 14B, 15A, 15B, 15C, 17A, 17B, 17C, 17D, 17E, 17F, 20A, 24A, 25A, 25B, 25C, 25D, 26A, 26B, 26C, 27A, 27B, 27C, 27D, 27E, 27F, 28A, 28B, 28C, 28D, 28E, 28F, 28G, 37A, 39A, 42A, 42B, 42C, 42D, 42E, 42F, 42G, 42H, 42I, 42J, 42K, 42L, 42M, 42N, 49A, 49B, 49C, 49D, 49E, 49F, 49G, 49H, 49I, 49J, 42K, 49L, 49M, 49N, 49O, 49P, 49Q, 49R, 49S, 52D, AG8A, AG8B, AG8C, AG8D, AG8E, AG8F, AG8G, AG8H, AG8I, AG8J, AG31, AG32, AG32A, AG33, AG34, AG35, AG36, AG37, AG38, AG39, AG40, AG41, AG42, AG43, AG44, AG45, AG46, AG47, AG48, AG49, AG50, AG51, AG52, AG53, AG54 and AG55 are added.

Objective

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2. The principles in this Standard complement the principles for recognizing, measuring, and presenting financial assets and financial liabilities in IPSAS 28, *Financial Instruments: Presentation* and [draft] IPSAS [X] (ED 62), *Financial Instruments*, ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~.

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Scope

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3. **This Standard shall be applied by all entities to all types of financial instruments, except:**
 - (a) Those interests in controlled entities, associates, or joint ventures that are accounted for in accordance with IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements* or IPSAS 36, *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 34, IPSAS 35, or IPSAS 37 require or permit an entity to account for an interest in a controlled entity, associate, or joint venture using [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in controlled entities, associates, or joint ventures unless the derivative meets the definition of an equity instrument in IPSAS 28.
 - (b) Employers' rights and obligations arising from employee benefit plans, to which IPSAS 39, *Employee Benefits* applies.
 - (c) Rights and obligations arising under insurance contracts. However, this Standard applies to:
 - (i) Derivatives that are embedded in insurance contracts if [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ requires the entity to account for them separately; and
 - (ii) An issuer of financial guarantee contracts if the issuer applies [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ in recognizing and measuring the contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply those standards in recognizing and measuring them.

In addition to (i) and (ii) above, an entity may apply this Standard to insurance contracts which involve the transfer of financial risk.
 - (d) Financial instruments, contracts, and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share-based payment applies, except for contracts within the scope of paragraphs 6-8 of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, to which that Standard applies.
 - (e) Instruments that are required to be classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS 28.

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4. This Standard applies to recognized and unrecognized financial instruments. Recognized financial instruments include financial assets and financial liabilities that are within the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~. Unrecognized financial instruments include some financial instruments that, although outside the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, are within the scope of this Standard (such as some loan commitments).

...

5. This Standard applies to contracts to buy or sell a non-financial item that are within the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ (see paragraphs 6-8 of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~).

...

- 5A. The credit risk disclosure requirements in paragraphs 42A–42N apply to those for receivables that result from exchange transactions that are within the scope of IPSAS 9 and non-exchange transactions within the scope of IPSAS 23 which give rise to financial instruments for the purpose of recognizing impairment gains or losses in accordance with paragraph 3 of [draft] IPSAS [X] (ED 62). Any reference to financial assets or financial instruments in these paragraphs shall include those rights unless otherwise specified.

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Definitions

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8. The following terms are used in this Standard with the meanings specified:

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Credit risk grades is a rating of credit risk based on the risk of a default occurring on the financial instrument.

Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Liquidity risk is 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 payable are financial liabilities, other than short-term trade payables on normal credit terms.

Market risk is 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.

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those 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.

~~A financial asset is past due when a counterparty has failed to make a payment when contractually due.~~

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately.

...

Significance of Financial Instruments for Financial Position and Financial Performance

...

Statement of Financial Position

Categories of Financial Assets and Financial Liabilities

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11. The carrying amounts of each of the following categories, as defined in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, shall be disclosed either in the statement of financial position or in the notes:
 - (a) Financial assets at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 149 of [draft] IPSAS [X] (ED 62), and (ii) ~~those classified as held for trading in accordance with IPSAS 29~~ those mandatorily measured at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62);
 - ~~(b) Held-to-maturity investments;~~
 - ~~(c) Loans and receivables;~~
 - ~~(d) Available-for-sale financial assets;~~
 - (e) Financial liabilities at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 149 of [draft] IPSAS [X] (ED 62), and (ii) ~~those classified as held for trading in accordance with IPSAS 29~~ those that meet the definition of held for trading in [draft] IPSAS [X] (ED 62); and
 - (f) Financial liabilities measured at amortized cost₁;
 - (g) Financial assets measured at amortized cost; and
 - (h) Financial assets measured at fair value through net assets/equity, showing separately (i) financial assets that are measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62); and (ii) investments in equity instruments designated as such upon initial recognition in accordance with paragraph 103 of [draft] IPSAS [X] (ED 62).

Financial Assets or Financial Liabilities at Fair Value through Surplus or Deficit

12. If the entity has designated as measured through surplus or deficit a financial asset (or group of financial assets) that would otherwise be measured at fair value through net assets/equity or amortized cost ~~a loan or receivable (or group of loans or receivables) as at fair value through surplus or deficit~~, it shall disclose:

- (a) The maximum exposure to credit risk (see paragraph 43(a)) of the financial asset (or group of financial assets) loan or receivable (or group of loans or receivables) at the end of the reporting period.
- (b) The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk (see paragraph 43(a)).
- (c) The amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
 - (i) As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
 - (ii) Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate, or index of prices or rates.

- (d) The amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset loan or receivable was designated.

...

- 13. If the entity has designated a financial liability as at fair value through surplus or deficit in accordance with paragraph 46 of [draft] IPSAS [X] (ED 62) and is required to present the effects of changes in that liability's credit risk in net assets/equity (see paragraph 105 of [draft] IPSAS [X] (ED 62)) of IPSAS 29, it shall disclose:

- (a) The amount of change, ~~during the period and~~ cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability (see paragraphs AG233–AG240 of [draft] IPSAS [X] (ED 62) for guidance on determining the effects of changes in a liability's credit risk); determined either:
 - ~~(i) As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see Appendix A, paragraph AG4); or~~
 - ~~(ii) Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.~~

~~Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate, or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.~~

- (b) The difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
- (c) Any transfers of the cumulative gain or loss within net assets/equity during the period including the reason for such transfers.

- (d) If a liability is derecognized during the period, the amount (if any) presented in net assets/equity that was realized at derecognition.

...

13A. If an entity has designated a financial liability as at fair value through surplus or deficit in accordance with paragraph 46 of [draft] IPSAS [X] (ED 62) and is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in surplus or deficit (see paragraphs 105 and 106 of [draft] IPSAS [X] (ED 62)), it shall disclose:

- (a) The amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability (see paragraphs AG233–AG240 of [draft] IPSAS [X] (ED 62) for guidance on determining the effects of changes in a liability's credit risk); and
- (b) The difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

...

14. The entity shall also disclose:

- (a) A detailed description of the ~~The~~ methods used to comply with the requirements in paragraphs 12(c), ~~and~~ 13(a) and 13A(a) and paragraph 105(a) of [draft] IPSAS [X] (ED 62), including an explanation of why the method is appropriate.
- (b) If the entity believes that the disclosure it has given, either in the statement of financial position or in the notes, to comply with the requirements in paragraph 12(c), ~~or~~ 13(a) or 13A(a) or paragraph 105(a) of [draft] IPSAS [X] (ED 62) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.
- (c) A detailed description of the methodology or methodologies used to determine whether presenting the effects of changes in a liability's credit risk in net assets/equity would create or enlarge an accounting mismatch in surplus or deficit (see paragraphs 105 and 106 of [draft] IPSAS [X] (ED 62)). If an entity is required to present the effects of changes in a liability's credit risk in surplus or deficit (see paragraph 106 of [draft] IPSAS [X] (ED 62)), the disclosure must include a detailed description of the economic relationship described in paragraph AG226 of [draft] IPSAS [X] (ED 62).

Investments in Equity Instruments Designated at Fair Value Through Net Assets/Equity

14A. If an entity has designated investments in equity instruments to be measured at fair value through net assets/equity, as permitted by paragraph 103 of [draft] IPSAS [X] (ED 62), it shall disclose:

- (a) Which investments in equity instruments have been designated to be measured at fair value through net assets/equity.
- (b) The reasons for using this presentation alternative.
- (c) The fair value of each such investment at the end of the reporting period.
- (d) Dividends recognized during the period, showing separately those related to investments derecognized during the reporting period and those related to investments held at the end of the reporting period.

- (e) Any transfers of the cumulative gain or loss within net assets/equity during the period including the reason for such transfers.
- 14B. If an entity derecognized investments in equity instruments measured at fair value through net assets/equity during the reporting period, it shall disclose:
 - (a) The reasons for disposing of the investments.
 - (b) The fair value of the investments at the date of derecognition.
 - (c) The cumulative gain or loss on disposal.

Reclassification

- 15. ~~If the entity has reclassified a financial asset (in accordance with paragraphs 60–63 of IPSAS 29) as one measured:~~
 - ~~(a) At cost or amortized cost, rather than at fair value; or~~
 - ~~(b) At fair value, rather than at cost or amortized cost;~~~~it shall disclose the amount reclassified into and out of each category and the reason for that reclassification.~~
- 15A. An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with paragraph 54 of [draft] IPSAS [X] (ED 62). For each such event, an entity shall disclose:
 - (a) The date of reclassification.
 - (b) A detailed explanation of the change in management model and a qualitative description of its effect on the entity's financial statements.
 - (c) The amount reclassified into and out of each category.
- 15B. For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified out of the fair value through surplus or deficit category so that they are measured at amortized cost or fair value through net assets/equity in accordance with paragraph 54 of [draft] IPSAS [X] (ED 62):
 - (a) The effective interest rate determined on the date of reclassification; and
 - (b) The interest revenue recognized.
- 15C. If, since its last reporting date, an entity has reclassified financial assets out of the fair value through net assets/equity category so that they are measured at amortized cost or out of the fair value through surplus or deficit category so that they are measured at amortized cost or fair value through net assets/equity it shall disclose:
 - (a) The fair value of the financial assets at the end of the reporting period; and
 - (b) The fair value gain or loss that would have been recognized in surplus or deficit or net assets/equity during the reporting period if the financial assets had not been reclassified.
- 16. ~~If the entity has reclassified a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 55 or 57 of IPSAS 29 or out of the available-for-sale category in accordance with paragraph 58 of IPSAS 29, it shall disclose:~~

- ~~(a) The amount reclassified into and out of each category;~~
- ~~(b) For each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods;~~
- ~~(c) If a financial asset was reclassified in accordance with paragraph 55 of IPSAS 29, the rare situation, and the facts and circumstances indicating that the situation was rare;~~
- ~~(d) For the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognized in surplus or deficit or in net assets/equity in that reporting period and in the previous reporting period;~~
- ~~(e) For each reporting period following the reclassification (including the reporting period in which the financial asset was reclassified) until derecognition of the financial asset, the fair value gain or loss that would have been recognized in surplus or deficit or in net assets/equity if the financial asset had not been reclassified, and the gain, loss, revenue, and expense recognized in surplus or deficit; and~~
- ~~(f) The effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.~~

Derecognition

~~17. An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 17–39 of IPSAS 29). The entity shall disclose for each class of such financial assets:~~

- ~~(a) The nature of the assets;~~
- ~~(b) The nature of the risks and rewards of ownership to which the entity remains exposed;~~
- ~~(c) When the entity continues to recognize all of the assets, the carrying amounts of the assets, and of the associated liabilities; and~~
- ~~(d) When the entity continues to recognize the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognize, and the carrying amount of the associated liabilities~~

Offsetting Financial Assets and Financial Liabilities

17A The disclosures in paragraphs 17B–17E supplement the other disclosure requirements of this Standard and are required for all recognized financial instruments that are set off in accordance with paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*. These disclosures also apply to recognized financial instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are set off in accordance with paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*.

17B An entity shall disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's financial position. This includes the effect or potential effect of rights of set-off associated with the entity's recognized financial assets and recognized financial liabilities that are within the scope of paragraph 17A.

17C To meet the objective in paragraph 17B, an entity shall disclose, at the end of the reporting period, the following quantitative information separately for recognized financial assets and recognized financial liabilities that are within the scope of paragraph 17A:

- (a) The gross amounts of those recognized financial assets and recognized financial liabilities;
- (b) The amounts that are set off in accordance with the criteria in paragraph 47 of IPSAS 28 when determining the net amounts presented in the statement of financial position;
- (c) The net amounts presented in the statement of financial position;
- (d) The amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 17C(b), including:
 - (i) Amounts related to recognized financial instruments that do not meet some or all of the offsetting criteria in paragraph 47 of IPSAS 28; and
 - (ii) Amounts related to financial collateral (including cash collateral); and
- (e) The net amount after deducting the amounts in (d) from the amounts in (c) above.

The information required by this paragraph shall be presented in a tabular format, separately for financial assets and financial liabilities, unless another format is more appropriate.

- 17D The total amount disclosed in accordance with paragraph 17C(d) for an instrument shall be limited to the amount in paragraph 17C(c) for that instrument.
- 17E An entity shall include a description in the disclosures of the rights of set-off associated with the entity's recognized financial assets and recognized financial liabilities subject to enforceable master netting arrangements and similar agreements that are disclosed in accordance with paragraph 17C(d), including the nature of those rights.
- 17F If the information required by paragraphs 17B–17E is disclosed in more than one note to the financial statements, an entity shall cross-refer between those notes.

Collateral

18. An entity shall disclose:
- (a) The carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph 34(a) of [draft] IPSAS [X] (ED 62) 39(a) of IPSAS 29; and
 - (b) The terms and conditions relating to its pledge.

...

Allowance Account for Credit Losses

20. ~~When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g., an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.~~
- 20A. The carrying amount of financial assets measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62) is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the statement of financial position as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

...

Statement of Financial Performance*Items of Revenue, Expense, Gains, or Losses*

24. An entity shall disclose the following items of revenue, expense, gains, or losses either in the statement of financial performance or in the notes:
- (a) Net gains or net losses on:
 - (i) Financial assets or financial liabilities at fair value through surplus or deficit, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with paragraph 149 of [draft] IPSAS [X] (ED 62), and those on financial assets or financial liabilities that are mandatorily measured at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) (e.g. financial liabilities that meet the definition of held for trading in [draft] IPSAS [X] (ED 62)). For financial liabilities designated as at fair value through surplus or deficit, an entity shall show separately the amount of gain or loss recognized in net assets/equity and the amount recognized in surplus or deficit classified as held for trading in accordance with IPSAS 29;
 - ~~(ii) Available-for-sale financial assets, showing separately the amount of gain or loss recognized in net assets/equity during the period and the amount reclassified from net assets/equity and recognized directly in surplus or deficit for the period;~~
 - ~~(iii) Held-to-maturity investments;~~
 - ~~(iv) Loans and receivables; and~~
 - (v) Financial liabilities measured at amortized cost;
 - (vi) Financial assets measured at amortized cost;
 - ~~(vii) Investments in equity instruments designated at fair value through net assets/equity in accordance with paragraph 103 of [draft] IPSAS [X] (ED 62); and~~
 - ~~(viii) Financial assets measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62), showing separately the amount of gain or loss recognized in net assets/equity during the period and the amount reclassified upon derecognition from accumulated net assets/equity to surplus or deficit for the period.~~
 - (b) Total interest revenue and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are measured at amortized cost or that are measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62) (showing these amounts separately); or financial liabilities that are not measured at fair value through surplus or deficit not at fair value through surplus or deficit;
 - (c) Fee revenue and expense (other than amounts included in determining the effective interest rate) arising from:
 - (i) Financial assets or financial liabilities that are not at fair value through surplus or deficit; and

- (ii) Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;
 - ~~(d) Interest revenue on impaired financial assets accrued in accordance with paragraph AG126 of IPSAS 29; and~~
 - ~~(e) The amount of any impairment loss for each class of financial asset.~~
- 24A. An entity shall disclose an analysis of the gain or loss recognized in the statement of financial performance arising from the derecognition of financial assets measured at amortized cost, showing separately gains and losses arising from derecognition of those financial assets. This disclosure shall include the reasons for derecognizing those financial assets.

...

Hedge Accounting

- 25A. An entity shall apply the disclosure requirements in paragraphs 25B–28F for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:
- (a) An entity's risk management strategy and how it is applied to manage risk;
 - (b) How the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
 - (c) The effect that hedge accounting has had on the entity's statement of financial position, statement of financial performance and statement of changes in net assets/equity.
- 25B. An entity shall present the required disclosures in a single note or separate section in its financial statements. However, an entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.
- 25C. When paragraphs 26A–28F require the entity to separate by risk category the information disclosed, the entity shall determine each risk category on the basis of the risk exposures an entity decides to hedge and for which hedge accounting is applied. An entity shall determine risk categories consistently for all hedge accounting disclosures.
- 25D. To meet the objectives in paragraph 25A, an entity shall (except as otherwise specified below) determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need additional explanations to evaluate the quantitative information disclosed. However, an entity shall use the same level of aggregation or disaggregation it uses for disclosure requirements of related information in this Standard.

...

Hedge Accounting

- ~~26. An entity shall disclose the following separately for each type of hedge described in IPSAS 29 (i.e., fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):~~
- ~~(a) A description of each type of hedge;~~

- ~~(b) A description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period; and~~
- ~~(c) The nature of the risks being hedged.~~

The Risk Management Strategy

26A. An entity shall explain its risk management strategy for each risk category of risk exposures that it decides to hedge and for which hedge accounting is applied. This explanation should enable users of financial statements to evaluate (for example):

- (a) How each risk arises.
- (b) How the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component (or components) of an item and why.
- (c) The extent of risk exposures that the entity manages.

26B. To meet the requirements in paragraph 26A, the information should include (but is not limited to) a description of:

- (a) The hedging instruments that are used (and how they are used) to hedge risk exposures;
- (b) How the entity determines the economic relationship between the hedged item and the hedging instrument for the purpose of assessing hedge effectiveness; and
- (c) How the entity establishes the hedge ratio and what the sources of hedge ineffectiveness are.

26C. When an entity designates a specific risk component as a hedged item (see paragraph 125 of [draft] IPSAS [X] (ED 62)) it shall provide, in addition to the disclosures required by paragraphs 26A and 26B, qualitative or quantitative information about:

- (a) How the entity determined the risk component that is designated as the hedged item (including a description of the nature of the relationship between the risk component and the item as a whole); and
- (b) How the risk component relates to the item in its entirety (for example, the designated risk component historically covered on average 80 percent of the changes in fair value of the item as a whole).

The Amount, Timing and Uncertainty of Future Cash Flows

~~27. For cash flow hedges, an entity shall disclose:~~

- ~~(a) The periods when the cash flows are expected to occur and when they are expected to affect surplus or deficit;~~
- ~~(b) A description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;~~
- ~~(c) The amount that was recognized in net assets/equity during the period;~~
- ~~(d) The amount that was reclassified from net assets/equity and included in surplus or deficit for the period, showing the amount included in each line item in the statement of financial performance; and~~

- ~~(e) The amount that was removed from net assets/equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.~~
- 27A. Unless exempted by paragraph 27C, an entity shall disclose by risk category quantitative information to allow users of its financial statements to evaluate the terms and conditions of hedging instruments and how they affect the amount, timing and uncertainty of future cash flows of the entity.
- 27B. To meet the requirement in paragraph 27A, an entity shall provide a breakdown that discloses:
- (a) A profile of the timing of the nominal amount of the hedging instrument; and
 - (b) If applicable, the average price or rate (for example strike or forward prices etc.) of the hedging instrument.
- 27C. In situations in which an entity frequently resets (i.e. discontinues and restarts) hedging relationships because both the hedging instrument and the hedged item frequently change (i.e. the entity uses a dynamic process in which both the exposure and the hedging instruments used to manage that exposure do not remain the same for long—such as in the example in paragraph AG314(b) of [draft] IPSAS [X] (ED 62)) the entity:
- (a) Is exempt from providing the disclosures required by paragraphs 27A and 27B.
 - (b) Shall disclose:
 - (i) Information about what the ultimate risk management strategy is in relation to those hedging relationships;
 - (ii) A description of how it reflects its risk management strategy by using hedge accounting and designating those particular hedging relationships; and
 - (iii) An indication of how frequently the hedging relationships are discontinued and restarted as part of the entity's process in relation to those hedging relationships.
- 27D. An entity shall disclose by risk category a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term.
- 27E. If other sources of hedge ineffectiveness emerge in a hedging relationship, an entity shall disclose those sources by risk category and explain the resulting hedge ineffectiveness.
- 27F. For cash flow hedges, an entity shall disclose a description of any forecast transaction for which hedge accounting had been used in the previous period, but which is no longer expected to occur.

The Effects of Hedge Accounting on Financial Position and Performance

28. ~~An entity shall disclose separately:~~
- ~~(a) In fair value hedges, gains or losses:~~
 - ~~(i) On the hedging instrument; and~~
 - ~~(ii) On the hedged item attributable to the hedged risk.~~
 - ~~(b) The ineffectiveness recognized in surplus or deficit that arises from cash flow hedges; and~~
 - ~~(c) The ineffectiveness recognized in surplus or deficit that arises from hedges of net investments in foreign operations.~~

28A. An entity shall disclose, in a tabular format, the following amounts related to items designated as hedging instruments separately by risk category for each type of hedge (fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation):

- (a) The carrying amount of the hedging instruments (financial assets separately from financial liabilities);
- (b) The line item in the statement of financial position that includes the hedging instrument;
- (c) The change in fair value of the hedging instrument used as the basis for recognizing hedge ineffectiveness for the period; and
- (d) The nominal amounts (including quantities such as tonnes or cubic meters) of the hedging instruments.

28B. An entity shall disclose, in a tabular format, the following amounts related to hedged items separately by risk category for the types of hedges as follows:

- (a) For fair value hedges:
 - (i) The carrying amount of the hedged item recognized in the statement of financial position (presenting assets separately from liabilities);
 - (ii) The accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item recognized in the statement of financial position (presenting assets separately from liabilities);
 - (iii) The line item in the statement of financial position that includes the hedged item;
 - (iv) The change in value of the hedged item used as the basis for recognizing hedge ineffectiveness for the period; and
 - (v) The accumulated amount of fair value hedge adjustments remaining in the statement of financial position for any hedged items that have ceased to be adjusted for hedging gains and losses in accordance with paragraph 136 of [draft] IPSAS [X] (ED 62).
- (b) For cash flow hedges and hedges of a net investment in a foreign operation:
 - (i) The change in value of the hedged item used as the basis for recognizing hedge ineffectiveness for the period (i.e. for cash flow hedges the change in value used to determine the recognized hedge ineffectiveness in accordance with paragraph 137(c) of [draft] IPSAS [X] (ED 62));
 - (ii) The balances in the cash flow hedge reserve and the foreign currency translation reserve for continuing hedges that are accounted for in accordance with paragraphs 137 and 139(a) of [draft] IPSAS [X] (ED 62); and
 - (iii) The balances remaining in the cash flow hedge reserve and the foreign currency translation reserve from any hedging relationships for which hedge accounting is no longer applied.

28C. An entity shall disclose, in a tabular format, the following amounts separately by risk category for the types of hedges as follows:

- (a) For fair value hedges:

- (i) Hedge ineffectiveness—i.e. the difference between the hedging gains or losses of the hedging instrument and the hedged item—recognized in surplus or deficit (or net assets/equity for hedges of an equity instrument for which an entity has elected to present changes in fair value in net assets/equity in accordance with paragraph 103 of [draft] IPSAS [X] (ED 62)); and
 - (ii) The line item in the statement of financial performance that includes the recognized hedge ineffectiveness.
 - (b) For cash flow hedges and hedges of a net investment in a foreign operation:
 - (i) Hedging gains or losses of the reporting period that were recognized in net assets/equity;
 - (ii) Hedge ineffectiveness recognized in surplus or deficit;
 - (iii) The line item in the statement of financial performance that includes the recognized hedge ineffectiveness;
 - (iv) The amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into surplus or deficit as a reclassification adjustment (see IPSAS 1) (differentiating between amounts for which hedge accounting had previously been used, but for which the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected surplus or deficit);
 - (v) The line item in the statement of financial performance that includes the reclassification adjustment (see IPSAS 1); and
 - (vi) For hedges of net positions, the hedging gains or losses recognized in a separate line item in the statement of financial performance (see paragraph 146 of [draft] IPSAS [X] (ED 62)).
- 28D. When the volume of hedging relationships to which the exemption in paragraph 27C applies is unrepresentative of normal volumes during the period (i.e. the volume at the reporting date does not reflect the volumes during the period) an entity shall disclose that fact and the reason it believes the volumes are unrepresentative.
- 28E. An entity shall provide a reconciliation of each component of net assets/equity and an analysis of net assets/equity in accordance with IPSAS 1 that, taken together:
- (a) Differentiates, at a minimum, between the amounts that relate to the disclosures in paragraph 28C(b)(i) and (b)(iv) as well as the amounts accounted for in accordance with paragraph (i) and (iii) of [draft] IPSAS [X] (ED 62);
 - (b) Differentiates between the amounts associated with the time value of options that hedge transaction related hedged items and the amounts associated with the time value of options that hedge time-period related hedged items when an entity accounts for the time value of an option in accordance with paragraph 141 of [draft] IPSAS [X] (ED 62); and
 - (c) Differentiates between the amounts associated with forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge transaction related hedged items, and the amounts associated with forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge time-period related hedged items when an entity accounts for those amounts in accordance with paragraph 142 of [draft] IPSAS [X] (ED 62).

28F. An entity shall disclose the information required in paragraph 28E separately by risk category. This disaggregation by risk may be provided in the notes to the financial statements.

Option to Designate a Credit Exposure as Measured at Fair Value Through Surplus or Deficit

28G. If an entity designated a financial instrument, or a proportion of it, as measured at fair value through surplus or deficit because it uses a credit derivative to manage the credit risk of that financial instrument it shall disclose:

- (a) For credit derivatives that have been used to manage the credit risk of financial instruments designated as measured at fair value through surplus or deficit in accordance with paragraph 149 of [draft] IPSAS [X] (ED 62), a reconciliation of each of the nominal amount and the fair value at the beginning and at the end of the period;
- (b) The gain or loss recognized in surplus or deficit on designation of a financial instrument, or a proportion of it, as measured at fair value through surplus or deficit in accordance with paragraph 149 of [draft] IPSAS [X] (ED 62); and
- (c) On discontinuation of measuring a financial instrument, or a proportion of it, at fair value through surplus or deficit, that financial instrument's fair value that has become the new carrying amount in accordance with paragraph 152 of [draft] IPSAS [X] (ED 62) and the related nominal or principal amount (except for providing comparative information in accordance with IPSAS 1, an entity does not need to continue this disclosure in subsequent periods).

...

34. If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG145-AG151 of [draft] IPSAS [X] (ED 62) ~~AG106-AG112 of IPSAS 29~~). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e., the fair value of the consideration given or received), unless conditions described in paragraph AG147 of [draft] IPSAS [X] (ED 62) ~~AG108 of IPSAS 29~~ are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:

- (a) Its accounting policy for recognizing that difference in surplus or deficit to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph AG148 of [draft] IPSAS [X] (ED 62) ~~AG109 of IPSAS 29~~); and
- (b) The aggregate difference yet to be recognized in surplus or deficit at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

35. Disclosures of fair value are not required:

- (a) When the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables; and
- ~~(b) For an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost in accordance with IPSAS 29 because its fair value cannot be measured reliably; and~~
- (c) For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.

36. In the ~~case cases~~ described in paragraph 35(b) and (c), an entity shall disclose information to help users of the financial statements make their own judgments about the extent of possible differences between the carrying amount of those contracts ~~financial assets or financial liabilities~~ and their fair value, including:
- (a) The fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
 - (b) A description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
 - (c) Information about the market for the instruments;
 - (d) Information about whether and how the entity intends to dispose of the financial instruments; and
 - (e) If financial instruments whose fair value previously could not be reliably measured are derecognized, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognized.

Concessionary Loans

37. Concessionary loans are granted by entities on below market terms. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education, and housing loans granted to low income families. For concessionary loans granted and measured at amortized cost in accordance with paragraph 40 of [draft] IPSAS [X] (ED 62), *Financial Instruments* an entity shall disclose:

- (a) A reconciliation between the opening and closing carrying amounts of the loans, including:
 - (i) Nominal value of new loans granted during the period;
 - (ii) The fair value adjustment on initial recognition;
 - (iii) Loans repaid during the period;
 - (iv) Impairment losses recognized;
 - (v) Any increase during the period in the discounted amount arising from the passage of time; and
 - (vi) Other changes.
- (b) Nominal value of the loans at the end of the period;
- (c) The purpose and terms of the various types of loans; and
- (d) Valuation assumptions.

- 37A. For concessionary loans measured at fair value in accordance with paragraph 41 or 43 of [draft] IPSAS [X] (ED 62), *Financial Instruments* an entity shall disclose:

- (a) A reconciliation between the opening and closing carrying amounts of the loans, including:
 - (i) Nominal value of new loans granted during the period;
 - (ii) The fair value adjustment on initial recognition;
 - (iii) Loans repaid during the period;

- (iv) The fair value adjustment during the period (separate from initial recognition); and
- (vi) Other changes.
- (b) Nominal value of the loans at the end of the period;
- (c) The purpose and terms of the various types of loans; and
- (d) Valuation assumptions.

...

Nature and Extend of Risks Arising from Financial Instruments

...

- 39A. Providing qualitative disclosures in the context of quantitative disclosures enables users to link related disclosures and hence form an overall picture of the nature and extent of risks arising from financial instruments. The interaction between qualitative and quantitative disclosures contributes to disclosure of information in a way that better enables users to evaluate an entity's exposure to risks.

...

Quantitative Disclosures

...

41. For each type of risk arising from financial instruments, an entity shall disclose:
- (a) Summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IPSAS 20, *Related Party Disclosures*), for example, the entity's governing body or chief executive officer.
 - (b) The disclosures required by paragraphs 43–49, to the extent not provided in accordance with (a), unless the risk is not material (see paragraphs 45–47 of IPSAS 1 for a discussion of materiality).
 - (c) Concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).

...

Credit Risk

Scope and Objectives

- 42A. An entity shall apply the disclosure requirements in paragraphs 42F–42N to financial instruments to which the impairment requirements in [draft] IPSAS [X] (ED 62) are applied. However:
- (a) For receivables that result from exchange transactions that are within the scope of IPSAS 9 and non-exchange transactions within the scope of IPSAS 23 and lease receivables, paragraph 42J applies to those receivables or lease receivables on which lifetime expected credit losses are recognized in accordance with paragraph 85 of [draft] IPSAS [X] (ED 62), if those financial assets are modified while more than 30 days past due; and

(b) Paragraph 42K(b) does not apply to lease receivables.

42B The credit risk disclosures made in accordance with paragraphs 42F–42N shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, credit risk disclosures shall provide:

- (a) Information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses;
- (b) Quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes; and
- (c) Information about an entity's credit risk exposure (i.e. the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

42C An entity need not duplicate information that is already presented elsewhere, provided that the information is incorporated by cross-reference from the financial statements to other statements, such as a management commentary or risk report that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

42D To meet the objectives in paragraph 42B, an entity shall (except as otherwise specified) consider how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation, and whether users of financial statements need additional explanations to evaluate the quantitative information disclosed.

42E If the disclosures provided in accordance with paragraphs 42F–42N are insufficient to meet the objectives in paragraph 42B, an entity shall disclose additional information that is necessary to meet those objectives.

The Credit Risk Management Practices

42F An entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective an entity shall disclose information that enables users of financial statements to understand and evaluate:

- (a) How an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:
 - (i) Financial instruments are considered to have low credit risk in accordance with paragraph 80 of [draft] IPSAS [X] (ED 62), including the classes of financial instruments to which it applies; and
 - (ii) The presumption in paragraph 81 of [draft] IPSAS [X] (ED 62), that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted;
- (b) An entity's definitions of default, including the reasons for selecting those definitions;
- (c) How the instruments were grouped if expected credit losses were measured on a collective basis;

- (d) How an entity determined that financial assets are credit-impaired financial assets;
- (e) An entity's write-off policy, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity; and
- (f) How the requirements in paragraph 82 of [draft] IPSAS [X] (ED 62) for the modification of contractual cash flows of financial assets have been applied, including how an entity:
 - (i) Determines whether the credit risk on a financial asset that has been modified while the loss allowance was measured at an amount equal to lifetime expected credit losses, has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month expected credit losses in accordance with paragraph 75 of [draft] IPSAS [X] (ED 62); and
 - (ii) Monitors the extent to which the loss allowance on financial assets meeting the criteria in (i) is subsequently remeasured at an amount equal to lifetime expected credit losses in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62).

42G An entity shall explain the inputs, assumptions and estimation techniques used to apply the requirements in paragraphs 71-90 of [draft] IPSAS [X] (ED 62). For this purpose an entity shall disclose:

- (a) The basis of inputs and assumptions and the estimation techniques used to:
 - (i) Measure the 12-month and lifetime expected credit losses;
 - (ii) Determine whether the credit risk of financial instruments have increased significantly since initial recognition; and
 - (iii) Determine whether a financial asset is a credit-impaired financial asset.
- (b) How forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information; and
- (c) Changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

Quantitative and Qualitative Information about Amounts Arising from Expected Credit Losses

42H To explain the changes in the loss allowance and the reasons for those changes, an entity shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for:

- (a) The loss allowance measured at an amount equal to 12-month expected credit losses;
- (b) The loss allowance measured at an amount equal to lifetime expected credit losses for:
 - (i) Financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;
 - (ii) Financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and
 - (iii) Receivables that result from exchange transactions that are within the scope of IPSAS 9 or non-exchange transactions that are within the scope of IPSAS 23 or lease

receivables for which the loss allowances are measured in accordance with paragraph 85 of [draft] IPSAS [X] (ED 62).

- (c) Financial assets that are purchased or originated credit-impaired. In addition to the reconciliation, an entity shall disclose the total amount of undiscounted expected credit losses at initial recognition on financial assets initially recognized during the reporting period.
- 42I To enable users of financial statements to understand the changes in the loss allowance disclosed in accordance with paragraph 42H, an entity shall provide an explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance. The information shall be provided separately for financial instruments that represent the loss allowance as listed in paragraph 42H(a)–(c) and shall include relevant qualitative and quantitative information. Examples of changes in the gross carrying amount of financial instruments that contributed to the changes in the loss allowance may include:
- (a) Changes because of financial instruments originated or acquired during the reporting period;
 - (b) The modification of contractual cash flows on financial assets that do not result in a derecognition of those financial assets in accordance with [draft] IPSAS [X] (ED 62);
 - (c) Changes because of financial instruments that were derecognized (including those that were written-off) during the reporting period; and
 - (d) Changes arising from whether the loss allowance is measured at an amount equal to 12-month or lifetime expected credit losses.
- 42J To enable users of financial statements to understand the nature and effect of modifications of contractual cash flows on financial assets that have not resulted in derecognition and the effect of such modifications on the measurement of expected credit losses, an entity shall disclose:
- (a) The amortized cost before the modification and the net modification gain or loss recognized for financial assets for which the contractual cash flows have been modified during the reporting period while they had a loss allowance measured at an amount equal to lifetime expected credit losses; and
 - (b) The gross carrying amount at the end of the reporting period of financial assets that have been modified since initial recognition at a time when the loss allowance was measured at an amount equal to lifetime expected credit losses and for which the loss allowance has changed during the reporting period to an amount equal to 12-month expected credit losses.
- 42K To enable users of financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from expected credit losses, an entity shall disclose by class of financial instrument:
- (a) The amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with IPSAS 28).
 - (b) A narrative description of collateral held as security and other credit enhancements, including:
 - (i) A description of the nature and quality of the collateral held;
 - (ii) An explanation of any significant changes in the quality of that collateral or credit enhancements as a result of deterioration or changes in the collateral policies of the entity during the reporting period; and

- (iii) Information about financial instruments for which an entity has not recognized a loss allowance because of the collateral.
 - (c) Quantitative information about the collateral held as security and other credit enhancements (for example, quantification of the extent to which collateral and other credit enhancements mitigate credit risk) for financial assets that are credit-impaired at the reporting date.
- 42L An entity shall disclose the contractual amount outstanding on financial assets that were written off during the reporting period and are still subject to enforcement activity.

Credit Risk Exposure

42M To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity shall disclose, by credit risk rating grades, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information shall be provided separately for financial instruments:

- (a) For which the loss allowance is measured at an amount equal to 12-month expected credit losses;
- (b) For which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:
 - (i) Financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;
 - (ii) Financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and
 - (iii) Receivables that result from exchange transactions that are within the scope of IPSAS 9 or non-exchange transactions that are within the scope of IPSAS 23 or lease receivables for which the loss allowances are measured in accordance with paragraph 85 of [draft] IPSAS [X] (ED 62).
- (c) That are purchased or originated credit-impaired financial assets.

42N For receivables that result from exchange transactions that are within the scope of IPSAS 9 or non-exchange transactions that are within the scope of IPSAS 23 receivables to which an entity applies paragraph 85 of [draft] IPSAS [X] (ED 62), the information provided in accordance with paragraph 42M may be based on a provision matrix (see paragraph AG196 of [draft] IPSAS [X] (ED 62)).

...

43. For all financial instruments within the scope of this Standard, but to which the impairment requirements in [draft] IPSAS [X] (ED 62) are not applied, an ~~An~~ entity shall disclose by class of financial instrument:
- (a) The amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g., netting agreements that do not qualify for offset in accordance with IPSAS 28); ~~this disclosure is not required for financial instruments whose carrying amount best represents the maximum exposure to credit risk;~~
 - (b) ~~In respect of the amount disclosed in (a),~~ A description of collateral held as security and other credit enhancements, and their financial effect (e.g. quantification of the extent to which

collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk (whether disclosed in accordance with (a) or represented by the carrying amount of a financial instrument);

- (c) ~~Information about the credit quality of financial assets that are neither past due nor impaired; and~~
- (d) ~~The carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.~~

Financial Assets that are Either Past Due or Impaired

~~44. An entity shall disclose by class of financial asset:~~

- ~~(a) An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired;~~
- ~~(b) An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired; and~~
- ~~(c) For the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.~~

Collateral and Other Credit Enhancements Obtained

45. When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g., guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose for such assets held at the reporting date:

- (a) The nature and carrying amount of the assets ~~obtained~~; and
- (b) When the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

...

Transfers of Financial Assets

49A. The disclosure requirements in paragraphs 49B–49H relating to transfers of financial assets supplement the other disclosure requirements of this Standard. An entity shall present the disclosures required by paragraphs 49B–49H in a single note in its financial statements. An entity shall provide the required disclosures for all transferred financial assets that are not derecognized and for any continuing involvement in a transferred asset, existing at the reporting date, irrespective of when the related transfer transaction occurred. For the purposes of applying the disclosure requirements in those paragraphs, an entity transfers all or a part of a financial asset (the transferred financial asset) if, and only if, it either:

- (a) Transfers the contractual rights to receive the cash flows of that financial asset; or
- (b) Retains the contractual rights to receive the cash flows of that financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement.

49B. An entity shall disclose information that enables users of its financial statements:

- (a) To understand the relationship between transferred financial assets that are not derecognized in their entirety and the associated liabilities; and
- (b) To evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognized financial assets.

49C. For the purposes of applying the disclosure requirements in paragraphs 49E–49H, an entity has continuing involvement in a transferred financial asset if, as part of the transfer, the entity retains any of the contractual rights or obligations inherent in the transferred financial asset or obtains any new contractual rights or obligations relating to the transferred financial asset. For the purposes of applying the disclosure requirements in paragraphs 49E–49H, the following do not constitute continuing involvement:

- (a) Normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;
- (b) Forward, option and other contracts to reacquire the transferred financial asset for which the contract price (or exercise price) is the fair value of the transferred financial asset; or
- (c) An arrangement whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities and the conditions in paragraph 16(a)–(c) of [draft] IPSAS [X] (ED 62) are met.

Transferred Financial Assets that are Not Derecognized in Their Entirety

49D. An entity may have transferred financial assets in such a way that part or all of the transferred financial assets do not qualify for derecognition. To meet the objectives set out in paragraph 49B(a), the entity shall disclose at each reporting date for each class of transferred financial assets that are not derecognized in their entirety:

- (a) The nature of the transferred assets.
- (b) The nature of the risks and rewards of ownership to which the entity is exposed.
- (c) A description of the nature of the relationship between the transferred assets and the associated liabilities, including restrictions arising from the transfer on the reporting entity's use of the transferred assets.
- (d) When the counterparty (counterparties) to the associated liabilities has (have) recourse only to the transferred assets, a schedule that sets out the fair value of the transferred assets, the fair value of the associated liabilities and the net position (the difference between the fair value of the transferred assets and the associated liabilities).
- (e) When the entity continues to recognize all of the transferred assets, the carrying amounts of the transferred assets and the associated liabilities.
- (f) When the entity continues to recognize the assets to the extent of its continuing involvement (see paragraphs 17(c)(ii) and 27 of [draft] IPSAS [X] (ED 62)), the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognize, and the carrying amount of the associated liabilities.

Transferred Financial Assets that are Derecognized in Their Entirety

49E. To meet the objectives set out in paragraph 49B(b), when an entity derecognizes transferred financial assets in their entirety (see paragraph 17(a) and 17(c)(i) of [draft] IPSAS [X] (ED 62)) but has continuing involvement in them, the entity shall disclose, as a minimum, for each type of continuing involvement at each reporting date:

- (a) The carrying amount of the assets and liabilities that are recognized in the entity's statement of financial position and represent the entity's continuing involvement in the derecognized financial assets, and the line items in which the carrying amount of those assets and liabilities are recognized.
- (b) The fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognized financial assets.
- (c) The amount that best represents the entity's maximum exposure to loss from its continuing involvement in the derecognized financial assets, and information showing how the maximum exposure to loss is determined.
- (d) The undiscounted cash outflows that would or may be required to repurchase derecognized financial assets (e.g. the strike price in an option agreement) or other amounts payable to the transferee in respect of the transferred assets. If the cash outflow is variable then the amount disclosed should be based on the conditions that exist at each reporting date.
- (e) A maturity analysis of the undiscounted cash outflows that would or may be required to repurchase the derecognized financial assets or other amounts payable to the transferee in respect of the transferred assets, showing the remaining contractual maturities of the entity's continuing involvement.
- (f) Qualitative information that explains and supports the quantitative disclosures required in (a)–(e).

49F. An entity may aggregate the information required by paragraph 49E in respect of a particular asset if the entity has more than one type of continuing involvement in that derecognized financial asset, and report it under one type of continuing involvement.

49G. In addition, an entity shall disclose for each type of continuing involvement:

- (a) The gain or loss recognized at the date of transfer of the assets.
- (b) Revenue and expenses recognized, both in the reporting period and cumulatively, from the entity's continuing involvement in the derecognized financial assets (e.g. fair value changes in derivative instruments).
- (c) If the total amount of proceeds from transfer activity (that qualifies for derecognition) in a reporting period is not evenly distributed throughout the reporting period (e.g. if a substantial proportion of the total amount of transfer activity takes place in the closing days of a reporting period):
 - (i) When the greatest transfer activity took place within that reporting period (e.g. the last five days before the end of the reporting period),
 - (ii) The amount (e.g. related gains or losses) recognized from transfer activity in that part of the reporting period, and

(iii) The total amount of proceeds from transfer activity in that part of the reporting period.

An entity shall provide this information for each period for which a statement of net assets/equity is presented.

Supplementary Information

49H. An entity shall disclose any additional information that it considers necessary to meet the disclosure objectives in paragraph 49B.

Initial application of [draft] IPSAS [X] (ED 62)

...

49I In the reporting period that includes the date of initial application of [draft] IPSAS [X] (ED 62), the entity shall disclose the following information for each class of financial assets and financial liabilities as at the date of initial application:

- (a) The original measurement category and carrying amount determined in accordance with IPSAS 29 or in accordance with a previous version of [draft] IPSAS [X] (ED 62) (if the entity's chosen approach to applying [draft] IPSAS [X] (ED 62) involves more than one date of initial application for different requirements);
- (b) The new measurement category and carrying amount determined in accordance with [draft] IPSAS [X] (ED 62);
- (c) The amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at fair value through surplus or deficit but are no longer so designated, distinguishing between those that [draft] IPSAS [X] (ED 62) requires an entity to reclassify and those that an entity elects to reclassify at the date of initial application.

49J In the reporting period that includes the date of initial application of [draft] IPSAS [X] (ED 62), an entity shall disclose qualitative information to enable users to understand:

- (a) How it applied the classification requirements in [draft] IPSAS [X] (ED 62) to those financial assets whose classification has changed as a result of applying [draft] IPSAS [X] (ED 62).
- (b) The reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through surplus or deficit at the date of initial application.

49K In the reporting period that an entity first applies the classification and measurement requirements for financial assets in [draft] IPSAS [X] (ED 62) (i.e. when the entity transitions from IPSAS 29 to [draft] IPSAS [X] (ED 62) for financial assets), it shall present the disclosures set out in paragraphs 49D–49G of this Standard as required by paragraph 169 of [draft] IPSAS [X] (ED 62).

49L When required by paragraph 49C, an entity shall disclose the changes in the classifications of financial assets and financial liabilities as at the date of initial application of [draft] IPSAS [X] (ED 62), showing separately:

- (a) The changes in the carrying amounts on the basis of their measurement categories in accordance with IPSAS 29 (i.e. not resulting from a change in measurement attribute on transition to [draft] IPSAS [X] (ED 62)); and
- (b) The changes in the carrying amounts arising from a change in measurement attribute on transition to [draft] IPSAS [X] (ED 62).

The disclosures in this paragraph need not be made after the reporting period in which the entity initially applies the classification and measurement requirements for financial assets in [draft] IPSAS [X] (ED 62).

49M When required by paragraph 49C, an entity shall disclose the following for financial assets and financial liabilities that have been reclassified so that they are measured at amortized cost and, in the case of financial assets, that have been reclassified out of fair value through surplus or deficit so that they are measured at fair value through net assets/equity, as a result of the transition to [draft] IPSAS [X] (ED 62):

- (a) The fair value of the financial assets or financial liabilities at the end of the reporting period; and
- (b) The fair value gain or loss that would have been recognized in surplus or deficit or net assets/equity during the reporting period if the financial assets or financial liabilities had not been reclassified.

The disclosures in this paragraph need not be made after the reporting period in which the entity initially applies the classification and measurement requirements for financial assets in [draft] IPSAS [X] (ED 62).

49N When required by paragraph 49C, an entity shall disclose the following for financial assets and financial liabilities that have been reclassified out of the fair value through surplus or deficit category as a result of the transition to [draft] IPSAS [X] (ED 62):

- (a) The effective interest rate determined on the date of initial application; and
- (b) The interest revenue or expense recognized.

If an entity treats the fair value of a financial asset or a financial liability as the new gross carrying amount at the date of initial application (see paragraph 164 of [draft] IPSAS [X] (ED 62)), the disclosures in this paragraph shall be made for each reporting period until derecognition. Otherwise, the disclosures in this paragraph need not be made after the reporting period in which the entity initially applies the classification and measurement requirements for financial assets in [draft] IPSAS [X] (ED 62).

49O When an entity presents the disclosures set out in paragraphs 49C–49F, those disclosures, and the disclosures in paragraph 29 of this Standard, must permit reconciliation between:

- (a) The measurement categories presented in accordance with IPSAS 29 and [draft] IPSAS [X] (ED 62); and
- (b) The class of financial instrument
as at the date of initial application.

49P On the date of initial application of paragraphs 71-90 of [draft] IPSAS [X] (ED 62), an entity is required to disclose information that would permit the reconciliation of the ending impairment allowances in accordance with IPSAS 29 and the provisions in accordance with IPSAS 19 to the opening loss allowances determined in accordance with [draft] IPSAS [X] (ED 62). For financial assets, this disclosure shall be provided by the related financial assets' measurement categories in accordance with IPSAS 29 and [draft] IPSAS [X] (ED 62), and shall show separately the effect of the changes in the measurement category on the loss allowance at that date.

49Q In the reporting period that includes the date of initial application of [draft] IPSAS [X] (ED 62), an entity is not required to disclose the line item amounts that would have been reported in accordance with the classification and measurement requirements (which includes the requirements related to amortized cost measurement of financial assets and impairment in paragraphs 67-70 and 71-90 of [draft] IPSAS [X] (ED 62)) of:

(a) [draft] IPSAS [X] (ED 62) for prior periods; and

(b) IPSAS 29 for the current period.

49R In accordance with paragraph 157 of [draft] IPSAS [X] (ED 62), if it is impracticable (as defined in IPSAS 3) at the date of initial application of [draft] IPSAS [X] (ED 62) for an entity to assess a modified time value of money element in accordance with paragraphs AG68–AG70 of [draft] IPSAS [X] (ED 62) based on the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the requirements related to the modification of the time value of money element in paragraphs AG68–AG70 of [draft] IPSAS [X] (ED 62). An entity shall disclose the carrying amount at the reporting date of the financial assets whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the requirements related to the modification of the time value of money element in paragraphs AG68–AG70 of [draft] IPSAS [X] (ED 62) until those financial assets are derecognized.

49S In accordance with paragraph 158 of [draft] IPSAS [X] (ED 62), if it is impracticable (as defined in IPSAS 3) at the date of initial application for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraphs AG74(c) of [draft] IPSAS [X] (ED 62) based on the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph AG74 of [draft] IPSAS [X] (ED 62). An entity shall disclose the carrying amount at the reporting date of the financial assets whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph AG74 of [draft] IPSAS [X] (ED 62) until those financial assets are derecognized.

...

Effective Date and Transition

...

52D. Paragraphs 2, 3, 4, 5, 8, 11, 12, 13, 14, 18, 24, 34, 35, 36, 37, 41, 43, 45, AG1, AG5, AG9, AG10, AG24, and AG29 were amended, paragraphs 16, 17, 20, 26, 27, 28 and 44 were deleted and several headings and paragraphs 5A, 13A, 14A, 14B, 15A, 15B, 15C, 17A, 17B, 17C, 17D, 17E, 17F, 20A, 24A, 25A, 25B, 25C, 25D, 26A, 26B, 26C, 27A, 27B, 27C, 27D, 27E, 27F, 28A, 28B, 28C, 28D, 28E, 28F, 28G, 37A, 39A, 42A, 42B, 42C, 42D, 42E, 42F, 42G, 42H, 42I, 42J, 42K, 42L, 42M, 42N, 49A, 49B, 49C, 49D, 49E, 49F, 49G, 49H, 49I, 49J, 49K, 49L, 49M, 49N, 49O, 49P, 49Q, 49R, 49S, 52C, 52D, AG8A, AG8B, AG8C, AG8D, AG8E, AG8F, AG8G, AG8H, AG8I, AG8J, AG31, AG32, AG32A, AG33, AG34, AG35, AG36, AG37, AG38, AG39, AG40, AG41, AG42, AG43, AG44, AG45, AG46, AG47, AG48, AG49, AG50, AG51, AG52, AG53, AG54 and AG55 are added by [draft] IPSAS [X]

(ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Application Guidance

This Appendix is an integral part of IPSAS 30.

...

Classes of Financial Instruments and Level of Disclosure (paragraph 9)

AG1. Paragraph 9 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 9 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ (which determine how financial instruments are measured and where changes in fair value are recognized).

...

Significance of Financial Instruments for Financial Position and Financial Performance

Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs 13 and 14)

~~AG4. If an entity designates a financial liability as at fair value through surplus or deficit, paragraph 13(a) requires it to disclose the amount of change in the fair value of the financial liability that is attributable to changes in the liability's credit risk. Paragraph 13(a)(i) permits an entity to determine this amount as the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk. If the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, this amount can be estimated as follows:~~

- ~~(a) First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.~~
- ~~(b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period, and (ii) the instrument-specific component of the internal rate of return as determined in (a).~~
- ~~(c) The difference between the observed market price of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.~~

~~This example assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in interest rates are not significant. If the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be disclosed in accordance with paragraph 13(a).~~

Other Disclosure—Accounting Policies (paragraph 25)

AG5. Paragraph 25 requires disclosure of 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. For financial instruments, such disclosure may include:

- (a) For financial ~~assets or financial~~ liabilities designated as at fair value through surplus or deficit:
 - (i) The nature of the financial ~~assets or financial~~ liabilities the entity has designated as at fair value through surplus or deficit;
 - (ii) The criteria for so designating such financial ~~assets or financial~~ liabilities on initial recognition; and
 - (iii) How the entity has satisfied the conditions in paragraph ~~46 10, 13, or 14~~ of [draft] IPSAS [X] (ED 62) IPSAS 29 for such designation. ~~For instruments designated in accordance with paragraph (b)(i) of the definition of a financial asset or financial liability at fair value through surplus or deficit in IPSAS 29, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph (b)(ii) of the definition of a financial asset or financial liability at fair value through surplus or deficit in IPSAS 29, that disclosure includes a narrative description of how designation at fair value through surplus or deficit is consistent with the entity's documented risk management or investment strategy.~~
- (b) For financial assets designated as measured at fair value through surplus or deficit:
 - (i) The nature of the financial assets the entity has designated as measured at fair value through surplus or deficit; and
 - (ii) How the entity has satisfied the criteria in paragraph 44 of [draft] IPSAS [X] (ED 62) for such designation.
- ~~(b) The criteria for designating financial assets as available for sale.~~
- (c) Whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph ~~11 40~~ of [draft] IPSAS [X] (ED 62) IPSAS 29).
- (d) ~~When an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:~~
 - ~~(i) The criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and~~
 - ~~(ii) The criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph 20).~~
- (e) How net gains or net losses on each category of financial instrument are determined (see paragraph 24(a)), for example, whether the net gains or net losses on items at fair value through surplus or deficit include interest or revenue from dividends or similar distributions.
- ~~(f) The criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph 24(e)).~~

- ~~(g) When the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph 43(d)).~~
- (h) For financial guarantee contracts issued through a non-exchange transaction, where no fair value can be determined and a provision is recognized in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, disclosure of the circumstances that result in a provision being recognized.

Paragraph 137 of IPSAS 1 also requires entities to disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements.

...

Credit Risk Management Practices (paragraphs 42F–42G)

AG8A. Paragraph 42F(b) requires the disclosure of information about how an entity has defined default for different financial instruments and the reasons for selecting those definitions. In accordance with paragraph 79 of [draft] IPSAS [X] (ED 62), the determination of whether lifetime expected credit losses should be recognized is based on the increase in the risk of a default occurring since initial recognition. Information about an entity's definitions of default that will assist users of financial statements in understanding how an entity has applied the expected credit loss requirements in [draft] IPSAS [X] (ED 62) may include:

- (a) The qualitative and quantitative factors considered in defining default;
- (b) Whether different definitions have been applied to different types of financial instruments; and
- (c) Assumptions about the cure rate (i.e. the number of financial assets that return to a performing status) after a default occurred on the financial asset.

AG8B. To assist users of financial statements in evaluating an entity's restructuring and modification policies, paragraph 42F(f)(i) requires the disclosure of information about how an entity monitors the extent to which the loss allowance on financial assets previously disclosed in accordance with paragraph 42F(f)(i) are subsequently measured at an amount equal to lifetime expected credit losses in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62). Quantitative information that will assist users in understanding the subsequent increase in credit risk of modified financial assets may include information about modified financial assets meeting the criteria in paragraph 42F(f)(i) for which the loss allowance has reverted to being measured at an amount equal to lifetime expected credit losses (i.e. a deterioration rate).

AG8C. Paragraph 42G(a) requires the disclosure of information about the basis of inputs and assumptions and the estimation techniques used to apply the impairment requirements in [draft] IPSAS [X] (ED 62). An entity's assumptions and inputs used to measure expected credit losses or determine the extent of increases in credit risk since initial recognition may include information obtained from internal historical information or rating reports and assumptions about the expected life of financial instruments and the timing of the sale of collateral.

Changes in the Loss Allowance (paragraph 42H)

AG8D. In accordance with paragraph 42H, an entity is required to explain the reasons for the changes in the loss allowance during the period. In addition to the reconciliation from the opening balance to the closing balance of the loss allowance, it may be necessary to provide a narrative explanation of the changes. This narrative explanation may include an analysis of the reasons for changes in the loss allowance during the period, including:

- (a) The portfolio composition;
- (b) The volume of financial instruments purchased or originated; and
- (c) The severity of the expected credit losses

AG8E. For loan commitments and financial guarantee contracts the loss allowance is recognized as a provision. An entity should disclose information about the changes in the loss allowance for financial assets separately from those for loan commitments and financial guarantee contracts. However, if a financial instrument includes both a loan (i.e. financial asset) and an undrawn commitment (i.e. loan commitment) component and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component, the expected credit losses on the loan commitment should be recognized together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognized as a provision.

Collateral (paragraph 42K)

AG8F. Paragraph 42K requires the disclosure of information that will enable users of financial statements to understand the effect of collateral and other credit enhancements on the amount of expected credit losses. An entity is neither required to disclose information about the fair value of collateral and other credit enhancements nor is it required to quantify the exact value of the collateral that was included in the calculation of expected credit losses (i.e. the loss given default).

AG8G. A narrative description of collateral and its effect on amounts of expected credit losses might include information about:

- (a) The main types of collateral held as security and other credit enhancements (examples of the latter being guarantees, credit derivatives and netting agreements that do not qualify for offset in accordance with IPSAS 28);
- (b) The volume of collateral held and other credit enhancements and its significance in terms of the loss allowance;
- (c) The policies and processes for valuing and managing collateral and other credit enhancements;
- (d) The main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
- (e) Information about risk concentrations within the collateral and other credit enhancements.

Credit Risk Exposure (paragraphs 42M–42N)

AG8H. Paragraph 42M requires the disclosure of information about an entity's credit risk exposure and significant concentrations of credit risk at the reporting date. A concentration of credit risk exists

when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. An entity should provide information that enables users of financial statements to understand whether there are groups or portfolios of financial instruments with particular features that could affect a large portion of that group of financial instruments such as concentration to particular risks. This could include, for example, loan-to-value groupings, geographical, industry or issuer-type concentrations.

AG8I. The number of credit risk rating grades used to disclose the information in accordance with paragraph 42M shall be consistent with the number that the entity reports to key management personnel for credit risk management purposes. If past due information is the only borrower-specific information available and an entity uses past due information to assess whether credit risk has increased significantly since initial recognition in accordance with paragraph 80 of [draft] IPSAS [X] (ED 62), an entity shall provide an analysis by past due status for those financial assets.

AG8J. When an entity has measured expected credit losses on a collective basis, the entity may not be able to allocate the gross carrying amount of individual financial assets or the exposure to credit risk on loan commitments and financial guarantee contracts to the credit risk rating grades for which lifetime expected credit losses are recognized. In that case, an entity should apply the requirement in paragraph 42M to those financial instruments that can be directly allocated to a credit risk rating grade and disclose separately the gross carrying amount of financial instruments for which lifetime expected credit losses have been measured on a collective basis.

Maximum Credit Risk Exposure (paragraph 43(a))

AG9. Paragraph 42K(a) and 43(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:

- (a) Any amounts offset in accordance with IPSAS 28; and
- (b) Any loss allowance ~~impairment losses~~ recognized in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~.

AG10. Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:

- (a) Granting loans ~~and receivables~~ to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.
- (b) Entering into derivative contracts (e.g., foreign exchange contracts, interest rate swaps, and credit derivatives). When the resulting asset is measured at fair value, the maximum exposure to credit risk at the end of the reporting period will equal the carrying amount.
- (c) Granting financial guarantees. In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognized as a liability.
- (d) Making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount

of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognized as a liability.

...

Interest Rate Risk

AG24. Interest rate risk arises on interest-bearing financial instruments recognized in the statement of financial position (e.g., ~~loans and receivables~~ and debt instruments acquired or issued) and on some financial instruments not recognized in the statement of financial position (e.g., some loan commitments).

...

AG29. In accordance with paragraph 47(a), the sensitivity of surplus or deficit (that arises, for example, from instruments measured classified as at fair value through surplus or deficit and impairments of available-for-sale financial assets) is disclosed separately from the sensitivity of net assets/equity (that arises, for example, from investments in equity instruments whose changes in fair value are presented in net assets/equity classified as available for sale).

...

Derecognition (paragraphs 49C–49H)

Continuing Involvement (paragraph 49C)

AG31. The assessment of continuing involvement in a transferred financial asset for the purposes of the disclosure requirements in paragraphs 49E–49H is made at the level of the reporting entity. For example, if a controlled entity transfers to an unrelated third party a financial asset in which the controlling entity of the controlled entity has continuing involvement, the controlled entity does not include the controlling entity's involvement in the assessment of whether it has continuing involvement in the transferred asset in its separate or individual financial statements (i.e. when the controlled entity is the reporting entity). However, a controlling entity would include its continuing involvement (or that of another member of the group) in a financial asset transferred by its controlling entity in determining whether it has continuing involvement in the transferred asset in its consolidated financial statements (i.e. when the reporting entity is the group).

AG32. An entity does not have a continuing involvement in a transferred financial asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset. An entity does not have continuing involvement in a transferred financial asset if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future. The term 'payment' in this context does not include cash flows of the transferred financial asset that an entity collects and is required to remit to the transferee.

AG32A. When an entity transfers a financial asset, the entity may retain the right to service that financial asset for a fee that is included in, for example, a servicing contract. The entity assesses the servicing contract in accordance with the guidance in paragraphs 49C and AG32 to decide whether the entity has continuing involvement as a result of the servicing contract for the purposes of the disclosure requirements. For example, a servicer will have continuing involvement in the

transferred financial asset for the purposes of the disclosure requirements if the servicing fee is dependent on the amount or timing of the cash flows collected from the transferred financial asset. Similarly, a servicer has continuing involvement for the purposes of the disclosure requirements if a fixed fee would not be paid in full because of non-performance of the transferred financial asset. In these examples, the servicer has an interest in the future performance of the transferred financial asset. This assessment is independent of whether the fee to be received is expected to compensate the entity adequately for performing the servicing.

- AG33. Continuing involvement in a transferred financial asset may result from contractual provisions in the transfer agreement or in a separate agreement with the transferee or a third party entered into in connection with the transfer.

Transferred Financial Assets that are Not Derecognized in Their Entirety (paragraph 49D)

- AG34. Paragraph 49D requires disclosures when part or all of the transferred financial assets do not qualify for derecognition. Those disclosures are required at each reporting date at which the entity continues to recognize the transferred financial assets, regardless of when the transfers occurred.

Types of Continuing Involvement (paragraphs 49E–49H)

- AG35. Paragraphs 49E–49H require qualitative and quantitative disclosures for each type of continuing involvement in derecognized financial assets. An entity shall aggregate its continuing involvement into types that are representative of the entity's exposure to risks. For example, an entity may aggregate its continuing involvement by type of financial instrument (e.g. guarantees or call options) or by type of transfer (e.g. factoring of receivables, securitizations and securities lending).

Maturity Analysis for Undiscounted Cash Outflows to Repurchase Transferred Assets (paragraph 49E(e))

- AG36. Paragraph 49E(e) requires an entity to disclose a maturity analysis of the undiscounted cash outflows to repurchase derecognized financial assets or other amounts payable to the transferee in respect of the derecognized financial assets, showing the remaining contractual maturities of the entity's continuing involvement. This analysis distinguishes cash flows that are required to be paid (e.g. forward contracts), cash flows that the entity may be required to pay (e.g. written put options) and cash flows that the entity might choose to pay (e.g. purchased call options).

- AG37. An entity shall use its judgment to determine an appropriate number of time bands in preparing the maturity analysis required by paragraph 49E(e). For example, an entity might determine that the following maturity time bands are appropriate:

- (a) Not later than one month;
- (b) Later than one month and not later than three months;
- (c) Later than three months and not later than six months;
- (d) Later than six months and not later than one year;
- (e) Later than one year and not later than three years;
- (f) Later than three years and not later than five years; and
- (g) More than five years.

- AG38. If there is a range of possible maturities, the cash flows are included on the basis of the earliest date on which the entity can be required or is permitted to pay.

Qualitative Information (paragraph 49E(f))

AG39. The qualitative information required by paragraph 49E(f) includes a description of the derecognized financial assets and the nature and purpose of the continuing involvement retained after transferring those assets. It also includes a description of the risks to which an entity is exposed, including:

- (a) A description of how the entity manages the risk inherent in its continuing involvement in the derecognized financial assets.
- (b) Whether the entity is required to bear losses before other parties, and the ranking and amounts of losses borne by parties whose interests rank lower than the entity's interest in the asset (i.e. its continuing involvement in the asset).
- (c) A description of any triggers associated with obligations to provide financial support or to repurchase a transferred financial asset.

Gain or Loss on Derecognition (paragraph 49G(a))

AG40. Paragraph 49G(a) requires an entity to disclose the gain or loss on derecognition relating to financial assets in which the entity has continuing involvement. The entity shall disclose if a gain or loss on derecognition arose because the fair values of the components of the previously recognized asset (i.e. the interest in the asset derecognized and the interest retained by the entity) were different from the fair value of the previously recognized asset as a whole. In that situation, the entity shall also disclose whether the fair value measurements included significant inputs that were not based on observable market data, as described in paragraph 32.

Supplementary Information (paragraph 49H)

AG41. The disclosures required in paragraphs 49D–49G may not be sufficient to meet the disclosure objectives in paragraph 49B. If this is the case, the entity shall disclose whatever additional information is necessary to meet the disclosure objectives. The entity shall decide, in the light of its circumstances, how much additional information it needs to provide to satisfy the information needs of users and how much emphasis it places on different aspects of the additional information. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation.

...

Offsetting Financial Assets and Financial Liabilities (paragraphs 17A–17F)*Scope (paragraph 17A)*

AG42. The disclosures in paragraphs 17B–17E are required for all recognized financial instruments that are set off in accordance with paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*. In addition, financial instruments are within the scope of the disclosure requirements in paragraphs 17B–17E if they are subject to an enforceable master netting arrangement or similar agreement that covers similar financial instruments and transactions, irrespective of whether the financial instruments are set off in accordance with paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*.

AG43. The similar agreements referred to in paragraphs 17A and AG31 include derivative clearing agreements, global master repurchase agreements, global master securities lending agreements, and any related rights to financial collateral. The similar financial instruments and transactions referred to in paragraph AG31 include derivatives, sale and repurchase agreements, reverse sale and repurchase agreements, securities borrowing, and securities lending agreements. Examples of financial instruments that are not within the scope of paragraph 17A are loans and customer deposits at the same institution (unless they are set off in the statement of financial position), and financial instruments that are subject only to a collateral agreement.

Disclosure of Quantitative Information for Recognized Financial Assets and Recognized Financial Liabilities within the Scope of Paragraph 17A (paragraph 17C)

AG44. Financial instruments disclosed in accordance with paragraph 17C may be subject to different measurement requirements (for example, a payable related to a repurchase agreement may be measured at amortized cost, while a derivative will be measured at fair value). An entity shall include instruments at their recognized amounts and describe any resulting measurement differences in the related disclosures.

Disclosure of the Gross Amounts of Recognized Financial Assets and Recognized Financial Liabilities within the Scope of Paragraph 17A (paragraph 17C(a))

AG45. The amounts required by paragraph 17C(a) relate to recognized financial instruments that are set off in accordance with paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*. The amounts required by paragraph 17C(a) also relate to recognized financial instruments that are subject to an enforceable master netting arrangement or similar agreement irrespective of whether they meet the offsetting criteria. However, the disclosures required by paragraph 17C(a) do not relate to any amounts recognized as a result of collateral agreements that do not meet the offsetting criteria in paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*. Instead, such amounts are required to be disclosed in accordance with paragraph 17C(d).

Disclosure of the Amounts that are Set Off in Accordance with the Criteria in Paragraph 47 of IPSAS 28 (paragraph 17C(b))

AG46. Paragraph 17C(b) requires that entities disclose the amounts set off in accordance with paragraph 47 of IPSAS 28, *Financial Instruments: Presentation* when determining the net amounts presented in the statement of financial position. The amounts of both the recognized financial assets and the recognized financial liabilities that are subject to set-off under the same arrangement will be disclosed in both the financial asset and financial liability disclosures. However, the amounts disclosed (in, for example, a table) are limited to the amounts that are subject to set-off. For example, an entity may have a recognized derivative asset and a recognized derivative liability that meet the offsetting criteria in paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*. If the gross amount of the derivative asset is larger than the gross amount of the derivative liability, the financial asset disclosure table will include the entire amount of the derivative asset (in accordance with paragraph 17C(a)) and the entire amount of the derivative liability (in accordance with paragraph 17C(b)). However, while the financial liability disclosure table will include the entire amount of the derivative liability (in accordance with paragraph 17C(a)), it will only include the amount of the derivative asset (in accordance with paragraph 137(b)) that is equal to the amount of the derivative liability.

Disclosure of the Net Amounts Presented in the Statement of Financial Position (paragraph 17C(c))

AG47. If an entity has instruments that meet the scope of these disclosures (as specified in paragraph 17A), but that do not meet the offsetting criteria in paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*, the amounts required to be disclosed by paragraph 17C(c) would equal the amounts required to be disclosed by paragraph 17C(a).

AG48. The amounts required to be disclosed by paragraph 17C(c) must be reconciled to the individual line item amounts presented in the statement of financial position. For example, if an entity determines that the aggregation or disaggregation of individual financial statement line item amounts provides more relevant information, it must reconcile the aggregated or disaggregated amounts disclosed in paragraph 17C(c) back to the individual line item amounts presented in the statement of financial position.

Disclosure of the Amounts Subject to an Enforceable Master Netting Arrangement or Similar Agreement that are not Otherwise Included in Paragraph 17C(b) (paragraph 17C(d))

AG49. Paragraph 17C(d) requires that entities disclose amounts that are subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 17C(b). Paragraph 17C(d)(i) refers to amounts related to recognized financial instruments that do not meet some or all of the offsetting criteria in paragraph 47 of IPSAS 28, *Financial Instruments: Presentation* (for example, current rights of set-off that do not meet the criterion in paragraph 47(b) of IPSAS 28, or conditional rights of set-off that are enforceable and exercisable only in the event of default, or only in the event of insolvency or bankruptcy of any of the counterparties).

AG50. Paragraph 17C(d)(ii) refers to amounts related to financial collateral, including cash collateral, both received and pledged. An entity shall disclose the fair value of those financial instruments that have been pledged or received as collateral. The amounts disclosed in accordance with paragraph 17C(d)(ii) should relate to the actual collateral received or pledged and not to any resulting payables or receivables recognized to return or receive back such collateral.

Limits on the Amounts Disclosed in Paragraph 17C(d) (paragraph 17D)

AG51. When disclosing amounts in accordance with paragraph 17C(d), an entity must take into account the effects of over-collateralization by financial instrument. To do so, the entity must first deduct the amounts disclosed in accordance with paragraph 17C(d)(i) from the amount disclosed in accordance with paragraph 17C(c). The entity shall then limit the amounts disclosed in accordance with paragraph 17C(d)(ii) to the remaining amount in paragraph 17C(c) for the related financial instrument. However, if rights to collateral can be enforced across financial instruments, such rights can be included in the disclosure provided in accordance with paragraph 17D.

Description of the Rights of Set-Off Subject to Enforceable Master Netting Arrangements and Similar Agreements (paragraph 17E)

AG52. An entity shall describe the types of rights of set-off and similar arrangements disclosed in accordance with paragraph 17C(d), including the nature of those rights. For example, an entity shall describe its conditional rights. For instruments subject to rights of set-off that are not contingent on a future event but that do not meet the remaining criteria in paragraph 47 of IPSAS 28, *Financial Instruments: Presentation*, the entity shall describe the reason(s) why the criteria are not met. For any financial collateral received or pledged, the entity shall describe the terms of the collateral agreement (for example, when the collateral is restricted).

Disclosure by Type of Financial Instrument or by Counterparty

AG53. The quantitative disclosures required by paragraph 17C(a)–(e) may be grouped by type of financial instrument or transaction (for example, derivatives, repurchase and reverse repurchase agreements or securities borrowing and securities lending agreements).

AG54. Alternatively, an entity may group the quantitative disclosures required by paragraph 17C(a)–(c) by type of financial instrument, and the quantitative disclosures required by paragraph 17C(c)–(e) by counterparty. If an entity provides the required information by counterparty, the entity is not required to identify the counterparties by name. However, designation of counterparties (Counterparty A, Counterparty B, Counterparty C, etc.) shall remain consistent from year to year for the years presented to maintain comparability. Qualitative disclosures shall be considered so that further information can be given about the types of counterparties. When disclosure of the amounts in paragraph 17C(c)–(e) is provided by counterparty, amounts that are individually significant in terms of total counterparty amounts shall be separately disclosed and the remaining individually insignificant counterparty amounts shall be aggregated into one line item.

Other

AG55. The specific disclosures required by paragraphs 17C–17E are minimum requirements. To meet the objective in paragraph 17B an entity may need to supplement them with additional (qualitative) disclosures, depending on the terms of the enforceable master netting arrangements and related agreements, including the nature of the rights of set-off, and their effect or potential effect on the entity's financial position.

...

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 30.

...

Significance of Financial Instruments for Financial Position and Financial Performance (paragraphs 10–36, AG4 and AG5)*Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs 13(a)(i) and AG4)*

IG7. ~~The following example illustrates the calculation that an entity might perform in accordance with paragraph AG4 of Appendix A of the Standard.~~

IG8. ~~On January 1, 20X1, an entity issues a 10-year bond with a par value of CU150,000⁴ and an annual fixed coupon rate of 8 percent, which is consistent with market rates for bonds with similar characteristics.~~

IG9. ~~The entity uses the London Interbank Offered Rate (LIBOR) as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 percent. At the end of the first year:~~

~~(a) — LIBOR has decreased to 4.75 percent.~~

⁴—In this guidance monetary amounts are denominated in "currency units (CU)."

~~(b) The fair value for the bond is CU153,811, consistent with an interest rate of 7.6 percent.⁵~~

~~IG10. The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.~~

~~IG11. The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:~~

<p>[paragraph AG4(a)]</p> <p>First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period.</p> <p>It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.</p>	<p>At the start of the period of a 10-year bond with a coupon of 8 percent, the bond's internal rate of return is 8 percent.</p> <p>Because the observed (benchmark) interest rate (LIBOR) is 5 percent, the instrument-specific component of the internal rate of return is 3 percent.</p>
<p>[paragraph AG4(b)]</p> <p>Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period, and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph AG4(a).</p>	<p>The contractual cash flows of the instrument at the end of the period are:</p> <ul style="list-style-type: none"> ■ Interest: CU12,000^(a) per year for each of years 2–10. ■ Principal: CU150,000 in year 10. <p>The discount rate to be used to calculate the present value of the bond is thus 7.75 percent, which is 4.75 percent end-of-period LIBOR rate, plus the 3 percent instrument-specific component.</p> <p>This gives a present value of CU152,367.^(b)</p>
<p>[paragraph AG4(c)]</p> <p>The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph AG4(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.</p>	<p>The market price of the liability at the end of the period is CU153,811.^(c)</p> <p>Thus, the entity discloses CU1,444, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.</p>
<p>(a) — $CU150,000 \times 8\% = CU12,000$</p> <p>(b) — $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$</p> <p>(c) — market price = $[CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$</p>	

...

Fair Value (paragraphs 31–34)

IG14. IPSAS 30 requires disclosures about the level in the fair value hierarchy in which fair value measurements are categorized for assets and liabilities measured in the statement of financial position. A tabular format is required unless another format is more appropriate. An entity might disclose the following for assets to comply with paragraph 33(a). (Disclosure of comparative information is also required, but is not included in the following example).

⁵—This reflects a shift in LIBOR from 5 percent to 4.75 percent and a movement of 0.15 percent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

Assets Measured at Fair Value				
Description	Dec 31, 20X2	Fair value measurement at end of the reporting period using:		
		Level 1	Level 2	Level 3
		CU million	CU million	CU million
Financial assets at fair value through surplus or deficit				
Trading securities	100	40	55	5
Trading derivatives	39	17	20	2
Available-for-sale—financial <u>Financial assets at fair value</u> <u>through net assets/equity</u>				
Equity investments	75	30	40	5
Total	214	87	115	12
Note: For liabilities, a similar table might be presented.				

IG15. IPSAS 30 requires a reconciliation from beginning to ending balances for those assets and liabilities that are measured in the statement of financial position at fair value based on a valuation technique for which any significant input is not based on observable market data (Level 3). A tabular format is required unless another format is more appropriate. An entity might disclose the following for assets to comply with paragraph 33(b). (Disclosure of comparative information is also required, but is not included in the following example).

Assets Measured at Fair Value Based on Level 3				
Fair value measurement at the end of the reporting period				
	Financial assets at fair value through surplus or deficit	Trading derivative s	Available-for-sale financial assets at fair value through net assets/equity	Total
	Trading securities	Equity investment s		
	CU million	CU million	CU million	CU million
Opening balance	6	5	4	15
Total gains or losses				
in surplus or deficit	(2)	(2)	-	(4)
in net assets/equity	-	-	(1)	(1)
Purchases	1	2	2	5
Issues	-	-	-	-
Settlements	-	(1)	-	(1)
Transfers out of Level 3	-	(2)	-	(2)
Closing balance	5	2	5	12
Total gains or losses for the period included in surplus or deficit for assets held at the end of the reporting period	(1)	(1)	-	(2)
(Note: For liabilities, a similar table might be presented.)				
Gains or losses included in surplus or deficit for the period (above) are presented in revenue as follows:				
			Revenue	
Total gains or losses included in surplus or deficit for the period			(4)	
Total gains or losses for the period included in surplus or deficit for assets held at the end of the reporting period			(2)	
(Note: For liabilities, a similar table might be presented.)				

IG16. The fair value at initial recognition of financial instruments that are not traded in active markets is determined in accordance with paragraph AG147 ~~AG108~~ of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~. However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognized in surplus or deficit in subsequent periods in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ and the entity's accounting policy. Such

recognition reflects changes in factors (including time) that market participants would consider in setting a price (see paragraph ~~AG147~~ ~~AG108~~ of [draft] IPSAS [X] (ED 62) ~~IPSAS-29~~). Paragraph 33 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 34:

Background		
On January 1, 20X1 an entity purchases for CU15 million financial assets that are not traded in an active market. The entity has only one class of such financial assets. The transaction price of CU15 million is the fair value at initial recognition.		
After initial recognition, the entity will apply a valuation technique to establish the financial assets' fair value. This valuation technique includes variables other than data from observable markets.		
At initial recognition, the same valuation technique would have resulted in an amount of CU14 million, which differs from fair value by CU1 million.		
The entity has existing differences of CU5 million at January 1, 20X1.		
Application of Requirements		
The entity's 20X2 disclosure would include the following:		
<i>Accounting Policies</i>		
The entity uses the following valuation technique to determine the fair value of financial instruments that are not traded in an active market: [description of technique not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29 , is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].		
<i>In the Notes to the Financial Statements</i>		
As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29 , the fair value of an instrument at inception is generally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].		
The differences yet to be recognized in surplus or deficit are as follows:		
	Dec 31, X2 CU million	Dec 31, X1 CU million
Balance at beginning of year	5.3	5.0
New transactions	—	1.0
Amounts recognized in surplus or deficit during the year	(0.7)	(0.8)
Other increases	—	0.2
Other decreases	(0.1)	(0.1)
Balance at end of year	<u>4.5</u>	<u>5.3</u>

...

Market Risk (paragraphs 47–49 and AG19–AG30)

...

IG36. The following example illustrates the application of the disclosure requirement in paragraph 47(a):

Interest Rate Risk

At December 31, 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, surplus for the year would have been CU1.7 million (20X1—CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings, ~~and other revenue would have been CU2.8 million (20X1—CU3.2 million) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale.~~ If interest rates had been 10 basis points higher, with all other variables held constant, surplus would have been CU1.5 million (20X1—CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings, ~~revenue would have been CU3.0 million (20X1—CU3.4 million) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale.~~ Surplus is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).^(a)

Foreign Currency Exchange Rate Risk

At December 31, 20X2, if the CU had weakened 10 percent against the US dollar with all other variables held constant, surplus for the year would have been CU2.8 million (20X1—CU6.4 million) lower, revenue would have been CU1.2 million (20X1—CU1.1 million) higher. Conversely, if the CU had strengthened 10 percent against the US dollar with all other variables held constant, surplus would have been CU2.8 million (20X1—CU6.4 million) higher, revenue would have been CU1.2 million (20X1—CU1.1 million) lower. The lower foreign currency exchange rate sensitivity in surplus in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt. Revenue is more sensitive in 20X2 than in 20X1 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt.

(a) Paragraph 46 requires disclosure of a maturity analysis of liabilities.

...

Derecognition (paragraphs 49D and 49E)

IG41 The following examples illustrate some possible ways to meet the quantitative disclosure requirements in paragraphs 49D and 49E.

IG42 The following examples illustrate how an entity that has adopted [draft] IPSAS [X] (ED 62) might meet the quantitative disclosure requirements in paragraphs 49D and 49E.

Transferred financial assets that are not derecognized in their entirety

Illustrating the application of paragraph 49D(d) and (e)

	<u>Financial assets at fair value through surplus or deficit</u>		<u>Financial assets at amortized cost</u>		<u>Financial assets at fair value through net assets/equity</u>
	<u>CU million</u>		<u>CU million</u>		<u>CU million</u>
	<u>Trading assets</u>	<u>Derivatives</u>	<u>Mortgages</u>	<u>Consumer loans</u>	<u>Equity investments</u>
<u>Carrying amount of assets</u>	X	X	X	X	X
<u>Carrying amount of associated liabilities</u>	(X)	(X)	(X)	(X)	(X)

	<u>Financial assets at fair value through surplus or deficit</u>		<u>Financial assets at amortized cost</u>		<u>Financial assets at fair value through net assets/equity</u>
<u>For those liabilities that have recourse only to the transferred assets:</u>					
<u>Fair value of assets</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>
<u>Fair value of associated liabilities</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>	<u>(X)</u>
<u>Net position</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>	<u>X</u>

Transferred financial assets that are derecognized in their entirety**Illustrating the application of paragraph 49E(a)–(d)**

	<u>Cash outflows to repurchase transferred (derecognized) assets</u>	<u>Carrying amount of continuing involvement in statement of financial position</u>			<u>Fair value of continuing involvement</u>		<u>Maximum exposure to loss</u>
	CU million	CU million			CU million		CU million
<u>Type of continuing involvement</u>		<u>Financial assets at fair value through surplus or deficit</u>	<u>Financial assets at fair value through net assets/equity</u>	<u>Financial liabilities at fair value through surplus or deficit</u>	<u>Assets</u>	<u>Liabilities</u>	
Written put options	(X)			(X)		(X)	X
Purchased call options	(X)	X			X		X
Securities lending	(X)			(X)	X	(X)	X
Total		X		(X)	X	(X)	X

Illustrating the application of paragraph 49E(e)

<u>Undiscounted cash flows to repurchase transferred assets</u>								
	<u>Maturity of continuing involvement CU million</u>							
<u>Type of continuing involvement</u>	<u>Total</u>	<u>less than 1 month</u>	<u>1–3 months</u>	<u>3–6 months</u>	<u>6 months –1 year</u>	<u>1–3 years</u>	<u>3–5 years</u>	<u>more than 5 years</u>
Written put options	X		X	X	X	X		
Purchased call options	X			X	X	X		X
Securities lending	X	X	X					

IG43 The following examples illustrate how an entity that has not adopted [draft] IPSAS [X] (ED 62) might meet the quantitative disclosure requirements in paragraphs 42D and 42E.

Transferred financial assets that are not derecognized in their entirety

Illustrating the application of paragraph 49D(d) and (e)

	<u>Financial assets at fair value through surplus or deficit</u>		<u>Loans and receivables</u>		<u>Available-for-sale financial assets</u>
	<u>CU million</u>		<u>CU million</u>		<u>CU million</u>
	<u>Trading securities</u>	<u>Derivatives</u>	<u>Mortgages</u>	<u>Consumer loans</u>	<u>Equity investments</u>
<u>Carrying amount of assets</u>	X	X	X	X	X
<u>Carrying amount of associated liabilities</u>	(X)	(X)	(X)	(X)	(X)
<u>For those liabilities that have recourse only to the transferred assets:</u>					
<u>Fair value of assets</u>	X	X	X	X	X
<u>Fair value of associated liabilities</u>	(X)	(X)	(X)	(X)	(X)
<u>Net position</u>	X	X	X	X	X

Transferred financial assets that are derecognized in their entirety

Illustrating the application of paragraph 49E(a)–(d)

	<u>Cash outflows to repurchase transferred (derecognized) assets</u>	<u>Carrying amount of continuing involvement in statement of financial position</u>			<u>Fair value of continuing involvement</u>	<u>Maximum exposure to loss</u>
	<u>CU million</u>	<u>CU million</u>			<u>CU million</u>	<u>CU million</u>
<u>Type of continuing involvement</u>		<u>Held for trading</u>	<u>Available-for-sale financial assets</u>	<u>Financial liabilities at fair value through surplus or deficit</u>	<u>Assets</u>	<u>Liabilities</u>
<u>Written put options</u>	(X)			(X)		(X)
<u>Purchased call options</u>	(X)	X			X	
<u>Securities lending</u>	(X)		X	(X)	X	(X)
<u>Total</u>		X	X	(X)	X	(X)

Illustrating the application of paragraph 49E(e)

Undiscounted cash flows to repurchase transferred assets								
Maturity of continuing involvement CU million								
Type of continuing involvement	Total	less than 1 month	1–3 months	3–6 months	6 months –1 year	1–3 years	3–5 years	more than 5 years
Written put options	X		X	X	X	X		
Purchased call options	X			X	X	X		X
Securities lending	X	X	X					

...

Disclosures (paragraphs 17A–17F and AG42-55)

IG44 The following examples illustrate ways in which an entity might provide the quantitative disclosures required by paragraph 17C. However, these illustrations do not address all possible ways of applying the disclosure requirements as set out in paragraphs 17B–17E.

Background

An entity has entered into transactions subject to an enforceable master netting arrangement or similar agreement with the following counterparties. The entity has the following recognized financial assets and financial liabilities resulting from those transactions that meet the scope of the disclosure requirements in paragraph 17A.

Counterparty A:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty A that meet the offsetting criteria in paragraph 47 of IPSAS 28. Consequently, the gross derivative liability is set off against the gross derivative asset, resulting in the presentation of a net derivative asset of CU20 million in the entity's statement of financial position. Cash collateral has also been received from Counterparty A for a portion of the net derivative asset (CU10 million). The cash collateral of CU10 million does not meet the offsetting criteria in paragraph 47 of IPSAS 28, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

Counterparty B:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty B that do not meet the offsetting criteria in paragraph 47 of IPSAS 28, but which the entity has the right to set off in the case of default and insolvency or bankruptcy. Consequently, the gross amount of the derivative asset (CU100 million) and the gross amount of the derivative liability (CU80 million) are presented separately in the entity's statement of financial position. Cash collateral has also been received from Counterparty B for the net amount of the derivative asset and derivative liability (CU20 million). The cash collateral of CU20 million does not meet the offsetting criteria in paragraph 47 of IPSAS 28, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

Counterparty C:

The entity has entered into a sale and repurchase agreement with Counterparty C that is accounted for as a collateralized borrowing. The carrying amount of the financial assets (bonds) used as collateral and posted by the entity for the transaction is CU79 million and their fair value is CU85 million. The carrying amount of the collateralized borrowing (repo payable) is CU80 million.

The entity has also entered into a reverse sale and repurchase agreement with Counterparty C that is accounted for as a collateralized lending. The fair value of the financial assets (bonds) received as collateral (and not recognized in the entity's statement of financial position) is CU105 million. The carrying amount of the collateralized lending (reverse repo receivable) is CU90 million.

The transactions are subject to a global master repurchase agreement with a right of set-off only in default and insolvency or bankruptcy and therefore do not meet the offsetting criteria in paragraph 47 of IPSAS 28. Consequently, the related repo payable and repo receivable are presented separately in the entity's statement of financial position.

Illustrating the application of paragraph 17C(a)–(e) by type of financial instrument

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)	(d)		(e)=(c)-(d)
				<u>Related amounts not set off in the statement of financial position</u>		
	<u>Gross amounts of recognized financial assets</u>	<u>Gross amounts of recognized financial liabilities set off in the statement of financial position</u>	<u>Net amounts of financial assets presented in the statement of financial position</u>	<u>(d)(i). (d)(ii) Financial instruments</u>	<u>(d)(ii) Cash collateral received</u>	<u>Net amount</u>
Description						
Derivatives	200	(80)	120	(80)	(30)	10
Reverse repurchase, securities borrowing and similar agreements	90	=	90	(90)	=	=
Other financial instruments	=	=	=	=	=	=
Total	290	(80)	210	(170)	(30)	10

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)	(d)	(e)=(c)-(d)	
			<u>Related amounts not set off in the statement of financial position</u>			
<u>Description</u>	<u>Gross amounts of recognized financial liabilities</u>	<u>Gross amounts of recognized financial assets set off in the statement of financial position</u>	<u>Net amounts of financial liabilities presented in the statement of financial position</u>	<u>(d)(i), (d)(ii) Financial instruments</u>	<u>(d)(ii) Cash collateral pledged</u>	<u>Net amount</u>
Derivatives	160	(80)	80	(80)	=	=
Repurchase, securities lending and similar agreements	80	=	80	(80)	=	=
Other financial instruments	=	=	=	=	=	=
Total	240	(80)	160	(160)	=	=

Illustrating the application of paragraph 17C(a)–(c) by type of financial instrument and paragraph 17C(c)–(e) by counterparty*Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements*

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)
	<u>Gross amounts of recognized financial assets</u>	<u>Gross amounts of recognized financial liabilities set off in the statement of financial position</u>	<u>Net amounts of financial assets presented in the statement of financial position</u>
<u>Description</u>			
Derivatives	200	(80)	120
Reverse repurchase, securities borrowing and similar agreements	90	=	90
Other financial instruments	=	=	=
Total	290	(80)	210

Net financial assets subject to enforceable master netting arrangements and similar agreements, by counterparty

CU million

<u>As at 31 December 20XX</u>	<u>(c)</u>	<u>(d)</u>		<u>(e)=(c)-(d)</u>
		<u>Related amounts not set off in the statement of financial position</u>		
	<u>Net amounts of financial assets presented in the statement of financial position</u>	<u>(d)(i), (d)(ii) Financial instruments</u>	<u>(d)(ii) Cash collateral received</u>	<u>Net amount</u>
<u>Counterparty A</u>	<u>20</u>	<u>=</u>	<u>(10)</u>	<u>10</u>
<u>Counterparty B</u>	<u>100</u>	<u>(80)</u>	<u>(20)</u>	<u>=</u>
<u>Counterparty C</u>	<u>90</u>	<u>(90)</u>	<u>=</u>	<u>=</u>
<u>Other</u>	<u>=</u>	<u>=</u>	<u>=</u>	<u>=</u>
<u>Total</u>	<u>210</u>	<u>(170)</u>	<u>(30)</u>	<u>10</u>

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

<u>CU million</u>			
<u>As at 31 December 20XX</u>	<u>(a)</u>	<u>(b)</u>	<u>(c)=(a)-(b)</u>
	<u>Gross amounts of recognized financial liabilities</u>	<u>Gross amounts of recognized financial assets set off in the statement of financial position</u>	<u>Net amounts of financial liabilities presented in the statement of financial position</u>
<u>Description</u>			
<u>Derivatives</u>	<u>160</u>	<u>(80)</u>	<u>80</u>
<u>Repurchase, securities lending and similar agreements</u>	<u>80</u>	<u>=</u>	<u>80</u>
<u>Other financial instruments</u>	<u>=</u>	<u>=</u>	<u>=</u>
<u>Total</u>	<u>240</u>	<u>(80)</u>	<u>160</u>

Net financial liabilities subject to enforceable master netting arrangements and similar agreements, by counterparty

<u>CU million</u>			
<u>As at 31 December 20XX</u>	<u>(c)</u>	<u>(d)</u>	<u>(e)=(c)-(d)</u>
		<u>Related amounts not set off in the statement of financial position</u>	
	<u>Net amounts of financial liabilities presented in the statement of financial position</u>	<u>(d)(i), (d)(ii) Financial instruments</u>	<u>(d)(ii) Cash collateral pledged</u>
			<u>Net amount</u>

<u>Counterparty A</u>	=	=	=	=
<u>Counterparty B</u>	<u>80</u>	<u>(80)</u>	=	=
<u>Counterparty C</u>	<u>80</u>	<u>(80)</u>	=	=
<u>Other</u>	=	=	=	=
<u>Total</u>	<u>160</u>	<u>(160)</u>	=	=

...

Transition from IPSAS 29 to [draft] IPSAS [X] (ED 62) (paragraphs 49K–49O)

IG45 The following illustration is an example of one possible way to meet the quantitative disclosure requirements in paragraphs 49K–49O of IPSAS 30 at the date of initial application of [draft] IPSAS [X] (ED 62). However, this illustration does not address all possible ways of applying the disclosure requirements of this standard.

**Reconciliation of statement of financial position balances from IPSAS 29 to [draft] IPSAS [X] (ED 62) at
MM DD, YYYY**

<u>Financial assets</u>	<u>(i)</u>	<u>(ii)</u>	<u>(iii)</u>	<u>(iv) = (i) + (ii) + (iii)</u>	<u>(v) = (iii)</u>
	<u>IPSAS 29 carrying amount 31 December 2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>[draft] IPSAS [X] (ED 62) carrying amount 1 January 2018</u>	<u>Accumulate d surplus or deficit effect on 1 January 2018 (2), (3)</u>

**Fair value
through surplus
or deficit**

Additions:

From available for
sale (IPSAS 29)

(a)

(c)

From amortized
cost (IPSAS 29) –
required
reclassification

(b)

From amortized
cost (IPSAS 29) –
fair value option
elected at 1
January 2018

Subtractions

·

To amortized cost
([draft] IPSAS [X]
(ED 62))

To fair value
through net
assets/equity –
debt instruments
([draft] IPSAS [X]
(ED 62))

**Reconciliation of statement of financial position balances from IPSAS 29 to [draft] IPSAS [X] (ED 62) at
MM DD, YYYY**

Financial assets	(i)	(ii)	(iii)	(iv) = (i) + (ii) + (iii)	(v) = (iii)
	<u>IPSAS 29 carrying amount 31 December 2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>[draft] IPSAS [X] (ED 62) carrying amount 1 January 2018</u>	<u>Accumulate d surplus or deficit effect on 1 January 2018 (2), (3)</u>
<u>To fair value through net assets/equity – equity instruments ([draft] IPSAS [X] (ED 62))</u>					
<u>Total change to fair value through surplus or deficit</u>					
<u>Fair value through net assets/equity</u>					
<u>Additions – debt instruments:</u>					
<u>From available for sale (IPSAS 29)</u>					<u>(g)</u>
<u>From amortized cost (IPSAS 29)</u>					<u>(h)</u>
<u>From fair value through surplus or deficit (IPSAS 29) – required reclassification based on classification criteria</u>					<u>(i)</u>
<u>From fair value through surplus or deficit (fair value option under IPSAS 29) – fair value option criteria not met at 1 January 2018</u>					<u>(j)</u>
<u>From fair value through surplus or deficit (IPSAS 29) – fair value option revoked at 1 January 2018 by choice</u>					<u>(k)</u>
<u>Additions – equity instruments:</u>					

**Reconciliation of statement of financial position balances from IPSAS 29 to [draft] IPSAS [X] (ED 62) at
MM DD, YYYY**

Financial assets	(i)	(ii)	(iii)	(iv) = (i) + (ii) + (iii)	(v) = (iii)
	<u>IPSAS 29 carrying amount 31 December 2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>[draft] IPSAS [X] (ED 62) carrying amount 1 January 2018</u>	<u>Accumulate d surplus or deficit effect on 1 January 2018 (2), (3)</u>
<u>From available- for-sale (IPSAS 29)</u>					
<u>From fair value through surplus or deficit (fair value option under IPSAS 29)–fair value through net assets/equity elected at 1 January 2018</u>					
<u>From cost (IPSAS 29)</u>					
<u>Subtractions – debt and equity instruments:</u>					
<u>Available for sale (IPSAS 29) to fair value through surplus or deficit ([draft] IPSAS [X] (ED 62)) – required reclassification based on classification criteria</u>					<u>(d)</u>
<u>Available for sale (IPSAS 29) to fair value through surplus or deficit ([draft] IPSAS [X] (ED 62)) – fair value option elected at 1 January 2018</u>					
<u>Available for sale (IPSAS 29) to amortized cost ([draft] IPSAS [X] (ED 62))</u>					<u>(e)</u>
<u>Total change to fair value through net assets/equity</u>					
<u>Amortized cost</u>					

**Reconciliation of statement of financial position balances from IPSAS 29 to [draft] IPSAS [X] (ED 62) at
MM DD, YYYY**

Financial assets	(i)	(ii)	(iii)	(iv) = (i) + (ii) + (iii)	(v) = (iii)
	<u>IPSAS 29 carrying amount 31 December 2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>[draft] IPSAS [X] (ED 62) carrying amount 1 January 2018</u>	<u>Accumulate d surplus or deficit effect on 1 January 2018 (2), (3)</u>
<u>Additions:</u>					
<u>From available for sale (IPSAS 29)</u>					<u>(f)</u>
<u>From fair value through surplus or deficit (IPSAS 29) – required reclassification</u>					
<u>From fair value through surplus or deficit (fair value option under IPSAS 29) – fair value option criteria not met at 1 January 2018</u>					
<u>From fair value through surplus or deficit (IPSAS 29) – fair value option revoked at 1 January 2018 by choice</u>					
<u>Subtractions</u>					
<u>To fair value through net assets/equity ([draft] IPSAS [X] (ED 62))</u>					<u>(l)</u>
<u>To fair value through surplus or deficit ([draft] IPSAS [X] (ED 62)) – required reclassification based on classification criteria</u>					
<u>To fair value through surplus or deficit ([draft] IPSAS [X] (ED 62)) – fair value option elected at 1 January 2018</u>					
<u>Total change to amortized cost</u>					

Reconciliation of statement of financial position balances from IPSAS 29 to [draft] IPSAS [X] (ED 62) at MM DD, YYYY

<u>Financial assets</u>	<u>(i)</u>	<u>(ii)</u>	<u>(iii)</u>	<u>(iv) = (i) + (ii) + (iii)</u>	<u>(v) = (iii)</u>
	<u>IPSAS 29 carrying amount 31 December 2017 (1)</u>	<u>Reclassifications</u>	<u>Remeasurements</u>	<u>[draft] IPSAS [X] (ED 62) carrying amount 1 January 2018</u>	<u>Accumulated surplus or deficit effect on 1 January 2018 (2), (3)</u>
<u>Total financial asset balances, reclassifications and remeasurements at 1 January 2018</u>	<u>(i)</u>	<u>Total (ii) = 0</u>	<u>(iii)</u>	<u>(iv) = (i) + (ii) + (iii)</u>	

- 1 Includes the effect of reclassifying hybrid instruments that were bifurcated under IPSAS 29 with host contract components of (a), which had associated embedded derivatives with a fair value of X at MM DD, YYYY, and (b), which had associated embedded derivatives with a fair value of Y at MM DD, YYYY.
- 2 Includes (c), (d), (e) and (f), which are amounts reclassified from net assets/equity to accumulated surplus or deficit at the date of initial application.
- 3 Includes (g), (h), (i), (j), (k) and (l), which are amounts reclassified from accumulated surplus or deficit to net assets/equity at the date of initial application.

...

Amendments to IPSAS 32, *Service Concession Arrangements*

Paragraphs 20, 29, AG37, AG45, AG52 and AG53 are amended and paragraph 36C is added. New text is underlined and deleted text is struck through.

...

Financial Liability Model

...

20. IPSAS 28, *Financial Instruments: Presentation*, ~~the derecognition requirements in IPSAS 29, *Financial Instruments: Recognition and Measurement*, and IPSAS 30, *Financial Instruments: Disclosures*~~ and the derecognition requirements in [draft] IPSAS [X] (ED 62), *Financial Instruments* apply to the financial liability recognized under paragraph 14, except where this Standard provides requirements and guidance.

...

Other Liabilities, Commitments, Contingent Liabilities and Contingent Assets

...

29. **The grantor shall account for other liabilities, commitments, contingent liabilities, and contingent assets arising from a service concession arrangement in accordance with**

IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, IPSAS 28, ~~IPSAS 29~~, and IPSAS 30, and [draft] IPSAS [X] (ED 62).

...

Effective Date

...

36C. Paragraphs 20, 29, AG37, AG45, AG52 and AG53 were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Application Guidance

This Appendix is an integral part of IPSAS 32.

...

Recognition and Measurement of Liabilities

...

AG37. When the grantor has an unconditional obligation to make a predetermined series of payments to the operator, the liability is a financial liability as defined in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~. The grantor has an unconditional obligation if it has little, if any, discretion to avoid the obligation usually because of the binding arrangement with the operator being enforceable by law.

...

AG45. The finance charge related to the liability in a service concession arrangement is presented consistently with other finance charges in accordance with IPSAS 28, ~~IPSAS 29~~, and IPSAS 30, and [draft] IPSAS [X] (ED 62).

...

AG52. Certain guarantees made by a grantor may meet the definition of a financial guarantee contract. The grantor determines whether guarantees made by the grantor as part of a service concession arrangement meet the definition of a financial guarantee contract and applies IPSAS 28, ~~IPSAS 29~~, and IPSAS 30, and [draft] IPSAS [X] (ED 62) in accounting for the guarantee. Where the guarantee is an insurance contract, the grantor can elect to apply the relevant international or national accounting standard dealing with insurance contracts. See IPSAS 28, paragraphs AG3–AG9 for further guidance.

AG53. Guarantees and commitments that do not meet the requirements in IPSAS 28 and [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ relating to financial guarantee contracts or are not insurance contracts are accounted for in accordance with IPSAS 19.

...

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 32.

...

The Financial Liability Model

...

BC26. Service concession arrangements are concluded by way of a binding arrangement, which may include contracts or similar arrangements that confer similar rights and obligations on the parties as if they were in the form of a contract. The IPSASB concluded that, if similar arrangements exist that confer the same rights and obligations on either party as if they were in the form of a contract, IPSAS 28, *Financial Instruments: Presentation*, ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~, and IPSAS 30, *Financial Instruments: Disclosures*, and [draft] IPSAS [X] (ED 62), *Financial Instruments* should be applied by analogy to such arrangements.

...

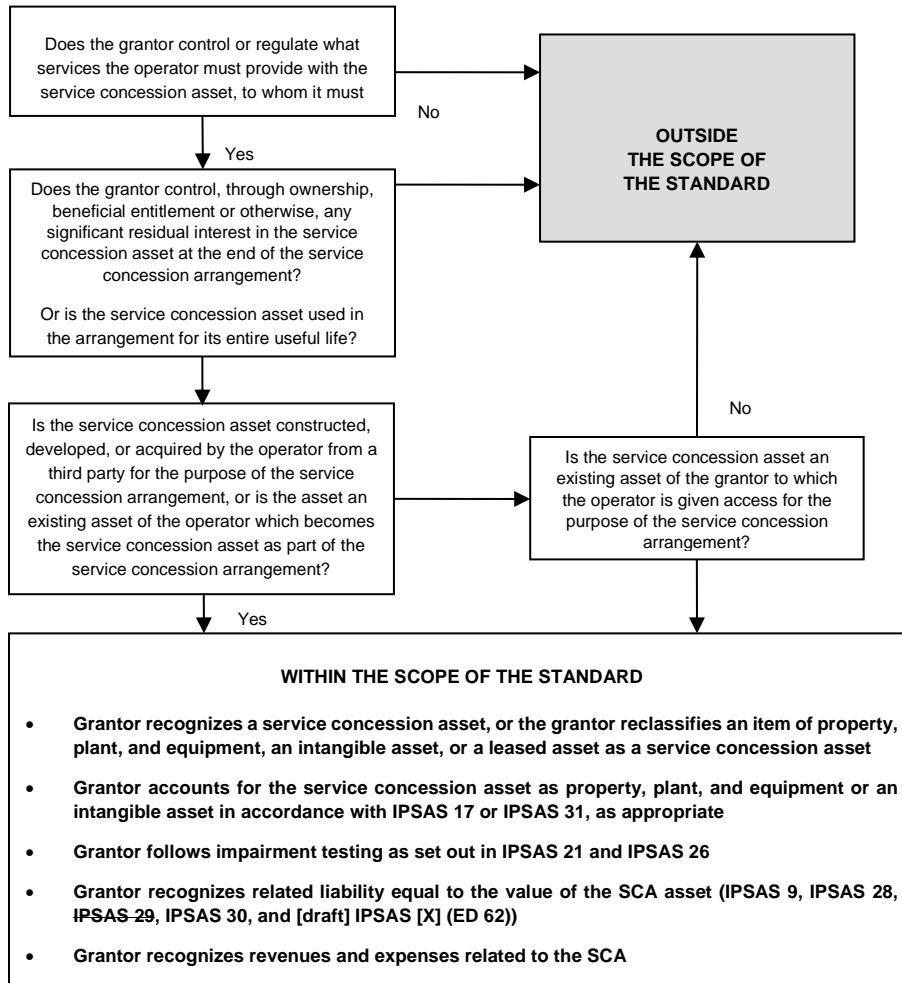
Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 32.

...

Accounting Framework for Service Concession Arrangements

IG2. The diagram below summarizes the accounting for service concession arrangements established by IPSAS 32.



...

Amendments to IPSAS 33, *First-Time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSAS)*

Paragraphs 36, 64, 72, 113, 114, 115, 116, 117, 118, 119, 120, 121, 122 and 124 are amended and paragraphs 114A, 119A, 119B, 119C, 119D, 122A, 122B, 122C, 122D, and 154A are added. New text is underlined and deleted text is struck through.

...

Recognition and/or Measurement of Assets and/or Liabilities

36. **Where a first-time adopter has not recognized assets and/or liabilities under its previous basis of accounting, it is not required to recognize and/or measure the following assets and/or liabilities for reporting periods beginning on a date within three years following the date of adoption of IPSASs:**

- Inventories (see IPSAS 12, *Inventories*);**
- Investment property (see IPSAS 16, *Investment Property*);**
- Property, plant and equipment (see IPSAS 17, *Property, Plant and Equipment*);**

- (d) **Defined benefit plans and other long-term employee benefits (see IPSAS 39, *Employee Benefits*);**
- (e) **Biological assets and agricultural produce (see IPSAS 27, *Agriculture*);**
- (f) **Intangible assets (see IPSAS 31, *Intangible Assets*);**
- (g) **Service concession assets and the related liabilities, either under the financial liability model or the grant of a right to the operator model (see IPSAS 32, *Service Concession Arrangements: Grantor*); and**
- (h) **Financial instruments (see [draft] IPSAS [X] (ED 62), *Financial Instruments* ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~).**

...

Using Deemed Cost to Measure Assets and/or Liabilities

64. **A first-time adopter may elect to measure the following assets and/or liabilities at their fair value when reliable cost information about the assets and liabilities is not available, and use that fair value as the deemed cost for:**

- (a) **Inventory (see IPSAS 12);**
- (b) **Investment property, if the first-time adopter elects to use the cost model in IPSAS 16;**
- (c) **Property, plant and equipment (see IPSAS 17);**
- (d) **Intangible assets, other than internally generated intangible assets (see IPSAS 31) that meets:**
 - (i) **The recognition criteria in IPSAS 31 (excluding the reliable measurement criterion); and**
 - (ii) **The criteria in IPSAS 31 for revaluation (including the existence of an active market);**
- (e) **Financial Instruments (see [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~); or**
- (f) **Service concession assets (see IPSAS 32).**

...

Using Deemed Cost for Investments in Controlled Entities, Joint Ventures and Associates (IPSAS 34)

72. **Where a first-time adopter measures an investment in a controlled entity, joint venture or associate at cost in its separate financial statements, it may, on the date of adoption of IPSASs, elect to measure that investment at one of the following amounts in its separate opening statement of financial position:**

- (a) **Cost; or**
- (b) **Deemed cost. The deemed cost of such an investment shall be its fair value (determined in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~) at the first-time adopter's date of adoption of IPSASs in its separate financial statements.**

...

[draft] IPSAS [X] (ED 62), Financial Instruments ~~IPSAS 29, Financial Instruments: Recognition and Measurement~~

Designation of Financial Instruments on the Date of Adoption of IPSAS or During the Period of Transition

113. A first-time adopter may designate a financial asset or financial liability as a financial asset or financial liability at fair value through surplus or deficit that meet the criteria for designation in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, in accordance with paragraph 114. A first-time adopter shall disclose the fair value of financial assets and financial liabilities designated into each category at the date of designation, their classification and carrying amount.
114. [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ permits a financial asset to be designated on initial recognition as ~~available for sale~~ or a financial instrument (provide it meets certain criteria) to be designated as a financial asset or financial liability at fair value through surplus or deficit. Despite this requirement, exceptions apply in the following circumstances:
- (a) ~~A first-time adopter is permitted to make an available for sale designation at the date of adoption of IPSASs.~~
 - (b) A first-time adopter is permitted to designate, at the date of adoption of IPSASs, any financial asset or financial liability as at fair value through surplus or deficit provided the asset or liability meets the criteria in paragraph 44, 46(a) or 46(b) of [draft] IPSAS [X] (ED 62) ~~10(b)(i), 10(b)(ii) or 13 of IPSAS 29~~ at that date.
- 114A. An entity may designate an investment in an equity instrument as at fair value through net assets/equity in accordance with paragraph 103 of [draft] IPSAS [X] (ED 62) on the basis of the facts and circumstances that exist at the date of adoption of IPSASs.

Derecognition of Financial Assets and Financial Liabilities

115. Except as permitted by paragraph 116 a first-time adopter shall apply the derecognition requirements in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ prospectively for transactions occurring on or after the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemptions not to recognize financial instruments, the date on which the exemptions that provided the relief have expired and/or the financial instruments are recognized (whichever is earlier). For example, if a first-time adopter derecognized non-derivative financial assets or non-derivative financial liabilities in accordance with its previous basis of accounting as a result of a transaction that occurred before the date of adoption of IPSASs, it shall not recognize those assets and liabilities in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, unless they qualify for recognition as a result of a later transaction or event.
116. Notwithstanding the provision in paragraph 115, a first-time adopter may apply the derecognition requirements in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ retrospectively from a date of the first-time adopter choosing, provided that the information needed to apply [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ to financial assets and financial liabilities derecognized as a result of past transactions was obtained at the time of initially accounting for these transactions.

Hedge Accounting

117. As required by [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, a first-time adopter shall at the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial

instruments, the date when the exemption that provided the relief has expired and/or the relevant financial instruments are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier):

- (a) Measure all derivatives at fair value; and
 - (b) Eliminate all deferred losses and gains arising on derivatives that were reported in accordance with its previous basis of accounting as if they were assets or liabilities.
118. A first-time adopter shall not reflect in its opening statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29 (for example, many hedging relationships where the hedging instrument is a stand-alone cash instrument or written option; or where the hedged item is a net position). However, if a first-time adopter designated a net position as a hedged item in accordance with its previous basis of accounting, it may designate as a hedged item in accordance with IPSASs an individual item within that net position, or a net position if that meets the requirements in paragraph 143 of [draft] IPSAS [X] (ED 62) as a hedged item in accordance with IPSASs, provided that it does so no later than the date of adoption of IPSASs or where it takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial instruments, the date when the exemption that provided the relief has expired, and/or the relevant financial instruments are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).
119. If, before the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial instruments the date on which the exemption that provided the relief has expired, and/or the relevant financial instruments are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier), a first-time adopter had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in [draft] IPSAS [X] (ED 62) IPSAS-29, the first-time adopter shall apply paragraphs 132 and 133 of [draft] IPSAS [X] (ED 62) 402 and 412 of IPSAS-29 to discontinue hedge accounting. Transactions entered into before the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial instruments, the date when the transitional exemption expires and/or the relevant financial instruments are recognized and/or measured in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29 (whichever is earlier), shall not be retrospectively designated as hedges.

Classification and Measurement of Financial Instruments

- 119A. An entity shall assess whether a financial asset meets the conditions in paragraph 40 or the conditions in paragraph 41 of [draft] IPSAS [X] (ED 62) on the basis of the facts and circumstances that exist at the date of adoption of IPSASs.
- 119B. If it is impracticable to assess a modified time value of money element in accordance with paragraphs AG68-AG70 of [draft] IPSAS [X] (ED 62) on the basis of the facts and circumstances that exist at the date of transition to IPSASs, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of adoption of IPSASs without taking into account the requirements related to the modification of the time value of money element in paragraphs AG68-AG70 of [draft] IPSAS [X] (ED 62). (In this case, the entity shall

also apply paragraph 49J of IPSAS 30 but references to 'paragraph 157 of [draft] IPSAS [X] (ED 62)' shall be read to mean this paragraph and references to 'initial recognition of the financial asset' shall be read to mean 'at the date of adoption of IPSASs'.)

119C. If it is impracticable to assess whether the fair value of a prepayment feature is insignificant in accordance with paragraph AG74(c) of [draft] IPSAS [X] (ED 62) on the basis of the facts and circumstances that exist at the date of adoption of IPSASs, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of adoption of IPSASs without taking into account the exception for prepayment features in paragraph AG74 of [draft] IPSAS [X] (ED 62). (In this case, the entity shall also apply paragraph 49K of IPSAS 30 but references to 'paragraph 158 of [draft] IPSAS [X] (ED 62)' shall be read to mean this paragraph and references to 'initial recognition of the financial asset' shall be read to mean 'at the date of adoption of IPSASs'.)

119D. If it is impracticable (as defined in IPSAS 3) for an entity to apply retrospectively the effective interest method in [draft] IPSAS [X] (ED 62), the fair value of the financial asset or the financial liability at the date of adoption of IPSASs shall be the new gross carrying amount of that financial asset or the new amortized cost of that financial liability at the date of adoption of IPSASs.

Impairment of Financial Assets

120. A first-time adopter shall apply the impairment requirements prospectively from the date of adoption of IPSASs, except in relation to those financial assets where it takes advantage of the exemptions in paragraphs 36, 38 and 42 which allow a three-year transitional relief period to not recognize and/or measure financial instruments. When a first-time adopter adopts the three year transitional relief period provided, it applies the impairment provisions when exemption that provided the relief has expired, and/or the relevant financial instruments are recognized and/or measured in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29 (whichever is earlier).

...

122. A first-time adopter shall apply the impairment requirements prospectively. This means that on the date of adoption of [draft] IPSAS [X] (ED 62) IPSAS-29, when the exemptions that provided the relief have expired, and/ or when the relevant financial instruments are recognized and/or measured, a first-time adopter shall be required to assess whether there is an indication that the financial instrument is impaired. Any impairment loss shall be recognized in opening accumulated surplus or deficit on the date of adoption of IPSASs, or in the opening accumulated surplus or deficit of the reporting period in which the exemptions that provided the relief have expired, and/or the relevant financial instruments are recognized and/or measured (whichever is earlier).

122A. At the date of adoption of [draft] IPSAS [X] (ED 62), when the exemptions that provided the relief have expired, and/ or when the relevant financial instruments are recognized and/or measured, a first-time adopter shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that financial instruments were initially recognized (or for loan commitments and financial guarantee contracts the date that the entity became a party to the irrevocable commitment in accordance with paragraph 76 of [draft] IPSAS [X] (ED 62)) and compare that to the credit risk at the date of adoption of IPSASs (also see paragraphs AG347-AG348 of [draft] IPSAS [X] (ED 62)).

122B. When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:

- (a) The requirements in paragraph 80 and AG176–AG179 of [draft] IPSAS [X] (ED 62); and
- (b) The rebuttable presumption in paragraph 81 of [draft] IPSAS [X] (ED 62) for contractual payments that are more than 30 days past due if an entity will apply the impairment requirements by identifying significant increases in credit risk since initial recognition for those financial instruments on the basis of past due information.

122C. If, at the date of adoption of IPSASs, determining whether there has been a significant increase in credit risk since the initial recognition of a financial instrument would require undue cost or effort, an entity shall recognize a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognized (unless that financial instrument is low credit risk at a reporting date, in which case paragraph 122B(a) applies).

Embedded Derivatives

122E. A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph AG109 of [draft] IPSAS [X] (ED 62).

IPSAS 30, Financial Instruments: Disclosures

...

124. A first-time adopter shall apply the requirements in IPSAS 30 prospectively from the date of adoption of IPSASs, or when the exemptions that provided the relief have expired, and/or when the relevant financial instrument is recognized and/or measured in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ (whichever is earlier).

...

Effective Date

...

154A. Paragraphs 36, 64, 72, 113, 114, 115, 116, 117, 118, 119, 120, 121, 122 and 124 were amended and paragraphs 114A, 119A, 119B, 119C, 119D, 122A, 122B, 122C, and 122D were added by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 33.

...

[draft] IPSAS [X] (ED 62), Financial Instruments ~~IPSAS 29, Financial Instruments: Recognition and Measurement~~

BC61. The existing transitional provisions in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ do not provide any relief to a first-time adopter for the recognition and/or measurement of financial instruments. Because many public sector entities will need some time to identify and appropriately classify their financial instruments, the IPSASB agreed that a transitional relief period should be provided to a first-time adopter for the recognition and/or measurement of financial instruments. A transitional relief period of three years was granted in line with the relief period provided for the recognition and/or measurement of other items.

...

BC63. As with non-monetary assets, the IPSASB agreed that the same principle should be applied to the recognition and/or measurement of monetary assets and/or liabilities, i.e. to the extent that a first-time adopter has recognized financial instruments under its previous basis of accounting, the IPSASB agreed that a three-year relief period should be granted for the measurement and classification of financial instruments following the date of adoption of IPSASs. During this transitional period, a first-time adopter will be able to develop reliable models for applying the principles in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~. It would also be allowed to apply accounting policies for the measurement of financial instruments that differs from the requirements in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ during the period of transition.

...

Deemed Cost for Investments in Controlled Entities, Joint Ventures or Associates

BC85. The IPSASB also agreed that a first-time adopter may elect to measure an investment in a controlled entity, joint venture or associate at cost in its separate financial statements on the date of adoption of IPSASs at either cost as determined in accordance with IPSAS 6, or deemed cost. Deemed cost is determined as fair value in accordance with [draft] IPSAS [X] (ED 62), *Financial Instruments* ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~.

...

[draft] IPSAS [X] (ED 62), Financial Instruments ~~IPSAS 29, Financial Instruments: Recognition and Measurement~~

BC111. The IPSASB concluded that, as it is in most instances impracticable to apply impairment principles retrospectively, the impairment of financial instruments should be applied prospectively.

This exemption is consistent with the exemption provided for non-cash-generating assets and cash-generating assets in accordance with IPSAS 21 and 26.

...

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 33.

...

[draft] IPSAS [X] (ED 62), Financial Instruments ~~IPSAS 29, Financial Instruments: Recognition and Measurement~~

Recognition

IG67. A first-time adopter recognizes all financial assets and financial liabilities (including all derivatives) that qualify for recognition in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ and have not yet qualified for derecognition in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, except non-derivative financial assets and non-derivative financial liabilities derecognized in accordance with its previous basis of accounting before the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), to which the first-time adopter does not choose to apply paragraph 116 of IPSAS 33 (see paragraphs 115 and 116 of IPSAS 33).

IG68. For example, a first-time adopter that does not apply paragraph 116 of IPSAS 33 does not recognize assets transferred in a securitization, transfer or other derecognition transaction that occurred before the date of adoption of IPSASs if those transactions qualified for derecognition in accordance with its previous basis of accounting. However, if the first-time adopter uses the same securitization arrangement or other derecognition arrangement for further transfers after the date of transition to IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), those further transfers qualify for derecognition only if they meet the derecognition criteria of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~.

Embedded Derivatives

IG69. When [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ requires a first-time adopter to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ reflect circumstances at that date ([draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ paragraph 49). If the first-time adopter cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it measures the entire combined contract as at fair value through surplus or deficit ([draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ paragraph 52).

Measurement

IG70. In preparing its opening statement of financial position, a first-time adopter applies the criteria in [draft] IPSAS [X] (ED 62) IPSAS 29 to identify those financial assets and financial liabilities that are measured at fair value and those that are measured at amortized ~~amortised~~ cost.

Adjusting the Carrying Amount of Financial Instruments on the Date of Adoption of Accrual Basis IPSASs or During the Period of Transition

IG71. A first-time adopter shall treat an adjustment to the carrying amount of a financial asset or financial liability as an adjustment to be recognized in the opening balance of accumulated surplus or deficit at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), only to the extent that it results from adopting [draft] IPSAS [X] (ED 62) IPSAS 29. Because all derivatives, other than those that are financial guarantee contracts or are designated and effective hedging instruments, are classified as held for trading, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives are recognized as an adjustment of the balance of accumulated surplus or deficit at the beginning of the financial year in which [draft] IPSAS [X] (ED 62) IPSAS 29 is initially applied, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier).

Hedge Accounting

...

IG74. A first-time adopter may, in accordance with its previous basis of accounting, have deferred gains and losses on a cash flow hedge of a forecast transaction. If, at the date of adoption of IPSAS, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), the hedged forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognized in net assets/equity. Any net cumulative gain or loss that has been reclassified to net assets/equity on initial application of [draft] IPSAS [X] (ED 62) IPSAS 29 or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier) remains in net assets/equity until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, (b) the forecast transaction affects surplus or deficit or (c) subsequently circumstances change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss is reclassified from net assets/equity to surplus or deficit. If the hedging instrument is still held, but the hedge does not qualify as a cash flow hedge in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29, hedge accounting is no longer appropriate starting from the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire

or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier).

...

Summary of Transitional Exemptions and Provisions Included in IPSAS 33 First-time Adoption of Accrual Basis IPSASs

IG91. The diagram below summarizes the transitional exemptions and provisions included in other accrual basis IPSASs

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 1, <i>Presentation of Financial Statements</i>						√ To extent that 3 year relief period was adopted		<ul style="list-style-type: none"> Presenting comparative info encouraged
IPSAS 2, <i>Cash Flow Statements</i>	√							
IPSAS 3, <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>	√							
IPSAS 4, <i>The Effects of Changes in Foreign Exchange Rates</i>								<ul style="list-style-type: none"> Exemption to comply with requirements for cumulative translation
IPSAS 5, <i>Borrowing Costs</i>			√ When allowed alternative is elected as accounting policy					<ul style="list-style-type: none"> Encouraged to apply benchmark treatment retrospectively Allowed alternative must be applied retrospectively

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 6, <i>Consolidated and Separate Financial Statements</i> (IPSAS 35 <i>Consolidated Financial Statements</i>)		√			√ To appropriately classify and identify interests in other entities		√	<ul style="list-style-type: none"> Provisions when controlling and/or controlled entity adopts IPSAS at different time Exemption to not prepare financial statements as consolidated financial statements (Assess if investment entity on date of adoption and measure at fair value at that date)
IPSAS 7, <i>Investments in Associates</i> (IPSAS 36 <i>Investments in Associates and Joint Ventures</i>)		√			√ To appropriately classify and identify interests in other entities		√	<ul style="list-style-type: none"> Provisions when controlling entity and associate adopts IPSAS at different time Exemption to not include investment in associate in consolidated financial statements

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 8, <i>Interests in Joint Venture</i> (IPSAS 36 <i>Investments in Associates and Joint Ventures</i>)		√			√ To appropriately classify and identify interests in other entities		√	<ul style="list-style-type: none"> Provisions when controlling entity and associate and jointly controlled entities adopt IPSAS at different time Exemption to not include interests in joint venture in consolidated financial statements
(IPSAS 37 <i>Joint Arrangements</i>)								<ul style="list-style-type: none"> Provision on how to measure investment in joint venture previously accounted for using proportionate consolidation

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 9, <i>Revenue from Exchange Transactions</i>	√				√ To extent that 3 year relief period was adopted for assets and/or liabilities			
IPSAS 10, <i>Financial Reporting In Hyperinflationary Economies</i>								• Provisions around severe hyperinflation
IPSAS 11, <i>Construction Contracts</i>	√							
IPSAS 12, <i>Inventories</i>		√	√ Inventory not recognized under previous basis of accounting	√ Inventory recognized under previous basis of accounting				
IPSAS 13, <i>Leases</i>			√ Leased assets and/or liabilities not recognized under previous basis of accounting	√ Leased assets and/or liabilities recognized under previous basis of				

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 14, <i>Events After the Reporting Date</i>	√							
IPSAS, 16 <i>Investment Property</i>		√	√ Investment property not recognized under previous basis of accounting	√ Investment property recognized under previous basis of accounting				

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS 17, <i>Property, Plant and Equipment</i>		√	√ Property, plant and equipment not recognized under previous basis of accounting	√ Property, plant and equipment recognized under previous basis of accounting				
IPSAS 18, <i>Segment Reporting</i>	√ No segmen t report to the extent that 3 year relief period was adopted							

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 19, <i>Provisions, Contingent Liabilities and Contingent Assets</i>			√ Only liabilities related to assets not recognized under previous basis of accounting to be included initial estimate of cost of dismantling/ removing item/ restoring site	√ Only liabilities related to assets recognized under previous basis of accounting to be included initial estimate of cost of dismantling/ removing item/ restoring site				

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS 20, <i>Related Party Disclosures</i>						√		
IPSAS 21, <i>Impairment of Non-Cash-Generating Assets</i>								<ul style="list-style-type: none"> Prospective application
IPSAS 22, <i>Disclosure of Information About the General Government Sector</i>	√							
IPSAS 23, <i>Revenue from Non-Exchange Transactions</i>			√ All non-exchange revenue not recognized under previous basis of accounting	√ All non-exchange revenue recognized under previous basis of accounting	√ To extent that 3 year relief period was adopted for assets and/or liabilities			

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 24, <i>Presentation of Budget Information in Financial Statements</i>	√							

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS 25, <i>Employee Benefits</i> <u>(IPSAS 39, <i>Employee Benefits</i>)</u>			√ defined benefit plans and other long-term employee benefits not recognized under previous basis of accounting	√ for defined benefit and other long- term employee benefits recognized under previous basis of accounting				<ul style="list-style-type: none"> • Provisions on how to determine initial liability • Provision to not separate cumulative actuarial gains and losses • Prospective disclosure on experience adjustments
IPSAS 26, <i>Impairment of Cash-Generating Assets</i>			√					<ul style="list-style-type: none"> • Prospective application
IPSAS 27, <i>Agriculture</i>			√ Biological and agricultural activities not recognized under previous basis of accounting	√ Biological and agricultural activities recognized under previous basis of accounting				

IPSAS	Transitional exemption provided	
	NO	YES

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 28, <i>Financial Instruments: Presentation</i>								<ul style="list-style-type: none"> Provisions not to separate liability and net asset/equity component under specific circumstances
[draft] IPSAS [X] (ED 62), <i>Financial Instruments</i> IPSAS 29, <i>Financial Instruments: Recognition and Measurement</i>		√	√ For financial instruments not recognized under previous basis of accounting	√ For financial instruments recognized under previous basis of accounting				<ul style="list-style-type: none"> Provisions around designation/derecognition/hedge accounting Apply impairment principles prospectively
IPSAS 30, <i>Financial Instruments: Disclosure</i>								<ul style="list-style-type: none"> No comparative info about nature and extent of risks

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

IPSAS 31, <i>Intangible Assets</i>		√ Intangible assets other than internally generated I/A	√ Intangible assets not recognized under previous basis of accounting	√ Intangible assets recognized under previous basis of accounting				<ul style="list-style-type: none"> Provision to recognize previously expensed internally generated intangible assets
IPSAS 32, <i>Service Concession Arrangements: Grantor</i>		√ Service concession asset	√ Service concession asset and related liability not recognized under previous basis of accounting	√ Service concession asset and related liability recognized under previous basis of accounting				<ul style="list-style-type: none"> Provision on how to recognize related liability

...

Appendix

Differentiation between transitional exemptions and provisions that a first-time adopter is required to apply and/or can elect to apply on adoption of accrual basis IPSASs

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 1 <ul style="list-style-type: none"> Present comparative information 		√	
IPSAS 4 <ul style="list-style-type: none"> Cumulative transitional differences at the date of adoption 		√	
IPSAS 5 <ul style="list-style-type: none"> Allowed alternative treatment and has taken advantage of relief period Adopt allowed alternative treatment on date of adoption – retrospective application Adopt bench mark treatment on the date of adoption – retrospective application of costs incurred before and after date of adoption 	√	√	√
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 6 (<i>IPSAS 35</i>) <ul style="list-style-type: none"> Relief to recognize and/or measure interests in controlled entity 			√ √

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
<ul style="list-style-type: none"> Elect to not eliminate inter-entity balances, transactions, revenue and expenses Controlled entity becomes first-time adopter later or earlier than its controlling entity Not present financial statements as consolidated financial statements if three year relief for recognition and/or measurement and/or elimination option was adopted <i>Assess if investment entity on date of adoption and determine fair value at that date)</i> 	<div>√</div> <div>√</div>		<div>√</div>
<p>IPSAS 7 (IPSAS 36)</p> <ul style="list-style-type: none"> Relief to recognize and/or measure interest in associate Elect to not eliminate share in associate's surplus and deficit Associate becomes first-time adopter later or earlier than its controlling entity Not present investment in associates in consolidated financial statements if three year relief for recognition and/or measurement and/or elimination option was adopted 	<div>√</div>		<div>√</div> <div>√</div> <div>√</div>
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 8 (IPSAS 36)</p> <ul style="list-style-type: none"> Relief to recognize and/or measure interest in joint venture 			<div>√</div>

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
<ul style="list-style-type: none"> Elect to not eliminate balances and transactions with jointly controlled entities Joint venture becomes first-time adopter later or earlier than its controlling entity Not present interest in joint venture in consolidated financial statements if three year relief for recognition and/or measurement and/or elimination option was adopted 	√		√
<i>IPSAS 37</i> <ul style="list-style-type: none"> <i>Measure investment in joint venture previously accounted for using proportionate consolidation</i> 	√		
<i>IPSAS 9</i> <ul style="list-style-type: none"> Relief for recognition and/or measurement of revenue related to adoption of three year relief period for recognition and/or measurement of financial instruments 			√
<i>IPSAS 10</i> <ul style="list-style-type: none"> Determine if hyperinflationary economy is subject to severe hyperinflation at the date of adoption 	√		
<ul style="list-style-type: none"> Measure assets and liabilities if date of adoption is on or after normalization date 	√		
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
IPSAS 12 <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets 			√
IPSAS 13 <ul style="list-style-type: none"> No recognition and/or measurement of finance lease liability and finance lease asset if relief period for recognition and/or measurement of assets is adopted Classification of lease based on circumstances at adoption of accrual basis IPSAS 	√		√
IPSAS 16 <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets 			√
IPSAS 17 <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets 			√
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 18		√	

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
<ul style="list-style-type: none"> No preparation of segment report within three years of adoption 			
IPSAS 19 <ul style="list-style-type: none"> No recognition and measurement of liability relating to initial estimate of costs of dismantling and removing item if relief for recognition and/or measurement of assets are adopted 			√
IPSAS 20 <ul style="list-style-type: none"> No disclosure of related party relationships, related party transactions and information about key management personnel 			√
IPSAS 21 <ul style="list-style-type: none"> Apply impairment provisions prospectively on date of adoption or when assets are recognized when relief period was applied 	√		
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 25 (IPSAS 39) <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and/or liabilities and changing the accounting policy to measure assets and/or liabilities 	√		√

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
<ul style="list-style-type: none"> Determine initial liability for defined benefit and other long-term employee benefit plans on date of adoption or when relief period expired Recognize increase/decrease on date of adoption or when relief period expires in opening accumulated surplus/deficit 	√		
IPSAS 26 <ul style="list-style-type: none"> Apply impairment provisions prospectively on date of adoption or when assets are recognized when relief period was applied 	√		
IPSAS 27 <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets 			√
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 28 <ul style="list-style-type: none"> Determine if financial instrument has liability and net asset/equity component on date of adoption Do not separate compound financial instrument if no liability exists on date of adoption 	√ √		
IPSAS 29			

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
<ul style="list-style-type: none"> Three-year relief for recognition and/or measurement of assets and/or liabilities and changing the accounting policy to measure assets and/or liabilities <i>Designation</i> <ul style="list-style-type: none"> Designate financial asset or liability at fair value through surplus or deficit on date of adoption <i>Impairment</i> <ul style="list-style-type: none"> Apply impairment provisions prospectively on date of adoption 	<div>√</div> <div>√</div>		<div>√</div>
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>[draft] IPSAS [X] (ED 62) IPSAS 29</p> <i>Derecognition</i> <ul style="list-style-type: none"> Apply derecognition provisions prospectively on date of adoption Apply derecognition provisions retrospectively if information is available as at the date of initial accounting 	<div>√</div>	<div>√</div>	
<i>Hedge accounting</i> <ul style="list-style-type: none"> Measure derivatives at fair value Eliminate all deferred losses and gains 	<div>√</div> <div>√</div>		

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
<ul style="list-style-type: none"> Only reflect hedges that qualify for hedge accounting on date of adoption Discontinue hedge transaction if conditions of hedge accounting on date of adoption are not met 	<p>√</p> <p>√</p>		
<p>IPSAS 30</p> <ul style="list-style-type: none"> No disclosure of information about nature and extent of risks 		<p>√</p>	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 31</p> <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets Recognize all internally generated intangible assets 	<p>√</p>		<p>√</p>
<p>IPSAS 32</p> <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and/or liabilities and changing the accounting policy to measure assets and/or liabilities Measure liability either under financial liability model or grant of a right to the operator model on date of adoption or when asset is recognized if relief period is adopted. 	<p>√</p>		<p>√</p>

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
Applying deemed cost to assets and/or liabilities		√	
Applying deemed cost to assets acquired in a non-exchange transaction		√	
Using deemed cost for investments in controlled entities, jointly controlled entities and associates		√	
Preparing reconciliations during transitional period	√		

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IPSAS 34, Separate Financial Statements

Paragraphs 6, 12, 13, 14, 15, 22, 26 and 30 are amended and paragraph 32A is added. New text is underlined and deleted text is struck through.

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Definitions

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6. The following terms are used in this Standard with the meanings specified:

Consolidated financial statements are the financial statements of an economic entity in which the assets, liabilities, net assets/equity, revenue, expenses and cash flows of the controlling entity and its controlled entities are presented as those of a single economic entity.

Separate financial statements are those presented by an entity, in which the entity could elect, subject to the requirements in this Standard, to account for its investments in controlled entities, joint ventures and associates either at cost, in accordance with [draft] IPSAS [X] (ED 62), Financial Instruments ~~IPSAS 29, Financial Instruments: Recognition and Measurement~~ or using the equity method as described in IPSAS 36, *Investments in Associates and Joint Ventures*.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately. The following terms are defined in IPSAS 35, *Consolidated Financial Statements*, IPSAS 36, *Investments in Associates and Joint Ventures* or IPSAS 37, *Joint Arrangements*: associate, control, controlled entity, controlling entity, economic entity, equity method, investment entity, joint control, joint operation, joint venture, joint venturer and significant influence.

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Preparation of Separate Financial Statements

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12. When an entity prepares separate financial statements, it shall account for similar investments in controlled entities, joint ventures and associates either:
- (a) At cost;
 - (b) In accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~; or
 - (c) Using the equity method as described in IPSAS 36.
13. If an entity elects, in accordance with paragraph 24 of IPSAS 36, to measure its investments in associates or joint ventures at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, it shall also account for those investments in the same way in its separate financial statements.
14. If a controlling entity is required, in accordance with paragraph 56 of IPSAS 35, to measure its investment in a controlled entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, it shall also account for that investment in the same way in its separate financial statements. If a controlling entity that is not itself an investment entity

is required, in accordance with paragraph 58 of IPSAS 35, to measure the investments of a controlled investment entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29 and consolidate the other assets and liabilities and revenue and expenses of the controlled investment entity, it shall also account for that investment in the controlled investment entity in the same way in its separate financial statements.

15. When a controlling entity ceases to be an investment entity, or becomes an investment entity, it shall account for the change from the date when the change in status occurred, as follows:
 - (a) When an entity ceases to be an investment entity, the entity shall account for an investment in a controlled entity in accordance with paragraph 12. The date of the change of status shall be the deemed acquisition date. The fair value of the controlled entity at the deemed acquisition date shall represent the transferred deemed consideration when accounting for the investment in accordance with paragraph 12.
 - (b) When an entity becomes an investment entity, it shall account for an investment in a controlled entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29. The difference between the previous carrying amount of the controlled entity and its fair value at the date of the change of status of the investor shall be recognized as a gain or loss in surplus or deficit. The cumulative amount of any gain or loss previously recognized directly in net assets/equity in respect of those controlled entities shall be treated as if the investment entity had disposed of those controlled entities at the date of change in status.

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Disclosure

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22. If a controlling entity that is not itself an investment entity is required, in accordance with paragraph 56 of IPSAS 35, to measure the investments of a controlled investment entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29 and consolidate the other assets and liabilities and revenue and expenses of the controlled investment entity, it shall disclose that fact. The entity shall also present the disclosures relating to investment entities required by IPSAS 38, *Disclosure of Interests in Other Entities*.

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Transitional Provisions

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26. At the date of initial application, an investment entity shall not make adjustments to the previous accounting for an interest in a controlled entity that it had previously elected to measure at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29, as permitted in paragraph 12.
- ...
30. At the date of initial application, a controlling entity that is not itself an investment entity but which is required, in accordance with paragraph 56 of IPSAS 35, to measure the investments of a controlled investment entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29 and consolidate the other assets and liabilities and revenue

and expenses of the controlled investment entity, shall use the transitional provisions in paragraphs 24–29 in accounting for its investment in the controlled investment entity in its separate financial statements.

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Effective Date

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32A. Paragraphs 6, 12, 13, 14, 15, 22, 26 and 30 were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendment for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 34.

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Use of the Equity Method in Separate Statements

BC3. IPSAS 6 permitted an entity, in its separate financial statements, to measure investments in controlled entities, jointly controlled entities and associates:

- (a) Using the equity method;
- (b) At cost; or
- (c) As a financial instrument in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29.

...

BC6. The IPSASB decided to continue to permit the use of the equity method in separate financial statements for the following reasons:

- (a) The equity method is a well-established method of accounting for certain investments in the public sector. In many circumstances where investments are held by public sector entities, the equity method can provide information that is reliable and useful, and possibly at a lower cost than either the cost method or the fair value method. In the public sector, investment entities are often used more as “instruments” to enable service provision, rather than as a holding for investment purposes, as might generally be the case in the private sector. The equity method may therefore, in some circumstances, be better suited to meeting user needs in the public sector, as it allows the financial statements to portray the fluctuations in the equity of, and performance by, an investment over time, in a cost effective and easily understood manner.
- (b) Although application of the cost method is often relatively straightforward, where investments have been held for some time, using the cost method may result in outdated and less relevant information, in which case, it would not meet user needs.

- (c) In the public sector there is likely to be a higher proportion of investments for which there are no active markets and in respect of which fair values are not readily observable. Although the guidance in [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ can be used to derive a value for such investments, the IPSASB considered that this approach would generally result in information that did not faithfully represent the underlying circumstances.

...

Separate Financial Statements of Investment Entities

BC8. In developing IPSAS 35 the IPSASB decided to introduce the concept of investment entities and to require that a controlling entity that is an investment entity measure its investments in most controlled entities at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~. Consequently, the IPSASB decided to require that an investment entity measure its investments in controlled entities at fair value through surplus or deficit in its separate financial statements. The IPSASB also decided that an investment entity preparing separate financial statements as its only financial statements, should also make the disclosures required in IPSAS 38 about its interests in controlled entities.

BC9. The IPSASB also decided to require a controlling entity of an investment entity that is not itself an investment entity to present consolidated financial statements in which it (i) measures the investments of a controlled investment entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity. Consequently, the IPSASB decided to require that a non-investment controlling entity should measure its investment in a controlled investment entity in the same way in its separate financial statements.

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IPSAS 35, Consolidated Financial Statements

Paragraphs 22, 45, 52, 55A, 56 and 58 are amended and paragraph 79D is added. New text is underlined and deleted text is struck through.

...

Control

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22. Two or more entities collectively control another entity when they must act together to direct the relevant activities. In such cases, because no single entity can direct the activities without the co-operation of the others, no single entity controls the other entity. Each entity would account for its interest in the other entity in accordance with the relevant IPSASs, such as IPSAS 36, IPSAS 37, or the IPSASs dealing with financial instruments (IPSAS 28, *Financial Instruments: Presentation*, ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~, and IPSAS 30, *Financial Instruments: Disclosures*, and [draft] IPSAS [X] (ED 62), *Financial Instruments*).

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Potential Voting Rights

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45. IPSAS 28 and [draft] IPSAS [X] (ED 62) IPSAS-29 do not apply to interests in controlled entities that are consolidated. When instruments containing potential voting rights in substance currently give access to the benefits associated with an ownership interest in a controlled entity, the instruments are not subject to the requirements of IPSAS 28 and [draft] IPSAS [X] (ED 62) IPSAS-29. In all other cases, instruments containing potential voting rights in a controlled entity are accounted for in accordance with IPSAS 28 and [draft] IPSAS [X] (ED 62) IPSAS-29.

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Loss of Control

52. **If a controlling entity loses control of a controlled entity, the controlling entity:**
- (a) **Derecognizes the assets and liabilities of the former controlled entity from the consolidated statement of financial position;**
 - (b) **Recognizes any investment retained in the former controlled entity and subsequently accounts for it and for any amounts owed by or to the former controlled entity in accordance with relevant IPSASs. That retained interest is remeasured, as described in paragraphs 54(b)(iii) and 55A. The remeasured value at the date that control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29 or the cost on initial recognition of an investment in an associate or joint venture, if applicable; and**
 - (c) **Recognizes the gain or loss associated with the loss of control attributable to the former controlling interest, as specified in paragraphs 54–55A.**

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- 55A. **If a controlling entity loses control of a controlled entity that does not contain an operation, as defined in IPSAS 40, as a result of a transaction involving an associate or a joint venture that is accounted for using the equity method, the controlling entity determines the gain or loss in accordance with paragraphs 54–55. The gain or loss resulting from the transaction is recognized in the controlling entity's surplus or deficit only to the extent of the unrelated investors' interests in that associate or joint venture. The remaining part of the gain is eliminated against the carrying amount of the investment in that associate or joint venture. In addition, if the controlling entity retains an investment in the former controlled entity and the former controlled entity is now an associate or a joint venture that is accounted for using the equity method, the controlling entity recognizes the part of the gain or loss resulting from the remeasurement at fair value of the investment retained in that former controlled entity in its surplus or deficit only to the extent of the unrelated investors' interests in the new associate or joint venture. The remaining part of that gain is eliminated against the carrying amount of the investment retained in the former controlled entity. If the controlling entity retains an investment in the former controlled entity that is now accounted for in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29, the part of the gain or loss resulting from the remeasurement at fair value of the investment retained in the former controlled entity is recognized in full in the controlling entity's surplus or deficit.**

Investment Entities: Fair Value Requirement

56. **Except as described in paragraph 57, an investment entity shall not consolidate its controlled entities or apply IPSAS 40 when it obtains control of another entity. Instead, an investment**

entity shall measure an investment in a controlled entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29.

...

58. A controlling entity of an investment entity that is not itself an investment entity shall present consolidated financial statements in which it (i) measures the investments of a controlled investment entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29 and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity in accordance with paragraphs 38–55 of this Standard.

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Effective Date

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79D. Paragraphs 22, 45, 52, 55A, 56 and 58 were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

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Application Guidance

This Appendix is an integral part of IPSAS 35.

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Fair Value Measurement

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AG105. In order to meet the requirement in AG104(a), an investment entity would:

- (a) Elect to account for any investment property using the fair value model in IPSAS 16, Investment Property;
- (b) Elect the exemption from applying the equity method in IPSAS 36 for its investments in associates and joint ventures; an
- (c) Measure its financial assets at fair value using the requirements in [draft] IPSAS [X] (ED 62) IPSAS 29.

...

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 35.

...

Investment Entities

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BC29. The IPSASB considered what type of information users would find most useful about a controlled investment entity. The IPSASB considered that users would find it most useful if the accounting for investments applied in a controlled investment entity's financial statements were extended to its controlling entity's financial statements. The IPSASB therefore proposed that a controlling entity with a controlled investment entity should be required to present consolidated financial statements in which it (i) measures the investments of the controlled investment entity at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS-29~~ and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity in accordance with the usual consolidation accounting policies required by the Standard. The IPSASB considered that its proposals reflect the fact that a controlling entity does not manage an investment entity itself on a fair value basis. Rather, it manages the investments of the investment entity on a fair value basis. This approach is also consistent with the accounting by an investment entity for its investments in other entities.

...

Amendments to IPSAS 36, *Investments in Associates and Joint Ventures*

Paragraphs 20, 24, 25, 26, 43, 44 and 45 are amended and paragraphs 44A, 44B, 44C and 51D are added. New text is underlined and deleted text is struck through.

...

Equity Method

...

20. ~~[Draft] IPSAS [X] (ED 62), *Financial Instruments*~~ ~~IPSAS-29, *Financial Instruments: Recognition and Measurement*~~ does not apply to interests in associates and joint ventures that are accounted for using the equity method. When instruments containing potential voting rights in substance currently give access to the benefits associated with an ownership interest in an associate or a joint venture, the instruments are not subject to [draft] IPSAS [X] (ED 62) ~~IPSAS-29~~. In all other cases, instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS-29~~.

...

Application of the Equity Method

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24. When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS-29~~. An investment entity will, by definition, have made this election.

25. When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29 regardless of whether the venture capital organization, or the mutual fund, unit trust and similar entities including investment-linked insurance funds, has significant influence over that portion of the investment. If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds. When an entity has an investment in an associate, a portion of which is held indirectly through an investment entity, the entity shall measure that portion of the investment at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29.

Discontinuing the Use of the Equity Method

26. **An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture as follows:**
- (a) **If the investment becomes a controlled entity, the entity shall account for its investment in accordance with the relevant national or international pronouncement dealing with public sector combinations and IPSAS 35.**
 - (b) **If the retained interest in the former associate or joint venture is a financial asset, the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with [draft] IPSAS [X] (ED 62) IPSAS-29. ~~If an entity is precluded by IPSAS 29, paragraphs AG113 and AG114 from measuring the retained interest at fair value, the entity shall measure the retained interest at the carrying amount of the investment at the date that it ceases to be an associate or joint venture and that carrying amount shall be regarded as its cost on initial recognition as a financial asset in accordance with IPSAS 29.~~ The entity shall recognize in surplus or deficit any difference between:**
 - (i) **The fair value (or, where relevant, the carrying amount) of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and**
 - (ii) **The carrying amount of the investment at the date the equity method was discontinued.**
 - (c) **When an entity discontinues the use of the equity method, the entity shall account for all amounts previously recognized directly in the entity's net assets/equity in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.**

...

Impairment Losses

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43. After application of the equity method, including recognizing the associate's or joint venture's deficits in accordance with paragraph 41, the entity applies ~~[draft] IPSAS [X] (ED 62) IPSAS 29~~ to determine whether ~~there it is necessary to recognize any objective evidence that additional impairment loss with respect to its net investment in the associate or joint venture is impaired.~~
44. The entity ~~also applies IPSAS 29 to determine whether any additional impairment loss is recognized with respect to the impairment requirements in [draft] IPSAS [X] (ED 62) to its other interests interest~~ in the associate or joint venture that are in scope of [draft] IPSAS [X] (ED 62) and that do not constitute part of the net investment and the amount of that impairment loss.
- 44A. The net investment in an associate or joint venture is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the net investment (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows from the net investment that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognized. Objective evidence that the net investment is impaired includes observable data that comes to the attention of the entity about the following loss events:
- (a) Significant financial difficulty of the associate or joint venture;
 - (b) A breach of contract, such as a default or delinquency in payments by the associate or joint venture;
 - (c) The entity, for economic or legal reasons relating to its associate's or joint venture's financial difficulty, granting to the associate or joint venture a concession that the entity would not otherwise consider;
 - (d) It becoming probable that the associate or joint venture will enter bankruptcy or other financial reorganization; or
 - (e) The disappearance of an active market for the net investment because of financial difficulties of the associate or joint venture.
- 44B. The disappearance of an active market because the associate's or joint venture's equity or financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an associate's or joint venture's credit rating or a decline in the fair value of the associate or joint venture, is not of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.
- 44C. In addition to the types of events in paragraph 44A, objective evidence of impairment for the net investment in the equity instruments of the associate or joint venture includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the associate or joint venture operates, and indicates that the cost of the investment in the equity instrument may not be recovered. 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.
45. Whenever application of ~~paragraphs 44A-44C IPSAS 29~~ indicates that the investment in an associate or a joint venture may be impaired, an entity applies IPSAS 26, *Impairment of Cash-Generating Assets*, and possibly, IPSAS 21, *Impairment of Non-Cash-Generating Assets*.

...

Effective Date

...

51D. Paragraphs 20, 24, 25, 26, 43, 44 and 45 were amended and paragraphs 44A, 44B and 44C were added by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 36.

...

Investment Entities

BC11. Some respondents to ED 50 requested that the IPSASB clarify the application of the equity method by investment entities and by investors with investments in an associate or a joint venture that is an investment entity. Accordingly the IPSASB:

- (a) Clarified that an investment entity will, by definition, have elected to account for investments in associates and joint ventures at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~; and
- (b) Required that an entity with an interest in an investment entity associate or an investment entity joint venture, shall, when applying the equity method, retain the fair value measurement applied by that investment entity associate or investment entity joint venture to its interests in controlled entities.

...

Amendments to IPSAS 37, *Investments in Associates and Joint Ventures*

Paragraphs 28, 30, 41, AG11 and AG33A are amended and 42D is added. New text is underlined and deleted text is struck through.

...

Joint Ventures

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28. **A party that participates in, but does not have joint control of, a joint venture shall account for its interest in the arrangement in accordance with the IPSASs dealing with financial instruments, being IPSAS 28, *Financial Instruments: Presentation*, ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*, and IPSAS 30, *Financial Instruments:*~~**

Disclosures, and [draft] IPSAS [X] (ED 62), *Financial Instruments* unless it has significant influence over the joint venture, in which case it shall account for it in accordance with IPSAS 36.

...

Separate Financial Statements

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30. In its separate financial statements, a party that participates in, but does not have joint control of, a joint arrangement shall account for its interest in:
- (a) A joint operation in accordance with paragraph 26; and
 - (b) A joint venture in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~, unless the entity has significant influence over the joint venture, in which case it shall apply paragraph 12 of IPSAS 34.

...

Transitional Provisions in an Entity's Separate Financial Statement

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41. An entity that, in accordance with paragraph 58 of IPSAS 6, *Consolidated and Separate Financial Statements*, was previously accounting in its separate financial statements for its interest in a joint operation as an investment using the equity method, at cost or in accordance with [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ shall:
- (a) Derecognize the investment and recognize the assets and the liabilities in respect of its interest in the joint operation at the amounts determined in accordance with paragraphs 37-39.
 - (b) Provide a reconciliation between the investment derecognized, and the assets and liabilities recognized, together with any remaining difference adjusted in accumulated surplus or deficit, at the beginning of the immediately preceding period.

...

Effective Date

...

- 42D. Paragraphs 28, 30, 41, AG11 and AG33A were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Application Guidance

This Appendix accompanies, but is not part of, IPSAS 37.

...

Joint Control (paragraphs 12–18)

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AG11. When an arrangement is outside the scope of IPSAS 37, *Joint Arrangements*, an entity accounts for its interest in the arrangement in accordance with relevant IPSASs, such as IPSAS 35, IPSAS 36, *Investments in Associates and Joint Ventures* or [draft] IPSAS [X] (ED 62), *Financial Instruments* ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~.

...

Assessing Other Facts and Circumstances

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AG33A. When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes an operation, as defined in IPSAS 40, it shall apply, to the extent of its share in accordance with paragraph 23, all of the principles on acquisition accounting in IPSAS 40, and other IPSASs, that do not conflict with the guidance in this Standard and disclose the information required by those IPSASs in relation to acquisitions. The principles on acquisition accounting that do not conflict with the guidance in this Standard include but are not limited to:

- (a) Measuring identifiable assets and liabilities at fair value, other than items for which exceptions are given in IPSAS 40 and other IPSASs;
- (b) Recognizing acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with the exception that the costs to issue debt or equity securities are recognized in accordance with IPSAS 28 and [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~;
- (c) Recognizing the excess of the consideration transferred over the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, if any, as goodwill; and
- (d) Testing for impairment a cash-generating unit to which goodwill has been allocated at least annually, and whenever there is an indication that the unit may be impaired, as required by IPSAS 26, *Impairment of Cash-Generating Assets*, for goodwill acquired in an acquisition.

...

Amendments to IPSAS 38, *Disclosure of Interests in Other Entities*

Paragraph 4 is amended and paragraphs 61A is added. New text is underlined and deleted text is struck through.

...

Scope

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4. **This Standard does not apply to:**

- (a) **Post-employment benefit plans or other long-term employee benefit plans to which IPSAS 39, *Employee Benefits* applies.**
- (b) **An entity's separate financial statements to which IPSAS 34, *Separate Financial Statements*, applies. However:**
 - (i) **If an entity has interests in structured entities that are not consolidated and prepares separate financial statements as its only financial statements, it shall apply the requirements in paragraphs 40–48 when preparing those separate financial statements.**
 - (ii) **An investment entity that prepares financial statements in which all of its controlled entities are measured at fair value through surplus or deficit in accordance with paragraph 56 of IPSAS 35 shall present the disclosures relating to investment entities required by this Standard.**
- (c) **An interest held by an entity that participates in, but does not have joint control of, a joint arrangement unless that interest results in significant influence over the arrangement or is an interest in a structured entity.**
- (d) **An interest in another entity that is accounted for in accordance with [draft] IPSAS [X] (ED 62), *Financial Instruments* ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~. However, an entity shall apply this Standard:**
 - (i) **When that interest is an interest in an associate or a joint venture that, in accordance with IPSAS 36, *Investments in Associates and Joint Ventures*, is measured at fair value through surplus or deficit; or**
 - (ii) **When that interest is an interest in a structured entity that is not consolidated.**

...

Effective Date

...

61A. Paragraph 4 was amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* in Month YYYY. An entity shall apply this amendment for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendment for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Amendments to IPSAS 40, *Public Sector Combinations*

Paragraphs 25, 45, 70, 111, 115, 117 and AG88 are amended and paragraphs 126A is added. New text is underlined and deleted text is struck through.

...

Classifying or Designating Assets and Liabilities in an Amalgamation

...

25. In some situations, IPSASs provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the resulting entity shall make on the basis of the classifications or designations previously applied by the combining operations include but are not limited to:
- (a) Classification of particular financial assets and liabilities as measured at fair value through surplus or deficit or at amortized cost, or measured at fair value through net assets/equity in accordance with [draft] IPSAS [X] (ED 62), *Financial Instruments* ~~IPSAS 29, *Financial Instruments: Recognition and Measurement*~~;
 - (b) Designation of a derivative instrument as a hedging instrument in accordance with [draft] IPSAS [X] (ED 62) *IPSAS 29*; and
 - (c) Assessment of whether an embedded derivative should be separated from a host contract in accordance with [draft] IPSAS [X] (ED 62) *IPSAS 29* (which is a matter of 'classification' as this Standard uses that term).

...

Amalgamation-Related Costs

...

45. Amalgamation-related costs are costs the resulting entity or combining operations incur to effect an amalgamation. Those costs include advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs; and any costs of registering and issuing debt and equity securities. The resulting entity and combining operations shall account for amalgamation-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with IPSAS 28, *Financial Instruments: Presentation*, and [draft] IPSAS [X] (ED 62), *Financial Instruments* ~~IPSAS 29~~.

...

Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in an Acquisition

...

70. In some situations, IPSASs provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:
- (a) Classification of particular financial assets and liabilities as measured at fair value or at amortized cost, in accordance with [draft] IPSAS [X] (ED 62) *IPSAS 29*;
 - (b) Designation of a derivative instrument as a hedging instrument in accordance with [draft] IPSAS [X] (ED 62) *IPSAS 29*; and

- (c) Assessment of whether an embedded derivative should be separated from a host contract in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29 (which is a matter of 'classification' as this Standard uses that term).

...

Acquisition-Related Costs

111. Acquisition-related costs are costs the acquirer incurs to effect an acquisition. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with IPSAS 28 and [draft] IPSAS [X] (ED 62) IPSAS 29.

Subsequent Measurement and Accounting

...

Contingent Liabilities

115. After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognized in an acquisition at the higher of:
- (a) The amount that would be recognized in accordance with IPSAS 19; and
 - (b) The amount initially recognized less, if appropriate, cumulative amortization recognized in accordance with IPSAS 9, *Revenue from Exchange Transactions*.

This requirement does not apply to contracts accounted for in accordance with [draft] IPSAS [X] (ED 62), *Financial Instruments* IPSAS 29.

...

Contingent Consideration

117. Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 102-106. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer shall account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:
- (a) Contingent consideration classified as a component of net assets/equity shall not be remeasured and its subsequent settlement shall be accounted for within net assets/equity.
 - (b) Other contingent consideration that:
 - (i) **Is within the scope of [draft] IPSAS [X] (ED 62) IPSAS 29 shall be measured at fair value at each reporting date and changes in fair value shall be recognized in surplus or deficit in accordance with [draft] IPSAS [X] (ED 62) IPSAS 29.**

- (ii) **Is not within the scope of [draft] IPSAS [X] (ED 62) ~~IPSAS 29~~ shall be measured at fair value at each reporting date and changes in fair value shall be recognized in surplus or deficit.**

...

Effective Date

...

126A. Paragraphs 25, 45, 70, 111, 115, 117 and AG88 were amended by [draft] IPSAS [X] (ED 62), *Financial Instruments* issued in Month YYYY. An entity shall apply these amendments for annual financial statements covering periods beginning on or after MM DD, YYYY. Earlier application is encouraged. If an entity applies the amendments for a period beginning before MM DD, YYYY it shall disclose that fact and apply [draft] IPSAS [X] (ED 62) at the same time.

...

Application Guidance

This Appendix is an integral part of IPSAS 40.

...

Measuring the fair value of particular identifiable assets and a non-controlling interest in an acquired operation in an acquisition (see paragraphs 72-73)

Assets with Uncertain Cash Flows (Valuation Allowances)

...

AG88. The acquirer shall not recognize a separate valuation allowance as of the acquisition date for assets acquired in an acquisition that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because this IPSAS requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values in accounting for an acquisition, the acquirer does not recognize a separate valuation allowance for the cash flows of the binding arrangement that are deemed to be uncollectible at that date or a loss allowance for expected credit losses.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, [draft] IPSAS [X] (ED 62).

Introduction

- BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in [draft] IPSAS [X] (ED 62), *Financial Instruments*. As this Standard is based on IFRS 9, *Financial Instruments* issued by the IASB, the Basis for Conclusions outlines only those areas where [draft] IPSAS [X] (ED 62) departs from the main requirements of IFRS 9.
- BC2. In July 2014, the IASB published the final version of IFRS 9, which brings together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39, *Financial Instruments*. In 2016, the IPSASB commenced work on a project to update those IPSASs that dealt with accounting for financial instruments as part of the IPSASB's convergence program which aims to converge IPSASs with IFRSs. The text of [draft] IPSAS [X] (ED 62) is based on the requirements of IFRS 9, modified as appropriate for public sector entities and to reflect the requirements of other IPSASs. This new IPSAS supersedes IPSAS 29.
- BC3. The IPSASB acknowledges that there are other aspects of financial instruments, insofar as they relate to the public sector, which are not addressed in IFRS 9. The IPSASB has undertaken separate projects on *Public Sector Specific Financial Instruments*, and *Revenue and Non-exchange Expenses*, to address:
- (a) Certain transactions undertaken by monetary authorities; and
 - (b) Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature.
- BC4. In developing this Standard, the IPSASB agreed to retain the existing text of IFRS 9 wherever consistent with existing IPSASs, and provide examples and implementation guidance for certain public sector specific issues. In particular, the IPSASB noted the usefulness of the application guidance on concessionary loans and financial guarantees issued through a non-exchange transaction in IPSAS 29 and the continued need for such guidance in [draft] IPSAS [X] (ED 62). The IPSASB's view is that it is critical to provide non-authoritative material to support constituents in applying the principles in this Standard. Therefore the IPSASB followed a rigorous process to develop the following additional public sector examples to help with application of this Standard:
- (a) Examples related to concessionary loans, including when to assess the classification (see examples 20 and 21 and implementation guidance G.1) and the impact of contingent repayment feature (see implementation guidance G.2);
 - (b) Examples related to measurement of unquoted equity instruments, including factors to be considered in determining the fair value (see examples 23 – 26 and implementation guidance E.2.4 and E.2.5) and accounting for those with a non-exchange component (see examples 27 and 28 and implementation guidance G.3);
 - (c) Example related to accounting for equity instruments with redemption features (see example 31);

- (d) Examples related to the application of the effective interest rate in calculating the amortized cost of a financial asset (see examples 32 and implementation guidance H.1).

BC5. The IPSASB also agreed to use revenue in place of income in IFRS 9, *Financial Instruments*, to be consistent with IPSAS 1, *Presentation of Financial Statements*, which uses revenue to correspond to income in the IASs/IFRSs. Therefore some items recognized as revenue or expense in IPSAS 1 are net amounts. As stated in the Basis for Conclusions in IPSAS 1, the IPSASs do not include a definition of income. The term income is broader than revenue, encompassing gains in addition to revenue.

Scope

BC6. Assets and liabilities may arise out of contractual non-exchange revenue transactions. The initial recognition and measurement of assets and liabilities arising out of non-exchange revenue transactions is addressed in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. IPSAS 23 does not provide requirements and guidance for the subsequent measurement or derecognition of these assets and liabilities. The IPSASB considered the interaction between this Standard and IPSAS 23 for assets and liabilities that arise out of non-exchange revenue transactions that meet the definition of financial assets and financial liabilities.

BC7. The IPSASB agreed that where an asset acquired in a non-exchange transaction is a financial asset, an entity:

- Initially recognizes the asset using IPSAS 23; and
- Initially measures the asset using IPSAS 23 and, considers the requirements in this Standard to determine the appropriate treatment for any transaction costs incurred to acquire the asset.

As IPSAS 23 does not prescribe subsequent measurement or derecognition requirements for assets acquired in a non-exchange transaction, this Standard is applied to those assets if they are financial assets.

BC8. For liabilities, the IPSASB agreed that liabilities arising from conditions imposed on a transfer of resources in accordance with IPSAS 23 are initially recognized and initially measured using that IPSAS, as these liabilities usually do not meet the definition of a financial liability at initial recognition (see IPSAS 28). After initial recognition, if circumstances indicate that the liability is a financial liability, an entity assesses if the liability recognized in accordance with IPSAS 23 should be derecognized and a financial liability recognized in accordance with this Standard.

BC9. The IPSASB agreed that other liabilities that arise from non-exchange revenue transactions, for example, the return of resources based on a restriction on the use of an asset, are recognized and measured in accordance with this Standard if they meet the definition of a financial liability.

Initial Measurement

BC10. The IPSASB acknowledged that there is an interaction between IPSAS 23 and this Standard for assets acquired through a non-exchange transaction that also meet the definition of a financial asset. IPSAS 23 requires that assets acquired in a non-exchange revenue transaction are measured initially at fair value. This Standard requires financial assets to be measured initially at fair value, plus transaction costs, if the asset is not subsequently measured at fair value through surplus or deficit. The two measurement approaches are broadly consistent, except for the treatment of transaction costs.

- BC11. The IPSASB concluded that it would be inappropriate for financial assets arising from non-exchange transactions to be measured differently from those arising from exchange transactions. Consequently, the IPSASB agreed that assets acquired in a non-exchange transaction should be measured initially at fair value using the requirements in IPSAS 23, but that this Standard should also be considered where transaction costs are incurred to acquire the asset.

Equity Instruments Arising from Non-Exchange Transactions

- BC12. In the public sector, equity instruments are sometimes obtained with minimal cash flow expectations as a way to provide funding to another public sector entity for providing a service. The IPSASB considered the need for additional guidance similar to concessionary loans for such equity instruments acquired at non-market terms. While the IPSASB agreed that there are fundamental differences between the economic substance of such arrangements compared to concessionary loans. The IPSASB also agreed that the guidance in IPSAS 23 and the Standard sufficiently address the recognition and measurement of such transactions, additional guidance is included to provide clarity.

Sale of Future Flows Arising from a Sovereign Right

- BC13. In the public sector, securitization schemes may involve a sale of future flows arising from a sovereign right, such as right to taxation. The IPSASB agreed that the sale of future flows arising from a sovereign right is a transaction that should be accounted for in accordance with the relevant revenue guidance. The IPSASB agreed that financial liabilities may arise from a securitization arrangement. Examples may include but are not limited to borrowings, financial guarantees, liabilities arising from servicing or administrative or payables relating to when the public sector entity (originating entity) collects cash flows and passes these along to a third party. The IPSASB considered application guidance to address such scenarios, and concluded that sufficient guidance exists in the Standard to address all other aspects of any financial instruments arising from those transactions.

Impairment

- BC14. The IPSASB notes that for many public sector entities, receivables may be the only significant financial asset held. In addition, public sector entities may not have an ability to choose the counterparties they transact with because of the nature of services provided and laws or regulations requiring provision of services to all service recipients (for example, when a public utility provides water or hydro services). Under such scenarios, credit risk information at an individual counterparty level and forward looking information/forecasts may not be available without undue cost or effort. The IPSASB considered whether public sector modifications or additional guidance should be included in the Standard and concluded that the simplified approach for receivables along with practical expedients available in determining expected credit losses provide appropriate relief to the practical challenges under such scenarios. The IPSASB further acknowledges that the Standard allows for historical data and existing models be incorporated in estimating expected credit losses under such circumstances with consideration for any adjustments as needed to reflect current and forecasted conditions, as prescribed in the Standard.”

Effective Interest Rate Method

- BC15. Constituents raised concerns with the IPSASB in regard to the cost/benefit of measuring financial liabilities (bonds) at amortized cost using the effective interest method. These constituents were

concerned that, when transaction costs and any premium or discount on issuance are insignificant, measuring amortized cost using the effective interest rate produced similar or identical results to using the straight line method. However, the costs of applying the effective interest rate method were greater.

- BC16. The IPSASB noted that paragraph 10 of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, addressed this concern. Paragraph 10 of IPSAS 3 states that:

“IPSASs set out accounting policies that the IPSASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events, and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave uncorrected, immaterial departures from IPSASs to achieve a particular presentation of an entity’s financial position, financial performance, or cash flows.”

- BC17. The IPSASB considered that, in instances when amortized cost calculated using the effective interest rate method is not materially different than an existing technique, the standards already allow for alternative approaches. The IPSASB also noted that IPSAS 1 includes similar provisions in relation to disclosures. Consequently, the IPSASB concluded that there was no cost/benefit justification for departing from the use of effective interest rate method in [draft] IPSAS [X] (ED 62).

Gold Bullion

- BC18. IFRS 9 does not consider gold bullion as a financial instrument. Given the IPSASB proposals in its Public Sector Specific Financial Instruments project related to monetary gold, the IPSASB considered whether this guidance was appropriate. The IPSASB noted that gold bullion has a wider meaning than monetary gold, and for entities that are not monetary authorities, the guidance is appropriate. The IPSASB therefore agreed to include the guidance in [draft] IPSAS [X] (ED 62). The IPSASB may amend this guidance when it concludes its Public Sector Specific Financial Instruments project.

Transition

- BC19. The IPSASB noted some public sector transactions may be reclassified under [draft] IPSAS [X] (ED 62). The IPSASB considered whether specific transitional provisions may be required for such reclassifications. The IPSASB noted that both general and specific transition relief was included in IFRS 9 and has been adopted in [draft] IPSAS [X] (ED 62). This includes a specific provision that provides relief from providing comparative information. The IPSASB therefore concluded that additional relief was not required.

ILLUSTRATIVE EXAMPLES

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Illustrative Examples

These examples accompany, but are not part of, [draft] IPSAS [X] (ED 62).

Financial Liabilities at Fair Value through Surplus or Deficit

- IE1. The following example illustrates the calculation that an entity might perform in accordance with paragraph AG238 of [draft] IPSAS [X] (ED 62).
- IE2. On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000⁶ and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.
- IE3. The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:
- LIBOR has decreased to 4.75 per cent.
 - The fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.⁷
- IE4. The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.
- IE5. The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

<p>[paragraph AG238(a)]</p> <p>First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.</p>	<p>At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent.</p> <p>Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.</p>
<p>[paragraph AG238(b)]</p> <p>Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph AG238(a).</p>	<p>The contractual cash flows of the instrument at the end of the period are:</p> <ul style="list-style-type: none"> Interest: CU12,000^(a) per year for each of years 2–10. Principal: CU150,000 in year 10. <p>The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is the end of period LIBOR rate of 4.75 per cent, plus the 3 per cent instrument-specific component.</p> <p>This gives a present value of CU152,367.^(b)</p>

⁶ In this guidance monetary amounts are denominated in 'currency units' (CU).

⁷ This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

[paragraph AG238(c)]

The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph AG238(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in net assets/equity in accordance with paragraph 105(a).

The market price of the liability at the end of the period is CU153,811.^(c)

Thus, the entity presents CU1,444 in net assets/equity, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.

(a) $CU150,000 \times 8 \text{ percent} = CU12,000$.

(b) $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$.

(c) $\text{market price} = [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$.

Impairment (Paragraphs 71-90)

Assessing Significant Increases in Credit Risk Since Initial Recognition

IE6. The following examples illustrate possible ways to assess whether there have been significant increases in credit risk since initial recognition. For simplicity of illustration, the following examples only show one aspect of the credit risk analysis. However, the assessment of whether lifetime expected credit losses should be recognized is a multifactor and holistic analysis that considers reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed.

Example 1—Significant Increase in Credit Risk

- IE7. Company Y has a funding structure that includes a senior secured loan facility with different tranches⁸. Company Y qualifies for assistance from the National Development Bank which provides a tranche of the loan facility to Company Y. At the time of origination of the loan by the National Development Bank, although Company Y's leverage was relatively high compared with other issuers with similar credit risk, it was expected that Company Y would be able to meet the covenants for the life of the instrument. In addition, the generation of revenue and cash flow was expected to be stable in Company Y's industry over the term of the senior facility. However, there was some business risk related to the ability to grow gross margins within its existing businesses.
- IE8. At initial recognition, because of the considerations outlined in paragraph IE7, the National Development Bank considers that despite the level of credit risk at initial recognition, the loan is not an originated credit-impaired loan because it does not meet the definition of a credit-impaired financial asset in paragraph 9 of [draft] IPSAS [X] (ED 62).
- IE9. Subsequent to initial recognition, macroeconomic changes have had a negative effect on total sales volume and Company Y has underperformed on its business plan for revenue generation and net cash flow generation. Although spending on inventory has increased, anticipated sales have not materialized. To increase liquidity, Company Y has drawn down more on a separate revolving credit facility, thereby increasing its leverage ratio. Consequently, Company Y is now

⁸ The security on the loan affects the loss that would be realized if a default occurs, but does not affect the risk of a default occurring, so it is not considered when determining whether there has been a significant increase in credit risk since initial recognition as required by paragraph 73 of [draft] IPSAS [X] (ED 62).

close to breaching its covenants on the senior secured loan facility with the National Development Bank.

- IE10. The National Development Bank makes an overall assessment of the credit risk on the loan to Company Y at the reporting date by taking into consideration all reasonable and supportable information that is available without undue cost or effort and that is relevant for assessing the extent of the increase in credit risk since initial recognition. This may include factors such as:
- (a) The National Development Bank's expectation that the deterioration in the macroeconomic environment may continue in the near future, which is expected to have a further negative impact on Company Y's ability to generate cash flows and to deleverage.
 - (b) Company Y is closer to breaching its covenants, which may result in a need to restructure the loan or reset the covenants.
 - (c) The National Development Bank's assessment that the trading prices for Company Y's bonds have decreased and that the credit margin on newly originated loans have increased reflecting the increase in credit risk, and that these changes are not explained by changes in the market environment (for example, benchmark interest rates have remained unchanged). A further comparison with the pricing of Company Y's peers shows that reductions in the price of Company Y's bonds and increases in credit margin on its loans have probably been caused by company-specific factors.
 - (d) The National Development Bank has reassessed its internal risk grading of the loan on the basis of the information that it has available to reflect the increase in credit risk.
- IE11. The National Development Bank determines that there has been a significant increase in credit risk since initial recognition of the loan in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62). Consequently, The National Development Bank recognizes lifetime expected credit losses on its senior secured loan to Company Y. Even if the National Development Bank has not yet changed the internal risk grading of the loan it could still reach this conclusion—the absence or presence of a change in risk grading in itself is not determinative of whether credit risk has increased significantly since initial recognition.

Example 2—No Significant Increase in Credit Risk

- IE12. Company C, is the holding company of a group that operates in a cyclical production industry. State Government B provided a loan to Company C. At that time, the prospects for the industry were positive, because of expectations of further increases in global demand. However, input prices were volatile and given the point in the cycle, a potential decrease in sales was anticipated.
- IE13. In addition, in the past Company C has been focused on external growth, acquiring majority stakes in companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to analyze the expected performance of the group and to forecast the cash that will be available at the holding company level. Even though leverage is at a level that is considered acceptable by Company C's creditors at the time that State Government B originates the loan, its creditors are concerned about Company C's ability to refinance its debt because of the short remaining life until the maturity of the current financing. There is also concern about Company C's ability to continue to service interest using the dividends it receives from its operating subsidiaries.

- IE14. At the time of the origination of the loan by State Government B, Company C's leverage was in line with that of other borrowers with similar credit risk and based on projections over the expected life of the loan, the available capacity (i.e. headroom) on its coverage ratios before triggering a default event, was high. State Government B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its loans. State Government B's internal rating categories are based on historical, current and forward-looking information and reflect the credit risk for the tenor of the loans. On initial recognition, State Government B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group's uncertain prospects for cash generation, could lead to default. However, State Government B does not consider the loan to be originated credit-impaired because it does not meet the definition of a purchased or originated credit-impaired financial asset in paragraph 9 of [draft] IPSAS [X] (ED 62).
- IE15. Subsequent to initial recognition, Company C has announced that three of its five key subsidiaries had a significant reduction in sales volume because of deteriorated market conditions but sales volumes are expected to improve in line with the anticipated cycle for the industry in the following months. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure to streamline its operating subsidiaries. This restructuring will increase the flexibility to refinance existing debt and the ability of the operating subsidiaries to pay dividends to Company C.
- IE16. Despite the expected continuing deterioration in market conditions, State Government B determines, in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62), that there has not been a significant increase in the credit risk on the loan to Company C since initial recognition. This is demonstrated by factors that include:
- (a) Although current sale volumes have fallen, this was as anticipated by State Government B at initial recognition. Furthermore, sales volumes are expected to improve, in the following months.
 - (b) Given the increased flexibility to refinance the existing debt at the operating subsidiary level and the increased availability of dividends to Company C, State Government B views the corporate restructure as being credit enhancing. This is despite some continued concern about the ability to refinance the existing debt at the holding company level.
 - (c) State Government B's credit risk department, which monitors Company C, has determined that the latest developments are not significant enough to justify a change in its internal credit risk rating.
- IE17. As a consequence, State Government B does not recognize a loss allowance at an amount equal to lifetime expected credit losses on the loan. However, it updates its measurement of the 12-month expected credit losses for the increased risk of a default occurring in the next 12 months and for current expectations of the credit losses that would arise if a default were to occur.

Example 3—Highly Collateralized Financial Asset

- IE18. Company H owns land which is financed by a five-year loan from the State owned Agricultural Bank with a loan-to-value (LTV) ratio of 50 per cent. The loan is secured by a first-ranking security over the land. At initial recognition of the loan, the State owned Agricultural Bank does not consider the loan to be originated credit-impaired as defined in paragraph 9 of [draft] IPSAS [X] (ED 62).

- IE19. Subsequent to initial recognition, the revenues and operating profits of Company H have decreased because of an economic recession. Furthermore, expected increases in regulations have the potential to further negatively affect revenue and operating profit. These negative effects on Company H's operations could be significant and ongoing.
- IE20. As a result of these recent events and expected adverse economic conditions, Company H's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. The State owned Agricultural Bank estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due.
- IE21. Recent third party appraisals have indicated a decrease in the value of the land, resulting in a current LTV ratio of 70 per cent.
- IE22. At the reporting date, the loan to Company H is not considered to have low credit risk in accordance with paragraph 80 of [draft] IPSAS [X] (ED 62). The State owned Agricultural Bank therefore needs to assess whether there has been a significant increase in credit risk since initial recognition in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62), irrespective of the value of the collateral it holds. It notes that the loan is subject to considerable credit risk at the reporting date because even a slight deterioration in cash flows could result in Company H missing a contractual payment on the loan. As a result, the State owned Agricultural Bank determines that the credit risk (i.e. the risk of a default occurring) has increased significantly since initial recognition. Consequently, the State owned Agricultural Bank recognizes lifetime expected credit losses on the loan to Company H.
- IE23. Although lifetime expected credit losses should be recognized, the measurement of the expected credit losses will reflect the recovery expected from the collateral (adjusting for the costs of obtaining and selling the collateral) on the property as required by paragraph AG216 of [draft] IPSAS [X] (ED 62) and may result in the expected credit losses on the loan being very small.

Example 4—Public Investment-Grade Bond

- IE24. Company A is a large listed national logistics company. The only debt in the capital structure is a five-year public bond with a restriction on further borrowing as the only bond covenant. Company A reports quarterly to its shareholders. The National Public Investment Fund is one of many investors in the bond. The Investment Fund considers the bond to have low credit risk at initial recognition in accordance with paragraph 80 of [draft] IPSAS [X] (ED 62). This is because the bond has a low risk of default and Company A is considered to have a strong capacity to meet its obligations in the near term. The Investment Fund's expectations for the longer term are that adverse changes in economic and business conditions may, but will not necessarily, reduce Company A's ability to fulfil its obligations on the bond. In addition, at initial recognition the bond had an internal credit rating that is correlated to a global external credit rating of investment grade.
- IE25. At the reporting date, the Investment Fund's main credit risk concern is the continuing pressure on the total volume of sales that has caused Company A's operating cash flows to decrease.
- IE26. Because the Investment Fund relies only on quarterly public information and does not have access to private credit risk information (because it is a bond investor), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

- IE27. The Investment Fund applies the low credit risk simplification in paragraph 80 of [draft] IPSAS [X] (ED 62). Accordingly, at the reporting date, the Investment Fund evaluates whether the bond is considered to have low credit risk using all reasonable and supportable information that is available without undue cost or effort. In making that evaluation, the Investment Fund reassesses the internal credit rating of the bond and concludes that the bond is no longer equivalent to an investment grade rating because:
- (a) The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent.
 - (b) Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.
 - (c) The bond price has also declined significantly, which has resulted in a higher yield to maturity. The Investment Fund assesses that the bond prices have been declining as a result of increases in Company A's credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity etc. are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).
- IE28. While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described in paragraph IE27, the Investment Fund determines that the bond does not have low credit risk at the reporting date. As a result, the Investment Fund needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, the Investment Fund determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime expected credit losses should be recognized in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62).

Example 5—Responsiveness to Changes in Credit Risk

- IE29. Housing Corporation ABC provides mortgages to citizens of ABC to finance residential real estate in three different regions. The mortgage loans are originated across a wide range of LTV criteria and a wide range of income groups. As part of the mortgage application process, borrowers are required to provide information such as the industry within which the borrower is employed and the post code of the property that serves as collateral on the mortgage.
- IE30. Housing Corporation ABC sets its acceptance criteria based on credit scores. Loans with a credit score above the 'acceptance level' are approved because these borrowers are considered to be able to meet contractual payment obligations. When new mortgage loans are originated, Housing Corporation ABC uses the credit score to determine the risk of a default occurring as at initial recognition.
- IE31. At the reporting date Housing Corporation ABC determines that economic conditions are expected to deteriorate significantly in all regions. Unemployment levels are expected to increase while the value of residential property is expected to decrease, causing the LTV ratios to increase. As a result of the expected deterioration in economic conditions, Housing Corporation ABC expects default rates on the mortgage portfolio to increase.

Individual Assessment

- IE32. In Region One, Housing Corporation ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioral scoring process. Its scoring models are based on current and historical past due statuses, levels of borrower indebtedness, LTV measures, the loan size and the time since the origination of the loan. Housing Corporation ABC updates the LTV measures on a regular basis through an automated process that re-estimates property values using recent sales in each post code area and reasonable and supportable forward-looking information that is available without undue cost or effort.
- IE33. Housing Corporation ABC has historical data that indicates a strong correlation between the value of residential property and the default rates for mortgages. That is, when the value of residential property declines, a borrower has less economic incentive to make scheduled mortgage repayments, increasing the risk of a default occurring.
- IE34. Through the impact of the LTV measure in the behavioral scoring model, an increased risk of a default occurring due to an expected decline in residential property value adjusts the behavioral scores. The behavioral score can be adjusted as a result of expected declines in property value even when the mortgage loan is a bullet loan with the most significant payment obligations at maturity (and beyond the next 12 months). Mortgages with a high LTV ratio are more sensitive to changes in the value of the residential property and Housing Corporation ABC is able to identify significant increases in credit risk since initial recognition on individual borrowers before a mortgage becomes past due if there has been a deterioration in the behavioral score.
- IE35. When the increase in credit risk has been significant, a loss allowance at an amount equal to lifetime expected credit losses is recognized. Housing Corporation ABC measures the loss allowance by using the LTV measures to estimate the severity of the loss, i.e. the loss given default (LGD). The higher the LTV measure, the higher the expected credit losses all else being equal.
- IE36. If Housing Corporation ABC was unable to update behavioral scores to reflect the expected declines in property prices, it would use reasonable and supportable information that is available without undue cost or effort to undertake a collective assessment to determine the loans on which there has been a significant increase in credit risk since initial recognition and recognize lifetime expected credit losses for those loans.

Collective Assessment

- IE37. In Regions Two and Three, Housing Corporation ABC does not have an automated scoring capability. Instead, for credit risk management purposes, Housing Corporation ABC tracks the risk of a default occurring by means of past due statuses. It recognizes a loss allowance at an amount equal to lifetime expected credit losses for all loans that have a past due status of more than 30 days past due. Although Housing Corporation ABC uses past due status information as the only borrower-specific information, it also considers other reasonable and supportable forward-looking information that is available without undue cost or effort to assess whether lifetime expected credit losses should be recognized on loans that are not more than 30 days past due. This is necessary in order to meet the objective in paragraph 74 of [draft] IPSAS [X] (ED 62) of recognizing lifetime expected credit losses for all significant increases in credit risk.

Region Two

IE38. Region Two includes a mining community that is largely dependent on the export of coal and related products. Housing Corporation ABC becomes aware of a significant decline in coal exports and anticipates the closure of several coal mines. Because of the expected increase in the unemployment rate, the risk of a default occurring on mortgage loans to borrowers who are employed by the coal mines is determined to have increased significantly, even if those borrowers are not past due at the reporting date. Housing Corporation ABC therefore segments its mortgage portfolio by the industry within which borrowers are employed (using the information recorded as part of the mortgage application process) to identify borrowers that rely on coal mining as the dominant source of employment (i.e. a 'bottom up' approach in which loans are identified based on a common risk characteristic). For those mortgages, Housing Corporation ABC recognizes a loss allowance at an amount equal to lifetime expected credit losses while it continues to recognize a loss allowance at an amount equal to 12-month expected credit losses for all other mortgages in Region Two.⁹ Newly originated mortgages to borrowers who are economically dependent on the coal mines in this community would, however, have a loss allowance at an amount equal to 12-month expected credit losses because they would not have experienced significant increases in credit risk since initial recognition. However, some of these mortgages may experience significant increases in credit risk soon after initial recognition because of the expected closure of the coal mines.

Region Three

IE39. In Region Three, Housing Corporation ABC anticipates the risk of a default occurring and thus an increase in credit risk, as a result of an expected increase in interest rates during the expected life of the mortgages. Historically, an increase in interest rates has been a lead indicator of future defaults on mortgages in Region Three—especially when borrowers do not have a fixed interest rate mortgage. Housing Corporation ABC determines that the variable interest-rate portfolio of mortgages in Region Three is homogenous and that unlike for Region Two, it is not possible to identify particular sub portfolios on the basis of shared risk characteristics that represent borrowers who are expected to have increased significantly in credit risk. However, as a result of the homogenous nature of the mortgages in Region Three, Housing Corporation ABC determines that an assessment can be made of a proportion of the overall portfolio that has significantly increased in credit risk since initial recognition (i.e. a 'top down' approach can be used). Based on historical information, Housing Corporation ABC estimates that an increase in interest rates of 200 basis points will cause a significant increase in credit risk on 20 per cent of the variable interest-rate portfolio. Therefore, as a result of the anticipated increase in interest rates, Housing Corporation ABC determines that the credit risk on 20 per cent of mortgages in Region Three has increased significantly since initial recognition. Accordingly Housing Corporation ABC recognizes lifetime expected credit losses on 20 per cent of the variable rate mortgage portfolio and a loss allowance at an amount equal to 12-month expected credit losses for the remainder of the portfolio.¹⁰

⁹ Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognized on those mortgages.

¹⁰ Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognized on those mortgages.

Example 6—Comparison to Maximum Initial Credit Risk

- IE40. The Economic Development Agency has two portfolios of small business loans with similar terms and conditions in Region W. The Economic Development Agency's policy on financing decisions for each loan is based on an internal credit rating system that considers a borrower's credit history, payment behavior and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to repeat borrowers with a similar internal credit risk rating and at initial recognition all loans were rated 3 or 4 on the internal rating scale. The Economic Development Agency determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to borrowers that responded to an advertisement for small business loans and the internal credit risk ratings of these borrowers range between 4 and 7 on the internal rating scale. The Economic Development Agency never originates a small business loan with an internal credit risk rating worse than 7 (i.e. with an internal rating of 8–10).
- IE41. For the purposes of assessing whether there have been significant increases in credit risk, The Economic Development Agency determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk but that there has been a significant increase in credit risk on any loan in this portfolio that has an internal rating worse than 5. This means that the Department of Finance does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the reporting date to determine whether lifetime expected credit losses should be recognized in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62).
- IE42. However, determining the maximum initial credit risk accepted at initial recognition for Portfolio 2 at an internal credit risk rating of 7, would not meet the objective of the requirements as stated in paragraph 74 of [draft] IPSAS [X] (ED 62). This is because the Economic Development Agency determines that significant increases in credit risk arise not only when credit risk increases above the level at which an entity would originate new financial assets (i.e. when the internal rating is worse than 7). Although the Economic Development Agency never originates an small business loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition to apply the approach used for Portfolio 1. This means that the Economic Development Agency cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly because the initial credit quality of loans in the portfolio is too diverse. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

Example 7—Counterparty Assessment of Credit Risk**Scenario 1**

- IE43. In 20X0 the Infrastructure Bank of Country A granted a loan of CU10,000 with a contractual term of 15 years to Company Q when the company had an internal credit risk rating of 4 on a scale of

1 (lowest credit risk) to 10 (highest credit risk). The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. In 20X5, when Company Q had an internal credit risk rating of 6, the Infrastructure Bank issued another loan to Company Q for CU5,000 with a contractual term of 10 years. In 20X7 Company Q fails to retain its contract with a major customer and correspondingly experiences a large decline in its revenue. the Infrastructure Bank considers that as a result of losing the contract, Company Q will have a significantly reduced ability to meet its loan obligations and changes its internal credit risk rating to 8.

- IE44. The Infrastructure Bank assesses credit risk on a counterparty level for credit risk management purposes and determines that the increase in Company Q's credit risk is significant. Although the Infrastructure Bank did not perform an individual assessment of changes in the credit risk on each loan since its initial recognition, assessing the credit risk on a counterparty level and recognizing lifetime expected credit losses on all loans granted to Company Q, meets the objective of the impairment requirements as stated in paragraph 74 of [draft] IPSAS [X] (ED 62). This is because, even since the most recent loan was originated (in 20X7) when Company Q had the highest credit risk at loan origination, its credit risk has increased significantly. The counterparty assessment would therefore achieve the same result as assessing the change in credit risk for each loan individually.

Scenario 2

- IE45. The Infrastructure Bank of Country A granted a loan of CU150,000 with a contractual term of 20 years to Company X in 20X0 when the company had an internal credit risk rating of 4. During 20X5 economic conditions deteriorate and demand for Company X's products has declined significantly. As a result of the reduced cash flows from lower sales, Company X could not make full payment of its loan installment to the Infrastructure Bank. The Infrastructure Bank re-assesses Company X's internal credit risk rating, and determines it to be 7 at the reporting date. The Infrastructure Bank considered the change in credit risk on the loan, including considering the change in the internal credit risk rating, and determines that there has been a significant increase in credit risk and recognizes lifetime expected credit losses on the loan of CU150,000.
- IE46. Despite the recent downgrade of the internal credit risk rating, the Infrastructure Bank another loan of CU50,000 to Company X in 20X6 with a contractual term of 5 years, taking into consideration the higher credit risk at that date.
- IE47. The fact that Company X's credit risk (assessed on a counterparty basis) has previously been assessed to have increased significantly, does not result in lifetime expected credit losses being recognized on the new loan. This is because the credit risk on the new loan has not increased significantly since the loan was initially recognized. If the Infrastructure Bank only assessed credit risk on a counterparty level, without considering whether the conclusion about changes in credit risk applies to all individual financial instruments provided to the same borrower, the objective in paragraph 74 of [draft] IPSAS [X] (ED 62) would not be met.

Recognition and Measurement of Expected Credit Losses

- IE48. The following examples illustrate the application of the recognition and measurement requirements in accordance with paragraphs 71-90 of [draft] IPSAS [X] (ED 62), as well as the interaction with the hedge accounting requirements.

Example 8—12-Month Expected Credit Loss Measurement Using an Explicit ‘Probability of Default’ Approach

Scenario 1

- IE49. Government A originates a single 10 year amortizing loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Government A estimates that the loan at initial recognition has a probability of default (PD) of 0.5 per cent over the next 12 months. Government A also determines that changes in the 12-month PD are a reasonable approximation of the changes in the lifetime PD for determining whether there has been a significant increase in credit risk since initial recognition.
- IE50. At the reporting date (which is before payment on the loan is due¹¹), there has been no change in the 12-month PD and Government A determines that there was no significant increase in credit risk since initial recognition. Government A determines that 25 per cent of the gross carrying amount will be lost if the loan defaults (i.e. the LGD is 25 per cent).¹² Government A measures the loss allowance at an amount equal to 12-month expected credit losses using the 12-month PD of 0.5 per cent. Implicit in that calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12 month expected credit losses is CU1,250 (0.5 percent × 25 percent × CU1,000,000).

Scenario 2

- IE51. Government B acquires a portfolio of 1,000 five year bullet loans for CU1,000 each (i.e. CU1million in total) with an average 12-month PD of 0.5 per cent for the portfolio. Government B determines that because the loans only have significant payment obligations beyond the next 12 months, it would not be appropriate to consider changes in the 12-month PD when determining whether there have been significant increases in credit risk since initial recognition. At the reporting date Government B therefore uses changes in the lifetime PD to determine whether the credit risk of the portfolio has increased significantly since initial recognition.
- IE52. Government B determines that there has not been a significant increase in credit risk since initial recognition and estimates that the portfolio has an average LGD of 25 per cent. Entity B determines that it is appropriate to measure the loss allowance on a collective basis in accordance with [draft] IPSAS [X] (ED 62). The 12-month PD remains at 0.5 per cent at the reporting date. Entity B therefore measures the loss allowance on a collective basis at an amount equal to 12-month expected credit losses based on the average 0.5 per cent 12-month PD. Implicit in the calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12-month expected credit losses is CU1,250 (0.5 percent × 25 percent × CU1,000,000).

Example 9—12-Month Expected Credit Loss Measurement Based on a Loss Rate Approach

- IE53. Government A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. Government A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared

¹¹ Thus for simplicity of illustration it is assumed there is no amortization of the loan.

¹² Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money.

credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per borrower of CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per borrower of CU300, for a total gross carrying amount of CU300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

- IE54. Government A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Government A considers samples of its own historical default and loss experience for those types of loans. In addition, Government A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 percent, based on four defaults, and historical loss rates for Group Y are 0.15 percent, based on two defaults.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss ^(a)	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	4	CU800	CU600	0.3%
Y	1,000	CU300	CU300,000	2	CU600	CU450	0.15%
(a) In accordance with paragraph 87(b) expected credit losses should be discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed.							

- IE55. At the reporting date, Government A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Government A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the historical loss per client.
- IE56. On the basis of the expected life of the loans, Government A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Government A measures the loss allowance at an amount equal to 12-month expected credit losses on the 1,000 loans in each group amounting to CU750 and CU675 respectively. This equates to a loss rate in the first year of 0.375 per cent for Group X and 0.225 per cent for Group Y.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	5	CU1,000	CU750	0.375%

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Y	1,000	CU300	CU300,000	3	CU900	CU675	0.225%

- IE57. Government A uses the loss rates of 0.375 per cent and 0.225 per cent respectively to estimate 12-month expected credit losses on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

Example 10—Revolving Credit Facilities

- IE58. The Development Agency of Country A issues revolving loans to small construction company that deliver public infrastructure. These revolving loans provide small construction companies with liquidity when cash inflows are limited. The revolving loans have a one-day notice period after which the Development Agency has the contractual right to cancel the loan (both the drawn and undrawn components). However, the Development Agency does not enforce its contractual right to cancel the revolving loans in the normal day-to-day management of the instruments and only cancels facilities when it becomes aware of an increase in credit risk and starts to monitor borrowers on an individual basis. The Development Agency therefore does not consider the contractual right to cancel the revolving loans to limit its exposure to credit losses to the contractual notice period.
- IE59. For credit risk management purposes the Development Agency considers that there is only one set of contractual cash flows from borrowers to assess and does not distinguish between the drawn and undrawn balances at the reporting date. The portfolio is therefore managed and expected credit losses are measured on a facility level.
- IE60. At the reporting date the outstanding balance on the revolving loan portfolio is CU60,000 and the available undrawn facility is CU40,000. The Development Agency determines the expected life of the portfolio by estimating the period over which it expects to be exposed to credit risk on the facilities at the reporting date, taking into account:
- The period over which it was exposed to credit risk on a similar portfolio of revolving construction loans;
 - The length of time for related defaults to occur on similar financial instruments; and
 - Past events that led to credit risk management actions because of an increase in credit risk on similar financial instruments, such as the reduction or removal of undrawn credit limits.
- IE61. On the basis of the information listed in paragraph IE60, Development Agency determines that the expected life of the revolving loan portfolio is 30 months.
- IE62. At the reporting date the Development Agency assesses the change in the credit risk on the portfolio since initial recognition and determines in accordance with paragraph 73 of [draft] IPSAS [X] (ED 62) that the credit risk on a portion of the loan facilities representing 25 per cent of the portfolio, has increased significantly since initial recognition. The outstanding balance on these credit facilities for which lifetime expected credit losses should be recognized is CU20,000 and the available undrawn facility is CU10,000.

- IE63. When measuring the expected credit losses in accordance with paragraph 90 of [draft] IPSAS [X] (ED 62), Development Agency considers its expectations about future draw-downs over the expected life of the portfolio (i.e. 30 months) in accordance with paragraph AG192 and estimates what it expects the outstanding balance (i.e. exposure at default) on the portfolio would be if borrowers were to default. By using its credit risk models Development Agency determines that the exposure at default on the revolving loan facilities for which lifetime expected credit losses should be recognized, is CU25,000 (i.e. the drawn balance of CU20,000 plus further draw-downs of CU5,000 from the available undrawn commitment). The exposure at default of the loan facilities for which 12-month expected credit losses are recognized, is CU45,000 (i.e. the outstanding balance of CU40,000 and an additional draw-down of CU5,000 from the undrawn commitment over the next 12 months).
- IE64. The exposure at default and expected life determined by the Development Agency are used to measure the lifetime expected credit losses and 12-month expected credit losses on its loan portfolio.
- IE65. The Development Agency measures expected credit losses on a facility level and therefore cannot separately identify the expected credit losses on the undrawn commitment component from those on the loan component. It recognizes expected credit losses for the undrawn commitment together with the loss allowance for the loan component in the statement of financial position. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be presented as a provision (in accordance with IPSAS 30 *Financial Instruments: Disclosure*).

Example 11—Modification of Contractual Cash Flows

- IE66. Government A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is CU1,000 with an interest rate of 5 per cent payable annually. The effective interest rate is 5 per cent. At the end of the first reporting period (Period 1), Government A recognizes a loss allowance at an amount equal to 12-month expected credit losses because there has not been a significant increase in credit risk since initial recognition. A loss allowance balance of CU20 is recognized.
- IE67. In the subsequent reporting period (Period 2), Government A determines that the credit risk on the loan has increased significantly since initial recognition. As a result of this increase, Government A recognizes lifetime expected credit losses on the loan. The loss allowance balance is CU30.
- IE68. At the end of the third reporting period (Period 3), following significant financial difficulty of the borrower, Government A modifies the contractual cash flows on the loan. It extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in the derecognition of the loan by Government A.
- IE69. As a result of that modification, Government A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan's original effective interest rate of 5 per cent. In accordance with paragraph 69 of [draft] IPSAS [X] (ED 62), the difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognized as a modification gain or loss. Government A recognizes the modification loss (calculated as CU300) against the gross carrying amount of the loan, reducing it to CU700, and a modification loss of CU300 in surplus or deficit.

- IE70. Government A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan shall continue to be measured at an amount equal to lifetime expected credit losses. Government A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Government A determines that the loan is not credit-impaired at the reporting date but that credit risk has still significantly increased compared to the credit risk at initial recognition and continues to measure the loss allowance at an amount equal to lifetime expected credit losses. The loss allowance balance for lifetime expected credit losses is CU100 at the reporting date.

Period	Beginning gross carrying amount	Impairment (loss)/gain	Modification (loss)/gain	Interest revenue	Cash flows	Ending gross carrying amount	Loss allowance	Ending amortised cost amount
	A	B	C	D Gross: $A \times 5\%$	E	$F = A + C + D - E$	G	$H = F - G$
1	CU1,000	(CU20)		CU50	CU50	CU1,000	CU20	CU980
2	CU1,000	(CU10)		CU50	CU50	CU1,000	CU30	CU970
3	CU1,000	(CU70)	(CU300)	CU50	CU50	CU700	CU100	CU600

- IE71. At each subsequent reporting date, Government A evaluates whether there is a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows), in accordance with paragraph 82 of [draft] IPSAS [X] (ED 62).
- IE72. Two reporting periods after the loan modification (Period 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Government A adjusts the borrower's internal credit rating at the end of the reporting period.
- IE73. Given the positive overall development, Government A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Government A once again measures the loss allowance at an amount equal to 12-month expected credit losses.

Example 12—Provision Matrix

- IE74. Municipality M provides water delivery services for households within its jurisdiction. Households are invoiced on a monthly basis based on the water consumed during the period. This represents a portfolio of trade receivables of CU30 million in 20X1 for Municipality M. The portfolio consists of a large number of households with small balances outstanding. The trade receivables are categorized by common risk characteristics that are representative of the households' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component. In accordance with paragraph 85 of [draft] IPSAS [X] (ED 62)

the loss allowance for such trade receivables is always measured at an amount equal to lifetime time expected credit losses.

IE75. To determine the expected credit losses for the portfolio, Municipality M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analyzed. In this case it is forecast that economic conditions will deteriorate over the next year.

IE76. On that basis, Municipality M estimates the following provision matrix:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

IE77. The trade receivables from the large number of households amount to CU30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	CU15,000,000	CU45,000
1–30 days past due	CU7,500,000	CU120,000
31–60 days past due	CU4,000,000	CU144,000
61–90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	CU580,000

Example 13—Debt Instrument Measured at Fair Value Through Net Assets/Equity

IE78. Public Investment Fund A purchases a debt instrument with a fair value of CU1,000 on 15 December 20X0 and measures the debt instrument at fair value through net assets/equity. The instrument has an interest rate of 5 per cent over the contractual term of 10 years, and has a 5 per cent effective interest rate. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired.

	Debit	Credit
Financial asset—Fair Value Through Net Assets/Equity	CU1,000	

	Debit	Credit
Cash		CU1,000
<i>(To recognize the debt instrument measured at its fair value)</i>		

- IE79. On 31 December 20X0 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that expected credit losses should be measured at an amount equal to 12-month expected credit losses, which amounts to CU30. For simplicity, journal entries for the receipt of interest revenue are not provided.

	Debit	Credit
Impairment loss (surplus or deficit)	CU30	
Net Assets/Equity ^(a)	CU20	
Financial asset—Fair Value Through Net Assets/Equity		CU50
<i>(To recognize 12-month expected credit losses and other fair value changes on the debt instrument)</i>		
(a) The cumulative loss in net assets/equity at the reporting date was CU20. That amount consists of the total fair value change of CU50 (i.e. CU1,000 – CU950) offset by the change in the accumulated impairment amount representing 12-month expected credit losses that was recognized (CU30).		

- IE80. Disclosure would be provided about the accumulated impairment amount of CU30.
- IE81. On 1 January 20X1, the entity decides to sell the debt instrument for CU950, which is its fair value at that date.

	Debit	Credit
Cash	CU950	
Financial asset—Fair Value Through Net Assets/Equity		CU950
Loss (surplus or deficit)	CU20	
Net Assets/Equity		CU20
<i>(To derecognize the fair value through net assets/equity asset and recycle amounts accumulated in net assets/equity to surplus or deficit)</i>		

Example 14—Interaction Between the Fair Value Through Net Assets/Equity Measurement Category and Foreign Currency Denomination, Fair Value Hedge Accounting and Impairment

- IE82. This example illustrates the accounting relating to a debt instrument denominated in a foreign currency, measured at fair value through net assets/equity and designated in a fair value hedge accounting relationship. The example illustrates the interaction with accounting for impairment.
- IE83. An entity purchases a debt instrument (a bond) denominated in a foreign currency (FC) for its fair value of FC100,000 on 1 January 20X0 and classifies the bond as measured at fair value through net assets/equity. The bond has five years remaining to maturity and a fixed coupon of 5 per cent over its contractual life on the contractual par amount of FC100,000. On initial recognition the bond has a 5 per cent effective interest rate. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1 on 1 January 20X0. At initial recognition the entity determines that the bond is not purchased or originated credit-impaired. In addition, as at 1 January 20X0 the 12-month expected credit losses are determined to be FC1,200. Its amortized cost in FC as at 1 January 20X0 is equal to its gross carrying amount of FC100,000 less the 12-month expected credit losses (FC100,000—FC1,200).
- IE84. The entity has the following risk exposures:
- (a) Fair value interest rate risk in FC: the exposure that arises as a result of purchasing a fixed interest rate instrument; and
 - (b) Foreign exchange risk: the exposure to changes in foreign exchange rates measured in LC.
- IE85. The entity hedges its risk exposures using the following risk management strategy:
- (a) For fixed interest rate risk (in FC) the entity decides to link its interest receipts in FC to current variable interest rates in FC. Consequently, the entity uses interest rate swaps denominated in FC under which it pays fixed interest and receives variable interest in FC; and
 - (b) For foreign exchange risk the entity decides not to hedge against any variability in LC arising from changes in foreign exchange rates.
- IE86. The entity designates the following hedge relationship:¹³ a fair value hedge of the bond in FC as the hedged item with changes in benchmark interest rate risk in FC as the hedged risk. The entity enters into an on-market swap that pays fixed and receives variable interest on the same day and designates the swap as the hedging instrument. The tenor of the swap matches that of the hedged item (i.e. five years).
- IE87. For simplicity, in this example it is assumed that no hedge ineffectiveness arises in the hedge accounting relationship. This is because of the assumptions made in order to better focus on illustrating the accounting mechanics in a situation that entails measurement at fair value through net assets/equity of a foreign currency financial instrument that is designated in a fair value hedge relationship, and also to focus on the recognition of impairment gains or losses on such an instrument.
- IE88. The entity makes the following journal entries to recognize the bond and the swap on 1 January 20X0:

¹³ This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 126 of [draft] IPSAS [X] (ED 62)). The following description of the designation is solely for the purpose of understanding this example (i.e. it is not an example of the complete formal documentation required in accordance with paragraph 126 of [draft] IPSAS [X] (ED 62)).

	Debit LC	Credit LC
Financial asset—Fair Value Through Net Assets/Equity	100,000	
Cash		100,000
<i>(To recognize the bond at its fair value)</i>		
Impairment loss (surplus or deficit)	1,200	
Net Assets/Equity		1,200
<i>(To recognize the 12-month expected credit losses)^(a)</i>		
Swap	—	
Cash		—
<i>(To recognize the swap at its fair value)</i>		
(a) In case of items measured in the functional currency of an entity the journal entry recognizing expected credit losses will usually be made at the reporting date.		

- IE89. As of 31 December 20X0 (the reporting date), the fair value of the bond decreased from FC100,000 to FC96,370 because of an increase in market interest rates. The fair value of the swap increased to FC1,837. In addition, as at 31 December 20X0 the entity determines that there has been no change to the credit risk on the bond since initial recognition and continues to carry a loss allowance for 12-month expected credit losses at FC1,200.¹⁴ As at 31 December 20X0, the exchange rate is FC1 to LC1.4. This is reflected in the following table:

	1 January 20X0	31 December 20X0
Bond		
Fair value (FC)	100,000	96,370
Fair value (LC)	100,000	134,918
Amortised cost (FC)	98,800	98,800
Amortised cost (LC)	98,800	138,320
Interest rate swap		
Interest rate swap (FC)	—	1,837

¹⁴ For the purposes of simplicity the example ignores the impact of discounting when computing expected credit losses.

	1 January 20X0	31 December 20X0
Interest rate swap (LC)	—	2,572
Impairment – loss allowance		
Loss allowance (FC)	1,200	1,200
Loss allowance (LC)	1,200	1,680
FX rate (FC:LC)	1:1	1:1.4

- IE90. The bond is a monetary asset. Consequently, the entity recognizes the changes arising from movements in foreign exchange rates in surplus or deficit in accordance with paragraphs 27(a) and 32 of IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* and recognizes other changes in accordance with [draft] IPSAS [X] (ED 62). For the purposes of applying paragraph 32 of IPSAS 4 the asset is treated as an asset measured at amortized cost in the foreign currency.
- IE91. As shown in the table, on 31 December 20X0 the fair value of the bond is LC134,918 (FC96,370 × 1.4) and its amortized cost is LC138,320 (FC(100,000–1,200) × 1.4).
- IE92. The gain recognized in surplus or deficit that is due to the changes in foreign exchange rates is LC39,520 (LC138,320 – LC98,800), i.e. the change in the amortized cost of the bond during 20X0 in LC. The change in the fair value of the bond in LC, which amounts to LC34,918, is recognized as an adjustment to the carrying amount. The difference between the fair value of the bond and its amortized cost in LC is LC3,402 (LC134,918 – LC138,320). However, the change in the cumulative gain or loss recognized in net assets/equity during 20X0 as a reduction is LC 4,602 (LC3,402 + LC1,200).
- IE93. A gain of LC2,572 (FC1,837 × 1.4) on the swap is recognized in surplus or deficit and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from net assets/equity in the same period. For simplicity, journal entries for the recognition of interest revenue are not provided. It is assumed that interest accrued is received in the period.
- IE94. The entity makes the following journal entries on 31 December 20X0:

	Debit LC	Credit LC
Financial asset—Fair Value Through Net Assets/Equity	34,918	
Net Assets/Equity	4,602	
Surplus or deficit		39,520
<i>(To recognize the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)</i>		

	Debit LC	Credit LC
Swap	2,572	
Surplus or deficit		2,572
<i>(To remeasure the swap at fair value)</i>		
Surplus or deficit	2,572	
Net Assets/Equity		2,572
<i>(To recognize in surplus or deficit the change in fair value of the bond due to a change in the hedged risk)</i>		

- IE95. In accordance with paragraph 20A of IPSAS 30, the loss allowance for financial assets measured at fair value through net assets/equity is not presented separately as a reduction of the carrying amount of the financial asset. However, disclosure would be provided about the accumulated impairment amount recognized in net assets/equity.
- IE96. As at 31 December 20X1 (the reporting date), the fair value of the bond decreased to FC87,114 because of an increase in market interest rates and an increase in the credit risk of the bond. The fair value of the swap increased by FC255 to FC2,092. In addition, as at 31 December 20X1 the entity determines that there has been a significant increase in credit risk on the bond since initial recognition, so a loss allowance at an amount equal to lifetime expected credit losses is recognized.¹⁵ The estimate of lifetime expected credit losses as at 31 December 20X1 is FC9,700. As at 31 December 20X1, the exchange rate is FC1 to LC1.25. This is reflected in the following table:

	31 December 20X0	31 December 20X1
Bond		
Fair value (FC)	96,370	87,114
Fair value (LC)	134,918	108,893
Amortised cost (FC)	98,800	90,300
Amortised cost (LC)	138,320	112,875
Interest rate swap		
Interest rate swap (FC)	1,837	2,092

¹⁵ For simplicity this example assumes that credit risk does not dominate the fair value hedge relationship.

	31 December 20X0	31 December 20X1
Interest rate swap (LC)	2,572	2,615
Impairment – loss allowance		
Loss allowance (FC)	1,200	9,700
Loss allowance (LC)	1,680	12,125
FX rate (FC:LC)	1:1.4	1:1.25

- IE97. As shown in the table, as at 31 December 20X1 the fair value of the bond is LC108,893 (FC87,114 × 1.25) and its amortized cost is LC112,875 (FC(100,000 – 9,700) × 1.25).
- IE98. The lifetime expected credit losses on the bond are measured as FC9,700 as of 31 December 20X1. Thus the impairment loss recognized in surplus or deficit in LC is LC10,625 (FC(9,700 – 1,200) × 1.25).
- IE99. The loss recognized in surplus or deficit because of the changes in foreign exchange rates is LC14,820 (LC112,875 – LC138,320 + LC10,625), which is the change in the gross carrying amount of the bond on the basis of amortized cost during 20X1 in LC, adjusted for the impairment loss. The difference between the fair value of the bond and its amortized cost in the functional currency of the entity on 31 December 20X1 is LC3,982 (LC108,893 – LC112,875). However, the change in the cumulative gain or loss recognized in net assets/equity during 20X1 as a reduction in net assets/equity is LC11,205 (LC3,982 – LC3,402 + LC10,625).
- IE100. A gain of LC43 (LC2,615 – LC2,572) on the swap is recognized in surplus or deficit and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from net assets/equity in the same period.
- IE101. The entity makes the following journal entries on 31 December 20X1:

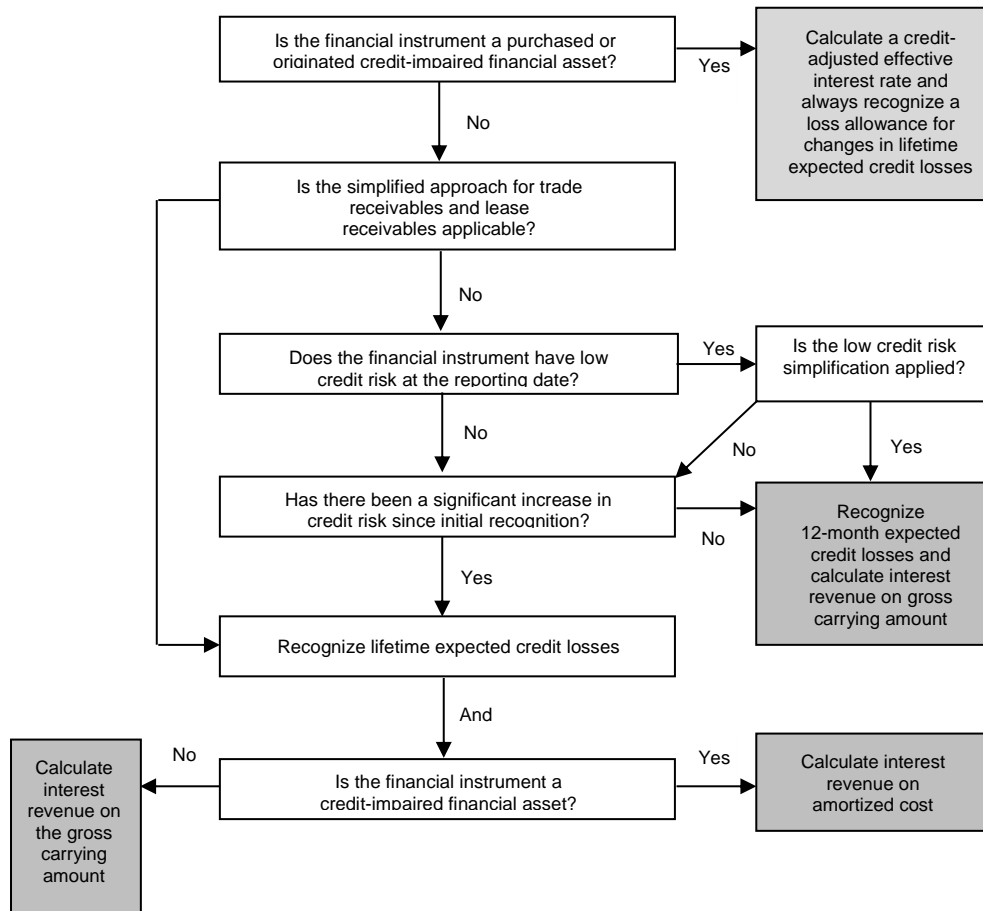
	Debit LC	Credit LC
Financial asset—Fair Value Through Net Assets/Equity		26,025
Net Assets/Equity	11,205	
Surplus or deficit	14,820	
<i>(To recognize the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)</i>		
Swap	43	
Surplus or deficit		43

	Debit LC	Credit LC
<i>(To remeasure the swap at fair value)</i>		
Surplus or deficit	43	
Net Assets/Equity		43
<i>(To recognize in surplus or deficit the change in fair value of the bond due to a change in the hedged risk)</i>		
Surplus or deficit (impairment loss)	10,625	
Net Assets/Equity (accumulated impairment amount)		10,625
<i>(To recognize lifetime expected credit losses)</i>		

- IE102. On 1 January 20X2, the entity decides to sell the bond for FC 87,114, which is its fair value at that date and also closes out the swap at fair value. The foreign exchange rate is the same as at 31 December 20X1. The journal entries to derecognize the bond and reclassify the gains and losses that have accumulated in net assets/equity would be as follows:

	Debit LC	Credit LC
Cash	108,893	
Financial asset—Fair Value Through Net Assets/Equity		108,893
Loss on sale (surplus or deficit)	1,367 ^(a)	
Net Assets/Equity		1,367
<i>(To derecognize the bond)</i>		
Swap		2,615
Cash	2,615	
<i>(To close out the swap)</i>		
(a) This amount consists of the changes in fair value of the bond, the accumulated impairment amount and the changes in foreign exchange rates recognized in net assets/equity (LC2,572 + LC1,200 + LC43 + LC10,625 – LC4,602 – LC11,205 = -LC1,367, which is recycled as a loss in surplus or deficit).		

Application of the Impairment Requirements on a Reporting Date



Reclassification of Financial Assets (Paragraphs 91-97)

IE103. This example illustrates the accounting requirements for the reclassification of financial assets between measurement categories in accordance with paragraphs 91-97 of [draft] IPSAS [X] (ED 62). The example illustrates the interaction with the impairment requirements in paragraphs 71-90 of [draft] IPSAS [X] (ED 62).

Example 15—Reclassification of Financial Assets

IE104. An entity purchases a portfolio of bonds for its fair value (gross carrying amount) of CU500,000.

IE105. The entity changes the management model for managing the bonds in accordance with paragraph 54 of [draft] IPSAS [X] (ED 62). The fair value of the portfolio of bonds at the reclassification date is CU490,000.

IE106. If the portfolio was measured at amortized cost or at fair value through net assets/equity immediately prior to reclassification, the loss allowance recognized at the date of reclassification

would be CU6,000 (reflecting a significant increase in credit risk since initial recognition and thus the measurement of lifetime expected credit losses).

IE107. The 12-month expected credit losses at the reclassification date are CU4,000.

IE108. For simplicity, journal entries for the recognition of interest revenue are not provided.

Scenario 1: Reclassification Out of the Amortized Cost Measurement Category and into the Fair Value Through Surplus or Deficit Measurement Category

IE109. Department of Treasury A reclassifies the portfolio of bonds out of the amortized cost measurement category and into the fair value through surplus or deficit measurement category. At the reclassification date, the portfolio of bonds is measured at fair value. Any gain or loss arising from a difference between the previous amortized cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognized in surplus or deficit on reclassification.

	Debit	Credit
Bonds (Fair Value Through Surplus or Deficit assets)	CU490,000	
Bonds (gross carrying amount of the amortized cost assets)		CU500,000
Loss allowance	CU6,000	
Reclassification loss (surplus or deficit)	CU4,000	
<i>(To recognize the reclassification of bonds from amortized cost to fair value through surplus or deficit and to derecognize the loss allowance.)</i>		

Scenario 2: Reclassification Out of the Fair Value Through Surplus or Deficit Measurement Category and into the Amortized Cost Measurement Category

IE110. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through surplus or deficit measurement category and into the amortized cost measurement category. At the reclassification date, the fair value of the portfolio of bonds becomes the new gross carrying amount and the effective interest rate is determined based on that gross carrying amount. The impairment requirements apply to the bond from the reclassification date. For the purposes of recognizing expected credit losses, the credit risk of the portfolio of bonds at the reclassification date becomes the credit risk against which future changes in credit risk shall be compared.

	Debit	Credit
Bonds (gross carrying amount of the amortized cost assets)	CU490,000	
Bonds (Fair Value Through Surplus or Deficit assets)		CU490,000
Impairment loss (surplus or deficit)	CU4,000	
Loss allowance		CU4,000

	Debit	Credit
<i>(To recognize reclassification of bonds from fair value through surplus or deficit to amortized cost including commencing accounting for impairment.)</i>		

Scenario 3: Reclassification Out of the Amortized Cost Measurement Category and into the Fair Value Through Net Assets/Equity Measurement Category

IE111. Department of Treasury A reclassifies the portfolio of bonds out of the amortized cost measurement category and into the fair value through net assets/equity measurement category. At the reclassification date, the portfolio of bonds is measured at fair value. Any gain or loss arising from a difference between the previous amortized cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognized in net assets/equity. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. The credit risk at initial recognition continues to be used to assess changes in credit risk. From the reclassification date the loss allowance ceases to be recognized as an adjustment to the gross carrying amount of the bond and is recognized as an accumulated impairment amount, which would be disclosed.

	Debit	Credit
Bonds (Fair Value Through Net Assets/Equity assets)	CU490,000	
Bonds (gross carrying amount of amortized cost assets)		CU500,000
Loss allowance	CU6,000	
Net Assets/Equity ^(a)	CU4,000	
<i>(To recognize the reclassification from amortized cost to fair value through net assets/equity. The measurement of expected credit losses is however unchanged.)</i>		
(a) For simplicity, the amount related to impairment is not shown separately. If it had been, this journal entry (i.e. DR CU4,000) would be split into the following two entries: DR Net Assets/Equity CU10,000 (fair value changes) and CR Net Assets/Equity CU6,000 (accumulated impairment amount).		

Scenario 4: Reclassification Out of the Fair Value Through Net Assets/Equity Measurement Category and into the Amortized Cost Measurement Category

IE112. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through net assets/equity measurement category and into the amortized cost measurement category. The portfolio of bonds is reclassified at fair value. However, at the reclassification date, the cumulative gain or loss previously recognized in net assets/equity is removed from net assets/equity and adjusted against the fair value of the portfolio of bonds. As a result, the portfolio of bonds is measured at the reclassification date as if it had always been measured at amortized cost. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. The credit risk at initial recognition continues to be used to assess changes in the credit risk on the bonds. The loss allowance is recognized as an adjustment to the gross carrying amount of the bond (to reflect the amortized cost amount) from the reclassification date.

	Debit	Credit
Bonds (gross carrying value of the amortized cost assets)	CU490,000	
Bonds (Fair Value Through Net Assets/Equity assets)		CU490,000
Bonds (gross carrying value of the amortized cost assets)	CU10,000	
Loss allowance		CU6,000
Net Assets/Equity ^(a)		CU4,000
<i>(To recognize the reclassification from fair value through net assets/equity to amortized cost including the recognition of the loss allowance deducted to determine the amortized cost amount. The measurement of expected credit losses is however unchanged.)</i>		
(a) The cumulative loss in net assets/equity at the reclassification date was CU4,000. That amount consists of the total fair value change of CU10,000 (i.e. CU500,000 – 490,000) offset by the accumulated impairment amount recognized (CU6,000) while the assets were measured at fair value through net assets/equity.		

Scenario 5: Reclassification Out of the Fair Value Through Surplus or Deficit Measurement Category and into the Fair Value Through Net Assets/Equity Measurement Category

IE113. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through surplus or deficit measurement category and into the fair value through net assets/equity measurement category. The portfolio of bonds continues to be measured at fair value. However, for the purposes of applying the effective interest method, the fair value of the portfolio of bonds at the reclassification date becomes the new gross carrying amount and the effective interest rate is determined based on that new gross carrying amount. The impairment requirements apply from the reclassification date. For the purposes of recognizing expected credit losses, the credit risk of the portfolio of bonds at the reclassification date becomes the credit risk against which future changes in credit risk shall be compared.

	Debit	Credit
Bonds (Fair Value Through Net Assets/Equity assets)	CU490,000	
Bonds (Fair Value Through Surplus or Deficit assets)		CU490,000
Impairment loss (surplus or deficit)	CU4,000	
Net Assets/Equity		CU4,000
<i>(To recognize the reclassification of bonds from fair value through surplus or deficit to fair value through net assets/equity including commencing accounting for impairment. The net assets/equity amount reflects the loss allowance at the date of reclassification (an accumulated impairment amount relevant for disclosure purposes) of CU4,000.)</i>		

Scenario 6: Reclassification Out of the Fair Value Through Net Assets/Equity Measurement Category and into the Fair Value Through Surplus or Deficit Measurement Category

IE114. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through net assets/equity measurement category and into the fair value through surplus or deficit

measurement category. The portfolio of bonds continues to be measured at fair value. However, the cumulative gain or loss previously recognized in net assets/equity is reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see IPSAS 1 *Presentation of Financial Statements*).

	Debit	Credit
Bonds (Fair Value Through Surplus or Deficit assets)	CU490,000	
Bonds (Fair Value Through Net Assets/Equity assets)		CU490,000
Reclassification loss (surplus or deficit)	CU4,000	
Net Assets/Equity ^(a)		CU4,000
<i>(To recognize the reclassification of bonds from fair value through net assets/equity to fair value through surplus or deficit.)</i>		
^(a) The cumulative loss in net assets/equity at the reclassification date was CU4,000. That amount consists of the total fair value change of CU10,000 (i.e. CU500,000 – 490,000) offset by the loss allowance that was recognized (CU6,000) while the assets were measured at fair value through net assets/equity.		

Hedge Accounting for Aggregated Exposures

IE115. The following examples illustrate the mechanics of hedge accounting for aggregated exposures.

Example 16—Combined Commodity Price Risk and Foreign Currency Risk Hedge (Cash Flow Hedge/Cash Flow Hedge Combination)

Fact Pattern

IE116. Municipality A wants to hedge a highly probable forecast electricity purchase (which is expected to occur at the end of Period 5). Entity A's functional currency is its Local Currency (LC). Electricity is traded in Foreign Currency (FC). Entity A has the following risk exposures:

- (a) Commodity price risk: the variability in cash flows for the purchase price, which results from fluctuations of the spot price of electricity in FC; and
- (b) Foreign currency (FX) risk: the variability in cash flows that result from fluctuations of the spot exchange rate between LC and FC.

IE117. Municipality A hedges its risk exposures using the following risk management strategy:

- (a) Municipality A uses benchmark commodity forward contracts, which are denominated in FC, to hedge its electricity purchases four periods before delivery. The electricity price that Municipality A actually pays for its purchase is different from the benchmark price because of differences in the type of electricity, the location and delivery arrangement.¹⁶ This gives rise to the risk of changes in the relationship between the two electricity prices (sometimes referred to as 'basis risk'), which affects the effectiveness of the hedging relationship.

¹⁶ For the purpose of this example it is assumed that the hedged risk is not designated based on a benchmark electricity price risk component. Consequently, the entire electricity price risk is hedged.

Municipality A does not hedge this risk because it is not considered economical under cost/benefit considerations.

- (b) Municipality A also hedges its FX risk. However, the FX risk is hedged over a different horizon—only three periods before delivery. Municipality A considers the FX exposure from the variable payments for the electricity purchase in FC and the gain or loss on the commodity forward contract in FC as one aggregated FX exposure. Hence, Municipality A uses one single FX forward contract to hedge the FX cash flows from a forecast electricity purchase and the related commodity forward contract.

IE118. The following table sets out the parameters used for Example 16 (the ‘basis spread’ is the differential, expressed as a percentage, between the price of the electricity that Municipality A actually buys and the price for the benchmark electricity):

Example 16—Parameters					
Period	1	2	3	4	5
Interest rates for remaining maturity [FC]	0.26%	0.21%	0.16%	0.06%	0.00%
Interest rates for remaining maturity [LC]	1.12%	0.82%	0.46%	0.26%	0.00%
Forward price [FC/MWh]	1.25	1.01	1.43	1.22	2.15
Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
FX rate (spot) [FC/LC]	1.3800	1.3300	1.4100	1.4600	1.4300

Accounting Mechanics

IE119. Municipality A designates as cash flow hedges the following two hedging relationships:¹⁷

- (a) A commodity price risk hedging relationship between the electricity price related variability in cash flows attributable to the forecast electricity purchase in FC as the hedged item and a commodity forward contract denominated in FC as the hedging instrument (the ‘first level relationship’). This hedging relationship is designated at the end of Period 1 with a term to the end of Period 5. Because of the basis spread between the price of the electricity that Municipality A actually buys and the price for the benchmark electricity, Municipality A

¹⁷ This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 126 of [draft] IPSAS [X] (ED 62)). The following description of the designation is solely for the purpose of understanding this example (i.e. it is not an example of the complete formal documentation required in accordance with paragraph 126(b) of [draft] IPSAS [X] (ED 62)).

designates a volume of 112,500 MWh of electricity as the hedging instrument and a volume of 118,421 MWh as the hedged item.¹⁸

- (b) An FX risk hedging relationship between the aggregated exposure as the hedged item and an FX forward contract as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 2 with a term to the end of Period 5. The aggregated exposure that is designated as the hedged item represents the FX risk that is the effect of exchange rate changes, compared to the forward FX rate at the end of Period 2 (i.e. the time of designation of the FX risk hedging relationship), on the combined FX cash flows in FC of the two items designated in the commodity price risk hedging relationship, which are the forecast electricity purchase and the commodity forward contract. Municipality A's long-term view of the basis spread between the price of the electricity that it actually buys and the price for the benchmark electricity has not changed from the end of Period 1. Consequently, the actual volume of hedging instrument that Municipality A enters into (the nominal amount of the FX forward contract of FC140,625) reflects the cash flow exposure associated with a basis spread that had remained at -5 per cent. However, Municipality A's actual aggregated exposure is affected by changes in the basis spread. Because the basis spread has moved from -5 per cent to -5.5 per cent during Period 2, Municipality A's actual aggregated exposure at the end of Period 2 is FC140,027.

IE120. The following table sets out the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserves and hedge ineffectiveness:¹⁹

Example 16—Calculations							
	Period	1	2	3	4	5	
Commodity Price Risk Hedging Relationship (First Level Relationship)							
<i>Forward purchase contract for electricity</i>							
Volume (MWh)	112,500						
Forward price [FC/MWh]	1.25	Price (fwd) [FC/MWh]	1.25	1.01	1.43	1.22	2.15
	Fair value [FC]	0	(26,943)	20,219	(3,373)	101,250	
	Fair value [LC]	0	(20,258)	14,339	(2,310)	70,804	
	Change in fair value [LC]		(20,258)	34,598	(16,650)	73,114	

¹⁸ In this example, the current basis spread at the time of designation is coincidentally the same as Municipality A's long-term view of the basis spread (-5 per cent) that determines the volume of electricity purchases that it actually hedges. Also, this example assumes that Municipality A designates the hedging instrument in its entirety and designates as much of its highly probable forecast purchases as it regards as hedged. That results in a hedge ratio of 1/(100%-5%). Other entities might follow different approaches when determining what volume of their exposure they actually hedge, which can result in a different hedge ratio and also designating less than a hedging instrument in its entirety (see paragraph 126 of [draft] IPSAS [X] (ED 62)).

¹⁹ In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities, net assets/equity and surplus or deficit) are in the format of positive (plus) and negative (minus) numbers (e.g. a surplus or deficit amount that is a negative number is a loss).

Example 16—Calculations			Period	1	2	3	4	5
<i>Hedged Forecast Electricity Purchase</i>								
Hedge ratio	105.26%	Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%	
Hedged volume	118,421	Price (fwd) [FC/MWh]	1.19	0.95	1.34	1.18	2.00	
Implied forward price	1.1875	Present value [FC]	0	27,540	(18,528)	1,063	(96,158)	
		Present value [LC]	0	20,707	(13,140)	728	(67,243)	
		Change in present value [LC]		20,707	(33,847)	13,868	(67,971)	
<i>Accounting</i>			<i>LC</i>	<i>LC</i>	<i>LC</i>	<i>LC</i>	<i>LC</i>	
Derivative			0	(20,258)	14,339	(2,310)	70,804	
Cash flow hedge reserve			0	(20,258)	13,140	(728)	67,243	
Change in cash flow hedge reserve				(20,258)	33,399	(13,868)	67,971	
Surplus or deficit				0	1,199	(2,781)	5,143	
Accumulated surplus or deficit			0	0	1,199	(1,582)	3,561	
FX Risk Hedging Relationship (Second Level Relationship)								
FX rate [FC/LC]		Spot	1.3800	1.3300	1.4100	1.4600	1.4300	
		Forward	1.3683	1.3220	1.4058	1.4571	1.4300	
<i>FX forward contract (Buy FC/Sell LC)</i>								
Volume [FC]	140,625							
Forward rate (in P ₂)	1.3220	Fair value [LC]		0	(6,313)	(9,840)	(8,035)	
		Change in fair value [LC]			(6,313)	(3,528)	1,805	
<i>Hedged FX risk</i>								
Aggregated FX exposure		Hedged volume [FC]		140,027	138,932	142,937	135,533	
		Present value [LC]		0	6,237	10,002	7,744	
		Change in present value [LC]			6,237	3,765	(2,258)	

Example 16—Calculations						
	Period	1	2	3	4	5
Accounting			LC	LC	LC	LC
Derivative			0	(6,313)	(9,840)	(8,035)
Cash flow hedge reserve			0	(6,237)	(9,840)	(7,744)
Change in cash flow hedge reserve				(6,237)	(3,604)	2,096
Surplus or deficit				(76)	76	(291)
Accumulated surplus or deficit			0	(76)	0	(291)

IE121. The commodity price risk hedging relationship is a cash flow hedge of a highly probable forecast transaction that starts at the end of Period 1 and remains in place when the FX risk hedging relationship starts at the end of Period 2, i.e. the first level relationship continues as a separate hedging relationship.

IE122. The volume of the aggregated FX exposure (in FC), which is the hedged volume of the FX risk hedging relationship, is the total of:²⁰

- (a) The hedged electricity purchase volume multiplied by the current forward price (this represents the expected spot price of the actual electricity purchase); and
- (b) The volume of the hedging instrument (designated nominal amount) multiplied by the difference between the contractual forward rate and the current forward rate (this represents the expected price differential from benchmark electricity price movements in FC that Municipality A will receive or pay under the commodity forward contract).

IE123. The present value (in LC) of the hedged item of the FX risk hedging relationship (i.e. the aggregated exposure) is calculated as the hedged volume (in FC) multiplied by the difference between the forward FX rate at the measurement date and the forward FX rate at the designation date of the hedging relationship (i.e. the end of Period 2).²¹

IE124. Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 137 of [draft] IPSAS [X] (ED 62)).

²⁰ For example, at the end of Period 3 the aggregated FX exposure is determined as: 118,421 MWh × 1.34 FC/MWh = FC159,182 for the expected price of the actual electricity purchase and 112,500 MWh × (1.25 [FC/ MWh] – 1.43 [FC/ MWh]) = FC(20,250) for the expected price differential under the commodity forward contract, which gives a total of FC138,932—the volume of the aggregated FX exposure at the end of Period 3.

²¹ For example, at the end of Period 3 the present value of the hedged item is determined as the volume of the aggregated exposure at the end of Period 3 (FC138,932) multiplied by the difference between the forward FX rate at the end of Period 3 (1/1.4058) and the forward FX rate and the time of designation (i.e. the end of Period 2: 1/1.3220) and then discounted using the interest rate (in LC) at the end of Period 3 with a term of 2 periods (i.e. until the end of Period 5 – 0.46%). The calculation is: FC138,932 × (1/(1.4058[FC/LC]) – 1/(1.3220 [FC/LC]))/(1 + 0.46%) = LC6,237.

IE125. The following table shows the effect on Municipality A's statement financial performance and its statement of financial position (for the sake of transparency the line items²² are disaggregated on the face of the statements by the two hedging relationships, i.e. for the commodity price risk hedging relationship and the FX risk hedging relationship):

Example 16—Overview of Effect on Statements of Financial Performance and Financial Position <i>[All amounts in LC]</i>					
Period	1	2	3	4	5
Statement of financial performance					
Hedge ineffectiveness					
Commodity hedge		0	(1,199)	2,781	(5,143)
FX hedge		0	76	(76)	291
Surplus or deficit	0	0	(1,123)	2,705	(4,852)
Statement of changes in net assets/equity					
Net assets/equity					
Commodity hedge		20,258	(33,399)	13,868	(67,971)
FX hedge		0	6,237	3,604	(2,096)
Total net assets/equity	0	20,258	(27,162)	17,472	(70,067)
Statement of financial position					
Commodity forward	0	(20,258)	14,339	(2,310)	70,804
FX forward		0	(6,313)	(9,840)	(8,035)
Total net assets	0	(20,258)	8,027	(12,150)	62,769
<i>Net assets/equity</i>					
Net assets/equity					
Commodity hedge	0	20,258	(13,140)	728	(67,243)
FX hedge		0	6,237	9,840	7,744
	0	20,258	(6,904)	10,568	(59,499)
Accumulated surplus or deficit					
Commodity hedge	0	0	(1,199)	1,582	(3,561)
FX hedge		0	76	0	291

²² The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IPSAS 30 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

Example 16—Overview of Effect on Statements of Financial Performance and Financial Position*[All amounts in LC]*

Period	1	2	3	4	5
	0	0	(1,123)	1,582	(3,270)
Total net assets/equity	0	20,258	(8,027)	12,150	(62,769)

IE126. The total cost of inventory after hedging is as follows:²³

<i>Cost of inventory [all amounts in LC]</i>	
Cash price (at spot for commodity price risk and FX risk)	165,582
Gain/loss from CFHR for commodity price risk	(67,243)
Gain/loss from CFHR for FX risk	7,744
Cost of inventory	106,083

IE127. The total overall cash flow from all transactions (the actual electricity purchase at the spot price and the settlement of the two derivatives) is LC102,813. It differs from the hedge adjusted cost of inventory by LC3,270, which is the net amount of cumulative hedge ineffectiveness from the two hedging relationships. This hedge ineffectiveness has a cash flow effect but is excluded from the measurement of the inventory.

Example 17—Combined Interest Rate Risk and Foreign Currency Risk Hedge (Fair Value Hedge/Cash Flow Hedge Combination)

Fact Pattern

IE128. State Government B wants to hedge a fixed rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of Period 4. State Government B's functional currency is its Local Currency (LC). State Government B has the following risk exposures:

- (a) Fair value interest rate risk and FX risk: the changes in fair value of the fixed rate liability attributable to interest rate changes, measured in LC.
- (b) Cash flow interest rate risk: the exposure that arises as a result of swapping the combined fair value interest rate risk and FX risk exposure associated with the fixed rate liability (see (a) above) into a variable rate exposure in LC in accordance with State Government B's risk management strategy for FC denominated fixed rate liabilities (see paragraph IE129(a) below).

IE129. State Government B hedges its risk exposures using the following risk management strategy:

²³ 'CFHR' is the cash flow hedge reserve, i.e. the amount accumulated in net assets/equity for a cash flow hedge.

- (a) State Government B uses cross-currency interest rate swaps to swap its FC denominated fixed rate liabilities into a variable rate exposure in LC. State Government B hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, State Government B enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap State Government B receives fixed interest in FC (used to pay the interest on the liability) and pays variable interest in LC.
- (b) State Government B considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated variable rate exposure in LC. From time to time, in accordance with its risk management strategy for variable rate interest rate risk (in LC), State Government B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC. State Government B seeks to obtain as a fixed rate exposure a single blended fixed coupon rate (i.e. the uniform forward coupon rate for the hedged term that exists at the start of the hedging relationship).²⁴ Consequently, State Government B uses interest rate swaps (denominated entirely in LC) under which it receives variable interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays fixed interest.

IE130. The following table sets out the parameters used for Example 17:

Example 17—Parameters					
	to	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2000	1.0500	1.4200	1.5100	1.3700
Interest curves (vertical presentation of rates for each quarter of a period on a p.a. basis)					
LC	2.50%	5.02%	6.18%	0.34%	[N/A]
	2.75%	5.19%	6.26%	0.49%	
	2.91%	5.47%	6.37%	0.94%	
	3.02%	5.52%	6.56%	1.36%	
	2.98%	5.81%	6.74%		
	3.05%	5.85%	6.93%		
	3.11%	5.91%	7.19%		
	3.15%	6.06%	7.53%		
	3.11%	6.20%			

²⁴ An entity may have a different risk management strategy whereby it seeks to obtain a fixed rate exposure that is not a single blended rate but a series of forward rates that are each fixed for the respective individual interest period. For such a strategy the hedge effectiveness is measured based on the difference between the forward rates that existed at the start of the hedging relationship and the forward rates that exist at the effectiveness measurement date for the individual interest periods. For such a strategy a series of forward contracts corresponding with the individual interest periods would be more effective than an interest rate swap (that has a fixed payment leg with a single blended fixed rate).

Example 17—Parameters					
	t ₀	Period 1	Period 2	Period 3	Period 4
FC	3.14%	6.31%			
	3.27%	6.36%			
	3.21%	6.40%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				
	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

Accounting Mechanics

IE131. State Government B designates the following hedging relationships:²⁵

- (a) As a fair value hedge, a hedging relationship for fair value interest rate risk and FX risk between the FC denominated fixed rate liability (fixed rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the beginning of Period 1 (i.e. t_0) with a term to the end of Period 4.
- (b) As a cash flow hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 1, when State Government B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the variability in cash flows that is the effect of changes in the combined cash flows of the two items designated in the fair value hedge of the fair value interest rate risk and FX risk (see (a) above), compared to the interest rates at the end of Period 1 (i.e. the time of designation of the hedging relationship between the aggregated exposure and the interest rate swap).

IE132. The following table²⁶ sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve and hedge ineffectiveness.²⁷ In this example, hedge ineffectiveness arises on both hedging relationships.²⁸

Example 17—Calculations					
	t_0	Period 1	Period 2	Period 3	Period 4
Fixed rate FX liability					
Fair value [FC]	(1,000,000)	(995,522)	(1,031,008)	(1,030,193)	(1,000,000)
Fair value [LC]	(1,200,000)	(1,045,298)	(1,464,031)	(1,555,591)	(1,370,000)
Change in fair value [LC]		154,702	(418,733)	(91,560)	185,591

²⁵ This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 126 of [draft] IPSAS [X] (ED 62)). The following description of the designation is solely for the purpose of understanding this example (i.e. it is not an example of the complete formal documentation required in accordance with paragraph 126(b) of [draft] IPSAS [X] (ED 62)).

²⁶ Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

²⁷ In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and equity) are in the format of positive (plus) and negative (minus) numbers (e.g. an amount in the cash flow hedge reserve that is in brackets is a loss).

²⁸ For a situation such as in this example, hedge ineffectiveness can result from various factors, for example credit risk, differences in the day count method or, depending on whether it is included in the designation of the hedging instrument, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis').

Example 17—Calculations					
	t₀	Period 1	Period 2	Period 3	Period 4
CCIRS (receive fixed FC/pay variable LC)					
Fair value [LC]	0	(154,673)	264,116	355,553	170,000
Change in fair value [LC]		(154,673)	418,788	91,437	(185,553)
IRS (receive variable/pay fixed)					
Fair value [LC]		0	18,896	(58,767)	0
Change in fair value [LC]			18,896	(77,663)	(58,767)
CF variability of the aggregated exposure					
Present value [LC]		0	(18,824)	58,753	0
Change in present value [LC]			(18,824)	77,577	(58,753)
CFHR					
Balance (end of period) [LC]		0	18,824	(58,753)	0
Change [LC]			18,824	(77,577)	58,753

IE133. The hedging relationship between the fixed rate FX liability and the cross-currency interest rate swap starts at the beginning of Period 1 (i.e. t₀) and remains in place when the hedging relationship for the second level relationship starts at the end of Period 1, i.e. the first level relationship continues as a separate hedging relationship.

IE134. The cash flow variability of the aggregated exposure is calculated as follows:

- (a) At the point in time from which the cash flow variability of the aggregated exposure is hedged (i.e. the start of the second level relationship at the end of Period 1), all cash flows expected on the fixed rate FX liability and the cross-currency interest rate swap over the hedged term (i.e. until the end of Period 4) are mapped out and equated to a single blended fixed coupon rate so that the total present value (in LC) is nil. This calculation establishes the single blended fixed coupon rate (reference rate) that is used at subsequent dates as the reference point to measure the cash flow variability of the aggregated exposure since the start of the hedging relationship. This calculation is illustrated in the following table:

Example 17—Cash Flow Variability of the Aggregated Exposure (Calibration)

Variability in Cash Flows of the Aggregated Exposure									
		FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV
		CF(s)	PV	CF(s)	PV	CF(s)	PV	1,200,000 Nominal 5.6963% Rate 4 Frequency	
		[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	[LC]	[LC]
Period 1	Time								
	t ₀								
	t ₁								
	t ₂								
	t ₃								
	t ₄								
Period 2	t ₅	0	0	0	0	(14,771)	(14,591)	17,089	16,881
	t ₆	(20,426)	(19,977)	20,246	19,801	(15,271)	(14,896)	17,089	16,669
	t ₇	0	0	0	0	(16,076)	(15,473)	17,089	16,449
	t ₈	(20,426)	(19,543)	20,582	19,692	(16,241)	(15,424)	17,089	16,229
Period 3	t ₉	0	0	0	0	(17,060)	(15,974)	17,089	16,002
	t ₁₀	(20,426)	(19,148)	20,358	19,084	(17,182)	(15,862)	17,089	15,776
	t ₁₁	0	0	0	0	(17,359)	(15,797)	17,089	15,551
	t ₁₂	(20,426)	(18,769)	20,582	18,912	(17,778)	(15,942)	17,089	15,324
Period 4	t ₁₃	0	0	0	0	(18,188)	(16,066)	17,089	15,095
	t ₁₄	(20,426)	(18,391)	20,246	18,229	(18,502)	(16,095)	17,089	14,866
	t ₁₅	0	0	0	0	(18,646)	(15,972)	17,089	14,638
	t ₁₆	(1,020,426)	(899,695)	1,020,582	899,832	(1,218,767)	(1,027,908)	1,217,089	1,026,493
Totals			(995,522)		995,550		(1,200,000)		1,199,971
Totals in LC			(1,045,298)		1,045,327		(1,200,000)		1,199,971
PV of all CF(s) [LC]									
<div><div></div><div>0←Σ</div></div>									

Example 17—Cash Flow Variability of the Aggregated Exposure (Calibration)

Variability in Cash Flows of the Aggregated Exposure							
FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV
CF(s)	PV	CF(s)	PV	CF(s)	PV	1,200,000 Nominal 5.6963% Rate 4 Frequency	
[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	[LC]	[LC]

The nominal amount that is used for the calibration of the reference rate is the same as the nominal amount of aggregated exposure that creates the variable cash flows in LC (LC1,200,000), which coincides with the nominal amount of the cross-currency interest rate swap for the variable rate leg in LC. This results in a reference rate of 5.6963 per cent (determined by iteration so that the present value of all cash flows in total is nil).

- (b) At subsequent dates, the cash flow variability of the aggregated exposure is determined by comparison to the reference point established at the end of Period 1. For that purpose, all remaining cash flows expected on the fixed rate FX liability and the cross-currency interest rate swap over the remainder of the hedged term (i.e. from the effectiveness measurement date until the end of Period 4) are updated (as applicable) and then discounted. Also, the reference rate of 5.6963 per cent is applied to the nominal amount that was used for the calibration of that rate at the end of Period 1 (LC1,200,000) in order to generate a set of cash flows over the remainder of the hedged term that is then also discounted. The total of all those present values represents the cash flow variability of the aggregated exposure. This calculation is illustrated in the following table for the end of Period 2:

Example 17—Cash Flow Variability of the Aggregated Exposure (at the End of Period 2)

Variability in Cash Flows of the Aggregated Exposure							
FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV
CF(s)	PV	CF(s)	PV	CF(s)	PV	1,200,000 Nominal 5.6963% Rate 4 Frequency	
[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	[LC]	[LC]
Time							
t ₀							
t ₁							
Period 1 t ₂							
t ₃							

Example 17—Cash Flow Variability of the Aggregated Exposure (at the End of Period 2)								
Variability in Cash Flows of the Aggregated Exposure								
	FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV
	CF(s)	PV	CF(s)	PV	CF(s)	PV	1,200,000 Nominal 5.6963% Rate 4 Frequency	
	[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	[LC]	[LC]
t ₄								
Period 2	t ₅	0	0	0	0	0	0	0
	t ₆	0	0	0	0	0	0	0
	t ₇	0	0	0	0	0	0	0
	t ₈	0	0	0	0	0	0	0
Period 3	t ₉	0	0	0	(18,120)	(17,850)	17,089	16,835
	t ₁₀	(20,426)	(20,173)	20,358	(18,360)	(17,814)	17,089	16,581
	t ₁₁	0	0	0	(18,683)	(17,850)	17,089	16,327
	t ₁₂	(20,426)	(19,965)	20,582	(19,203)	(18,058)	17,089	16,070
Period 4	t ₁₃	0	0	0	(19,718)	(18,243)	17,089	15,810
	t ₁₄	(20,426)	(19,726)	20,246	(20,279)	(18,449)	17,089	15,547
	t ₁₅	0	0	0	(21,014)	(18,789)	17,089	15,280
	t ₁₆	(1,020,426)	(971,144)	1,020,582	(1,221,991)	(1,072,947)	1,217,089	1,068,643
Totals		<u>(1,031,008)</u>		<u>1,031,067</u>		<u>(1,200,000)</u>		<u>1,181,092</u>
Totals in LC		(1,464,031)		1,464,116		(1,200,000)		1,181,092
PV of all CF(s) [LC]								
<div style="display: flex; align-items: center; justify-content: center;"> <div style="border-top: 1px solid black; width: 70%;"></div> <div style="border-left: 1px solid black; width: 10px; height: 10px; margin: 0 auto;"></div> <div style="border-top: 1px solid black; width: 70%;"></div> </div> <div style="display: flex; align-items: center; justify-content: center; margin-top: 10px;"> (18,824) ← Σ </div>								

The changes in interest rates and the exchange rate result in a change of the cash flow variability of the aggregated exposure between the end of Period 1 and the end of Period 2 that has a present value of LC-18,824.²⁹

²⁹ This is the amount that is included in the table with the overview of the calculations (see paragraph IE132) as the present value of the cash flow variability of the aggregated exposure at the end of Period 2.

- IE135. Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 137 of [draft] IPSAS [X] (ED 62)).
- IE136. The following table shows the effect on Entity B's statement of financial performance and its statement of financial position (for the sake of transparency some line items³⁰ are disaggregated on the face of the statements by the two hedging relationships, i.e. for the fair value hedge of the fixed rate FX liability and the cash flow hedge of the aggregated exposure):³¹

Example 17—Overview of Effect on Statements of Financial Performance and Financial Position <i>[All amounts in LC]</i>					
	to	Period 1	Period 2	Period 3	Period 4
Statement of financial performance					
Interest expense					
FX liability		45,958	50,452	59,848	58,827
FVH adjustment		(12,731)	11,941	14,385	(49,439)
		33,227	62,393	74,233	9,388
Reclassifications (CFH)			5,990	(5,863)	58,982
Total interest expense		33,227	68,383	68,370	68,370
Other gains/losses					
Change in fair value of the CCIRS		154,673	(418,788)	(91,437)	185,553
FVH adjustment (FX liability)		(154,702)	418,733	91,560	(185,591)
Hedge ineffectiveness		0	(72)	(54)	(19)
Total other gains/losses		(29)	(127)	68	(57)
Surplus or deficit		33,198	68,255	68,438	68,313
Statement of changes in net assets/equity					

³⁰ The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IPSAS 30 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

³¹ For Period 4 the values in the table with the overview of the calculations (see paragraph IE132) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (i.e. including interest accruals) equal the 'clean' values (i.e. excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, i.e. the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and accumulated surplus or deficit would be nil).

Example 17—Overview of Effect on Statements of Financial Performance and Financial Position <i>[All amounts in LC]</i>					
	to	Period 1	Period 2	Period 3	Period 4
Net assets/equity					
Effective CFH gain/loss			(12,834)	71,713	229
Reclassifications			(5,990)	5,863	(58,982)
Total net assets/equity			(18,842)	77,577	(58,753)
Statement of financial position					
FX liability	(1,200,000)	(1,045,298)	(1,464,031)	(1,555,591)	(1,397,984)
CCIRS	0	(154,673)	264,116	355,553	194,141
IRS		0	18,896	(58,767)	(13,004)
Cash	1,200,000	1,166,773	1,098,390	1,030,160	978,641
Net assets	0	(33,198)	(82,630)	(228,645)	(238,205)
<i>Net Assets/equity</i>					
Net assets/equity		0	(18,824)	58,753	0
Accumulated surplus or deficit	0	33,198	101,454	169,892	238,205
Total net assets/equity	0	33,198	82,630	228,645	238,205

IE137. The total interest expense in surplus or deficit reflects State Government B's interest expense that results from its risk management strategy:

- (a) In Period 1 the risk management strategy results in interest expense reflecting variable interest rates in LC after taking into account the effect of the cross-currency interest rate swap, including a difference between the cash flows on the fixed rate FX liability and the fixed leg of the cross-currency interest rate swap that were settled during Period 1 (this means the interest expense does not exactly equal the variable interest expense that would arise in LC on a borrowing of LC1,200,000). There is also some hedge ineffectiveness that results from a difference in the changes in value for the fixed rate FX liability (as represented by the fair value hedge adjustment) and the cross-currency interest rate swap.
- (b) For Periods 2 to 4 the risk management strategy results in interest expense that reflects, after taking into account the effect of the interest rate swap entered into at the end of Period 1, fixed interest rates in LC (i.e. locking in a single blended fixed coupon rate for a three-

period term based on the interest rate environment at the end of Period 1). However, State Government B's interest expense is affected by the hedge ineffectiveness that arises on its hedging relationships. In Period 2 the interest expense is slightly higher than the fixed rate payments locked in with the interest rate swap because the variable payments received under the interest rate swap are less than the total of the cash flows resulting from the aggregated exposure.³² In Periods 3 and 4 the interest expense is equal to the locked in rate because the variable payments received under the swap are more than the total of the cash flows resulting from the aggregated exposure.³³

Example 18—Combined Interest Rate Risk and Foreign Currency Risk Hedge (Cash Flow Hedge/Fair Value Hedge Combination)

Fact Pattern

IE138. State Government C wants to hedge a variable rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of Period 4. State Government C's functional currency is its Local Currency (LC). State Government C has the following risk exposures:

- (a) Cash flow interest rate risk and FX risk: the changes in cash flows of the variable rate liability attributable to interest rate changes, measured in LC.
- (b) Fair value interest rate risk: the exposure that arises as a result of swapping the combined cash flow interest rate risk and FX risk exposure associated with the variable rate liability (see (a) above) into a fixed rate exposure in LC in accordance with State Government C's risk management strategy for FC denominated variable rate liabilities (see paragraph IE139(a) below).

IE139. State Government C hedges its risk exposures using the following risk management strategy:

- (a) State Government C uses cross-currency interest rate swaps to swap its FC denominated variable rate liabilities into a fixed rate exposure in LC. State Government C hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, State Government C enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap State Government C receives variable interest in FC (used to pay the interest on the liability) and pays fixed interest in LC.
- (b) State Government C considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated fixed rate exposure in LC. From time to time, in accordance with its risk management strategy for fixed rate interest rate risk (in LC), State

³² In other words, the cash flow variability of the interest rate swap was lower than, and therefore did not fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'underhedge' situation). In those situations the cash flow hedge does not contribute to the hedge ineffectiveness that is recognized in surplus or deficit because the hedge ineffectiveness is not recognized (see paragraph 137 of [draft] IPSAS [X] (ED 62)). The hedge ineffectiveness arising on the fair value hedge affects surplus or deficit in all periods.

³³ In other words, the cash flow variability of the interest rate swap was higher than, and therefore more than fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'overhedge' situation). In those situations the cash flow hedge contributes to the hedge ineffectiveness that is recognized in surplus or deficit (see paragraph 137 of [draft] IPSAS [X] (ED 62)). The hedge ineffectiveness arising on the fair value hedge affects surplus or deficit in all periods.

Government C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC. Consequently, State Government C uses interest rate swaps (denominated entirely in LC) under which it receives fixed interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays variable interest.

IE140. The following table sets out the parameters used for Example 18:

Example 18—Parameter Overview					
	t₀	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2	1.05	1.42	1.51	1.37
Interest curves (vertical presentation of rates for each quarter of a period on a p.a. basis)					
LC	2.50%	1.00%	3.88%	0.34%	[N/A]
	2.75%	1.21%	4.12%	0.49%	
	2.91%	1.39%	4.22%	0.94%	
	3.02%	1.58%	5.11%	1.36%	
	2.98%	1.77%	5.39%		
	3.05%	1.93%	5.43%		
	3.11%	2.09%	5.50%		
	3.15%	2.16%	5.64%		
	3.11%	2.22%			
	3.14%	2.28%			
	3.27%	2.30%			
	3.21%	2.31%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				
FC	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		

Example 18—Parameter Overview

	t₀	Period 1	Period 2	Period 3	Period 4
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

Accounting Mechanics

IE141. State Government C designates the following hedging relationships:³⁴

- (a) As a cash flow hedge, a hedging relationship for cash flow interest rate risk and FX risk between the FC denominated variable rate liability (variable rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the beginning of Period 1 (i.e. t_0) with a term to the end of Period 4.
- (b) As a fair value hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 1, when State Government C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the change in value that is the effect of changes in the value of the combined cash flows of the two items designated in the cash flow hedge of the cash flow interest rate risk and FX risk (see (a) above), compared to the interest rates at the end of Period 1 (i.e. the time of designation of the hedging relationship between the aggregated exposure and the interest rate swap).

³⁴ This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 126 of [draft] IPSAS [X] (ED 62)). The following description of the designation is solely for the purpose of understanding this example (i.e. it is not an example of the complete formal documentation required in accordance with paragraph 126(b) of [draft] IPSAS [X] (ED 62)).

IE142. The following table³⁵ sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve.³⁶ In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made.³⁷

Example 18—Calculations					
	to	Period 1	Period 2	Period 3	Period 4
Variable rate FX liability					
Fair value [FC]	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)
Fair value [LC]	(1,200,000)	(1,050,000)	(1,420,000)	(1,510,000)	(1,370,000)
Change in fair value [LC]		150,000	(370,000)	(90,000)	140,000
PV of change in variable CF(s) [LC]	0	192,310	(260,346)	(282,979)	(170,000)
Change in PV [LC]		192,310	(452,656)	(22,633)	112,979
CCIRS (receive variable FC/pay fixed LC)					
Fair value [LC]	0	(192,310)	260,346	282,979	170,000
Change in fair value [LC]		(192,310)	452,656	22,633	(112,979)
CFHR					
Opening balance	0	0	(42,310)	(28,207)	(14,103)
Reclassification FX risk		153,008	(378,220)	(91,030)	140,731
Reclassification (current period CF)		(8,656)	(18,410)	2,939	21,431
Effective CFH gain/loss		(186,662)	(479,286)	20,724	(135,141)
Reclassification for interest rate risk		0	(82,656)	67,367	(27,021)

³⁵ Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

³⁶ In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and equity) are in the format of positive (plus) and negative (minus) numbers (e.g. an amount in the cash flow hedge reserve that is a negative number is a loss).

³⁷ Those assumptions have been made for didactical reasons, in order to better focus on illustrating the accounting mechanics in a cash flow hedge/fair value hedge combination. The measurement and recognition of hedge ineffectiveness has already been demonstrated in Example 16 and Example 17. However, in reality such hedges are typically not perfectly effective because hedge ineffectiveness can result from various factors, for example credit risk, differences in the day count method or, depending on whether it is included in the designation of the hedging instrument, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis').

Example 18—Calculations					
	t₀	Period 1	Period 2	Period 3	Period 4
Amortisation of CFHR		0	14,103	14,103	14,103
Ending balance		(42,103)	(28,207)	(14,103)	0
IRS (receive fixed/pay variable)					
Fair value [LC]		0	(82,656)	(15,289)	(42,310)
Change in fair value			(82,656)	67,367	(27,021)
Change in present value of the aggregated exposure					
Present value [LC]		(1,242,310)	(1,159,654)	(1,227,021)	(1,200,000)
Change in present value [LC]			82,656	(67,367)	27,021

IE143. The hedging relationship between the variable rate FX liability and the cross-currency interest rate swap starts at the beginning of Period 1 (i.e. t₀) and remains in place when the hedging relationship for the second level relationship starts at the end of Period 1, i.e. the first level relationship continues as a separate hedging relationship. However, the hedge accounting for the first level relationship is affected by the start of hedge accounting for the second level relationship at the end of Period 1. The fair value hedge for the second level relationship affects the timing of the reclassification to surplus or deficit of amounts from the cash flow hedge reserve for the first level relationship:

- (a) The fair value interest rate risk that is hedged by the fair value hedge is included in the amount that is recognized in net assets/equity as a result of the cash flow hedge for the first level hedging relationship (i.e. the gain or loss on the cross-currency interest rate swap that is determined to be an effective hedge).³⁸ This means that from the end of Period 1 the part of the effective cash flow hedging gain or loss that represents the fair value interest rate risk (in LC), and is recognized in net assets/equity in a first step, is in a second step immediately (i.e. in the same period) transferred from the cash flow hedge reserve to surplus or deficit. That reclassification adjustment offsets the gain or loss on the interest rate swap that is recognized in surplus or deficit.³⁹ In the context of accounting for the aggregated exposure as the hedged item, that reclassification adjustment is the equivalent of a fair value hedge adjustment because in contrast to a hedged item that is a fixed rate debt instrument (in LC) at amortized cost, the aggregated exposure is already remeasured for changes regarding

³⁸ As a consequence of hedging its exposure to cash flow interest rate risk by entering into the cross-currency interest rate swap that changed the cash flow interest rate risk of the variable rate FX liability into a fixed rate exposure (in LC), State Government C in effect assumed an exposure to fair value interest rate risk (see paragraph IE139).

³⁹ In the table with the overview of the calculations (see paragraph IE142) this reclassification adjustment is the line item "Reclassification for interest rate risk" in the reconciliation of the cash flow hedge reserve (e.g. at the end of Period 2 a reclassification of a gain of LC82,656 from the cash flow hedge reserve to surplus or deficit—see paragraph IE144 for how that amount is calculated).

the hedged risk but the resulting gain or loss is recognized in net assets/equity because of applying cash flow hedge accounting for the first level relationship. Consequently, applying fair value hedge accounting with the aggregated exposure as the hedged item does not result in changing the hedged item's measurement but instead affects where the hedging gains and losses are recognized (i.e. reclassification from the cash flow hedge reserve to surplus or deficit).

- (b) The amount in the cash flow hedge reserve at the end of Period 1 (LC42,310) is amortized over the remaining life of the cash flow hedge for the first level relationship (i.e. over Periods 2 to 4).⁴⁰

IE144. The change in value of the aggregated exposure is calculated as follows:

- (a) At the point in time from which the change in value of the aggregated exposure is hedged (i.e. the start of the second level relationship at the end of Period 1), all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term (i.e. until the end of Period 4) are mapped out and their combined present value, in LC, is calculated. This calculation establishes the present value that is used at subsequent dates as the reference point to measure the change in present value of the aggregated exposure since the start of the hedging relationship. This calculation is illustrated in the following table:

Example 18—Present Value of the Aggregated Exposure (Starting Point)						
Present Value of the Aggregated Exposure						
FX liability		CCIRS FC leg		CCIRS LC leg		
CF(s)	PV	CF(s)	PV	CF(s)	PV	
[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	
Period 1	Time					
	t ₀					
	t ₁					
	t ₂					
	t ₃					
	t ₄					
Period 2	t ₅	(11,039)	(10,918)	11,039	10,918	(9,117) (9,094)
	t ₆	(11,331)	(11,082)	11,331	11,082	(9,117) (9,067)
	t ₇	(11,375)	(11,000)	11,375	11,000	(9,117) (9,035)
	t ₈	(10,689)	(10,227)	10,689	10,227	(9,117) (9,000)

⁴⁰ In the table with the overview of the calculations (see paragraph IE142) this amortization results in a periodic reclassification adjustment of LC14,103 that is included in the line item "Amortization of CFHR" in the reconciliation of the cash flow hedge reserve.

Example 18—Present Value of the Aggregated Exposure (Starting Point)							
Present Value of the Aggregated Exposure							
		FX liability		CCIRS FC leg		CCIRS LC leg	
		CF(s)	PV	CF(s)	PV	CF(s)	PV
		[FC]	[FC]	[FC]	[FC]	[LC]	[LC]
Period 3	t ₉	(10,375)	(9,824)	10,375	9,824	(9,117)	(8,961)
	t ₁₀	(10,164)	(9,528)	10,164	9,528	(9,117)	(8,918)
	t ₁₁	(10,028)	(9,307)	10,028	9,307	(9,117)	(8,872)
	t ₁₂	(10,072)	(9,255)	10,072	9,255	(9,117)	(8,825)
Period 4	t ₁₃	(10,256)	(9,328)	10,256	9,328	(9,117)	(8,776)
	t ₁₄	(10,159)	(9,147)	10,159	9,147	(9,117)	(8,727)
	t ₁₅	(10,426)	(9,290)	10,426	9,290	(9,117)	(8,678)
	t ₁₆	(1,010,670)	(891,093)	1,010,670	891,093	(1,209,117)	(1,144,358)
Totals			(1,000,000)		1,000,000		(1,242,310)
Totals in LC			(1,050,000)		1,050,000		(1,242,310)
PV of aggregated exposure [LC]							
		(1,242,310) ← Σ					

The present value of all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term at the end of Period 1 is LC-1,242,310.⁴¹

- (b) At subsequent dates, the present value of the aggregated exposure is determined in the same way as at the end of Period 1 but for the remainder of the hedged term. For that purpose, all remaining cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the remainder of the hedged term (i.e. from the effectiveness measurement date until the end of Period 4) are updated (as applicable) and then discounted. The total of those present values represents the present value of the aggregated exposure. This calculation is illustrated in the following table for the end of Period 2:

⁴¹ In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made (see paragraph IE142). Consequently, the absolute values of the variable rate FX liability and the FC denominated leg of the cross-currency interest rate are equal (but with opposite signs). In situations in which hedge ineffectiveness arises, those absolute values would not be equal so that the remaining net amount would affect the present value of the aggregated exposure.

Example 18—Present Value of the Aggregated Exposure (at the End of Period 2)						
Present Value of the Aggregated Exposure						
FX liability		CCIRS FC leg		CCIRS LC leg		
	CF(s)	PV	CF(s)	PV	CF(s)	PV
	[FC]	[FC]	[FC]	[FC]	[LC]	[LC]
Period 1	Time					
	t ₀					
	t ₁					
	t ₂					
	t ₃					
	t ₄					
Period 2	t ₅	0	0	0	0	0
	t ₆	0	0	0	0	0
	t ₇	0	0	0	0	0
	t ₈	0	0	0	0	0
Period 3	t ₉	(6,969)	(6,921)	6,969	(9,117)	(9,030)
	t ₁₀	(5,544)	(5,475)	5,544	(9,117)	(8,939)
	t ₁₁	(4,971)	(4,885)	4,971	(9,117)	(8,847)
	t ₁₂	(5,401)	(5,280)	5,401	(9,117)	(8,738)
Period 4	t ₁₃	(5,796)	(5,632)	5,796	(9,117)	(8,624)
	t ₁₄	(6,277)	(6,062)	6,277	(9,117)	(8,511)
	t ₁₅	(6,975)	(6,689)	6,975	(9,117)	(8,397)
	t ₁₆	(1,007,725)	(959,056)	1,007,725	(1,209,117)	(1,098,568)
Totals		(1,000,000)		1,000,000		(1,159,654)
Totals in LC		(1,420,000)		1,420,000		(1,159,654)
PV of aggregated exposure [LC]						
<div style="text-align: center;"> <div style="display: flex; justify-content: space-between; align-items: center;"> <div style="border-top: 1px solid black; width: 40%;"></div> <div style="border-top: 1px solid black; width: 40%;"></div> </div> <div style="display: flex; justify-content: space-between; align-items: center; margin-top: 10px;"> <div style="text-align: right;">(1,159,654) ←</div> <div style="text-align: center;">Σ</div> </div> </div>						

The changes in interest rates and the exchange rate result in a present value of the aggregated exposure at the end of Period 2 of LC-1,159,654. Consequently, the change in

the present value of the aggregated exposure between the end of Period 1 and the end of Period 2 is a gain of LC82,656.⁴²

IE145. Using the change in present value of the hedged item (i.e. the aggregated exposure) and the fair value of the hedging instrument (i.e. the interest rate swap), the related reclassifications from the cash flow hedge reserve to surplus or deficit (reclassification adjustments) are then determined.

IE146. The following table shows the effect on Entity C's statement of financial performance and its statement of financial position (for the sake of transparency some line items⁴³ are disaggregated on the face of the statements by the two hedging relationships, i.e. for the cash flow hedge of the variable rate FX liability and the fair value hedge of the aggregated exposure):⁴⁴

Example 18—Overview of Effect on Statements of Financial Performance and Financial Position					
<i>[All amounts in LC]</i>					
	to	Period 1	Period 2	Period 3	Period 4
Statement of financial performance					
Interest expense					
FX liability		45,122	54,876	33,527	15,035
FVH adjustment		0	(20,478)	16,517	(26,781)
		45,122	34,398	50,045	(11,746)
Reclassifications (CFH)		(8,656)	(18,410)	2,939	21,431
		36,466	15,989	52,983	9,685
Amortisation of CFHR		0	14,103	14,103	14,103
Total interest expense		36,466	30,092	67,087	23,788
Other gains/losses					
IRS		0	82,656	(67,367)	27,021
FX gain/loss (liability)		(150,000)	370,000	90,000	(140,000)

42 This is the amount that is included in the table with the overview of the calculations (see paragraph IE142) as the change in present value of the aggregated exposure at the end of Period 2.

43 The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IPSAS 30 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

44 For Period 4 the values in the table with the overview of the calculations (see paragraph IE142) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (i.e. including interest accruals) equal the 'clean' values (i.e. excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, i.e. the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and accumulated surplus or deficit would be nil).

Example 18—Overview of Effect on Statements of Financial Performance and Financial Position*[All amounts in LC]*

	to	Period 1	Period 2	Period 3	Period 4
FX gain/loss (interest)		(3,008)	8,220	1,030	(731)
Reclassification for FX risk		153,008	(378,220)	(91,030)	140,731
Reclassification for interest rate risk		0	(82,656)	67,367	(27,021)
Total other gains/losses		0	0	0	0
Surplus or deficit		36,466	30,092	67,087	23,788
Statement of changes in net assets/equity					
Net assets/equity					
Effective gain/loss		186,662	(479,286)	(20,724)	135,141
Reclassification (current period CF)		8,656	18,410	(2,939)	(21,431)
Reclassification for FX risk		(153,008)	378,220	91,030	(140,731)
Reclassification for interest rate risk		0	82,656	(67,367)	27,021
Amortisation of CFHR		0	(14,103)	(14,103)	(14,103)
Total net assets/equity		42,310	(14,103)	(14,103)	(14,103)
Statement of financial position					
FX liability	(1,200,000)	(1,050,000)	(1,420,000)	(1,510,000)	(1,375,306)
CCIRS	0	(192,310)	260,346	282,979	166,190
IRS		0	(82,656)	(15,289)	(37,392)
Cash	1,200,000	1,163,534	1,147,545	1,094,562	1,089,076
Net assets	0	(78,776)	(94,765)	(147,748)	(157,433)
Net assets/equity	0	42,310	28,207	14,103	0
Accumulated surplus or deficit	0	36,466	66,558	133,645	157,433
Total net assets/equity	0	78,776	94,765	147,748	157,433

IE147. The total interest expense in surplus or deficit reflects State Government C's interest expense that results from its risk management strategy:

- (a) In Period 1 the risk management strategy results in interest expense reflecting fixed interest rates in LC after taking into account the effect of the cross-currency interest rate swap.
- (b) For Periods 2 to 4, after taking into account the effect of the interest rate swap entered into at the end of Period 1, the risk management strategy results in interest expense that changes with variable interest rates in LC (i.e. the variable interest rate prevailing in each period). However, the amount of the total interest expense is not equal to the amount of the variable rate interest because of the amortization of the amount that was in the cash flow hedge reserve for the first level relationship at the end of Period 1.⁴⁵

Foreign Operations (Appendix B)

IE148. This example illustrates the application of paragraphs B12, B13, B14 and B15 of Appendix B in connection with the reclassification adjustment on the disposal of a foreign operation.

Example 19—Disposal of a Foreign Operation

Background

- IE149. This example assumes the economic entity structure set out in paragraph B16 and that Controlling Entity D used a USD borrowing in Controlled Entity A to hedge the EUR/USD risk of the net investment in Controlled Entity C in Controlling Entity D's consolidated financial statements. Controlling Entity D uses the step-by-step method of consolidation. Assume the hedge was fully effective and the full USD/EUR accumulated change in the value of the hedging instrument before disposal of Controlled Entity C is €24 million (gain). This is matched exactly by the fall in value of the net investment in Controlled Entity C, when measured against the functional currency of Controlling Entity D (euro).
- IE150. If the direct method of consolidation is used, the fall in the value of Controlling Entity D's net investment in Controlled Entity C of €24 million would be reflected totally in the foreign currency translation reserve relating to Controlled Entity C in Controlling Entity D's consolidated financial statements. However, because Controlling Entity D uses the step-by-step method, this fall in the net investment value in Controlled Entity C of €24 million would be reflected both in Controlled Entity B's foreign currency translation reserve relating to Controlled Entity C and in Controlling Entity D's foreign currency translation reserve relating to Controlled Entity B.
- IE151. The aggregate amount recognized in the foreign currency translation reserve in respect of Controlled Entities B and C is not affected by the consolidation method. Assume that using the direct method of consolidation, the foreign currency translation reserves for Controlled Entities B and C in Controlling Entity D's consolidated financial statements are €62 million gain and €24 million loss respectively; using the step-by-step method of consolidation those amounts are €49 million gain and €11 million loss respectively.

Reclassification

⁴⁵ See paragraph IE143(b). That amortization becomes an expense that has an effect like a spread on the variable interest rate.

IE152. When the investment in Controlled Entity C is disposed of, [draft] IPSAS [X] (ED 62) requires the full €24 million gain on the hedging instrument to be recognized in surplus or deficit. Using the step-by-step method, the amount to be reclassified to surplus or deficit in respect of the net investment in Controlled Entity C would be only €11 million loss. Controlling Entity D could adjust the foreign currency translation reserves of both Controlled Entities B and C by €13 million in order to match the amounts reclassified in respect of the hedging instrument and the net investment as would have been the case if the direct method of consolidation had been used, if that was its accounting policy. An entity that had not hedged its net investment could make the same reclassification.

Concessionary Loans (Paragraphs AG118-AG124)

Example 20—Receipt of a Concessionary Loan (Interest Concession)

IE153. A local authority receives loan funding to the value of CU5 million from an international development agency to build primary healthcare clinics over a period of 5 years. The agreement stipulates that the loan is to be repaid over the 5 year period as follows:

Year 1: no capital repayments

Year 2: 10 percent of the capital

Year 3: 20 percent of the capital

Year 4: 30 percent of the capital

Year 5: 40 percent of the capital

Interest is paid annually in arrears, at a rate of 5 percent per annum on the outstanding balance of the loan. A market related rate of interest for a similar transaction is 10 percent.

IE154. The entity has received a concessionary loan of CU5 million, which will be repaid at 5 percent below the current market interest rate. The difference between the proceeds of the loan and the present value of the contractual payments in terms of the loan agreement, discounted using the market related rate of interest, is recognized in accordance with IPSAS 23. After assessing the substance of the concessionary loan, the department of education classifies the financial asset in accordance with paragraph 39-44. Based on the facts in the example, the department of education classifies the financial asset as measured at amortized cost.

IE155. The journal entries to account for the concessionary loan are as follows:

1. On initial recognition, the entity recognizes the following:

Dr	Bank	5,000,000	
	Cr	Loan (refer to Table 2 below)	4,215,450
	Cr	Liability or non-exchange revenue	784,550

Recognition of the receipt of the loan at fair value

IPSAS 23 is considered in recognizing either a liability or revenue for the off-market portion of the loan. Paragraph IG54 of that Standard provides journal entries for the recognition and measurement of the off-market portion of the loan deemed to be non-exchange revenue.

2. Year 1: The entity recognizes the following:

Dr	Interest (refer to Table 3 below)	421,545	
	Cr	Loan	421,545

Recognition of interest using the effective interest method (CU4,215,450 × 10%)

Dr	Loan (refer to Table 1 below)	250,000	
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Cr	Bank	250,000
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Recognition of interest paid on outstanding balance (CU5m × 5%)

3. Year 2: The entity recognizes the following:

Dr	Interest	438,700	
	Cr	Loan	438,700

Recognition of interest using the effective interest method (CU4,386,995 × 10 percent)

Dr	Loan	750,000	
	Cr	Bank	750,000

Recognition of interest and principal paid on outstanding balance (CU5m × 5 percent + CU500,000)

4. Year 3: The entity recognizes the following:

Dr	Interest	407,569	
	Cr	Loan	407,569

Recognition of interest using the effective interest method (CU4,075,695 × 10 percent)

Dr	Loan	1,225,000	
	Cr	Bank	1,225,000

Recognition of interest and principal paid on outstanding balance (CU4.5m × 5 percent + CU1m capital repaid)

5. Year 4: The entity recognizes the following:

Dr	Interest	325,827	
	Cr	Loan	325,827

Recognition of interest using the effective interest method (CU 3,258,264 × 10 percent)

Dr	Loan	1,675,000	
	Cr	Bank	1,675,000

Recognition of interest and principal paid on outstanding balance (CU3.5m × 5 percent + CU1.5m)

6. Year 5: The entity recognizes the following:

Dr	Interest	190,909	
	Cr	Loan	190,909

Recognition of interest using the effective interest method (CU1,909,091 × 10 percent)

Dr	Loan	2,100,000	
	Cr	Bank	2,100,000

Recognition of interest and principal paid on outstanding balance (CU2m × 5 percent + CU2m)

*Calculations:***Table 1: Amortization Schedule (Using Contractual Repayments at 5 percent Interest)**

	Year 0 CU	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital	5,000,000	5,000,000	5,000,000	4,500,000	3,500,000	2,000,000
Interest	–	250,000	250,000	225,000	175,000	100,000
Payments	–	(250,000)	(750,000)	(1,225,000)	(1,675,000)	(2,100,000)
Balance	5,000,000	5,000,000	4,500,000	3,500,000	2,000,000	–

Table 2: Discounting Contractual Cash Flows (Based on a Market Rate of 10%)

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital balance	5,000,000	4,500,000	3,500,000	2,000,000	–
Interest payable	250,000	250,000	225,000	175,000	100,000
Total payments (capital and interest)	250,000	750,000	1,225,000	1,675,000	2,100,000
Present value of payments	227,272	619,835	920,360	1,144,048	1,303,935
Total present value of payments					4,215,450
Proceeds received					5,000,000
Less: Present value of outflows (fair value of loan on initial recognition)					4,215,450
Off-market portion of loan to be recognized as non-exchange revenue					784,550

Table 3: Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital	4,215,450	4,386,995	4,075,695	3,258,264	1,909,091
Interest accrual	421,545	438,700	407,569	325,827	190,909
Interest	250,000	250,000	225,000	175,000	100,000
Capital payments	–	500,000	1,000,000	1,500,000	2,000,000
Balance	4,386,995	4,075,695	3,258,264	1,909,091	–

Example 21—Payment of a Concessionary Loan (Principal Concession)⁴⁶

IE156. The department of education makes low interest loans available to qualifying students with delayed repayment terms as a means of promoting post-secondary education.

IE157. The department advanced CU250 million to various students at the beginning of the financial year, with the following terms and conditions:

Capital to be repaid as follows:

Year 1 to 3: no capital repayments

Year 4: 30 percent capital to be repaid

⁴⁶ For simplicity, this example excludes any considerations in relation to calculating expected credit losses.

Year 5: 30 percent capital to be repaid

Year 6: 30 percent capital to be repaid

The remaining capital balance (10 percent of CU250 million) outstanding at the end of year 6 is to be forgiven.

Interest is calculated at 11.5 percent interest on the outstanding loan balance, and is to be paid annually in arrears. Assume the market rate of interest for a similar loan is 11.5 percent.

Scenario 1: Amortized Cost

IE158. After assessing the substance of the concessionary loan, the department of education classifies the financial asset in accordance with paragraph 39-44. Based on the facts in the example, the department of education classifies the financial asset as measured at amortized cost.

IE159. The journal entries to account for the concessionary loan when measured at amortized cost are as follows:

1. On initial recognition, the entity recognizes the following:

Dr	Loan	236,989,595	
Dr	Expense	13,010,405	
	Cr Bank		250,000,000

Recognition of the advance of the loan at fair value

Paragraph AG123(b) is considered in recognizing an expense for the off-market portion of the loan deemed to be a non-exchange expense.

2. Year 1: The entity recognizes the following

Dr	Loan	27,253,803	
	Cr Interest revenue		27,253,803

Interest accrual using the effective interest method $CU236,989,595 \times 11.5\%$

Dr	Bank	28,750,000	
	Cr Loan		28,750,000

Interest payment of $CU250m \times 11.5\%$

3. Year 2: The entity recognizes the following:

Dr	Loan	27,081,741	
	Cr Interest revenue		27,081,741

Interest accrual using the effective interest method $CU235,493,398 \times 11.5\%$

Dr	Bank	28,750,000	
	Cr Loan		28,750,000

Interest payment of $CU250m \times 11.5\%$

4. Year 3: The entity recognizes the following:

Dr	Loan	26,889,891	
	Cr Interest revenue		26,889,891

Interest accrual using the effective interest method $CU233,825,139 \times 11.5\%$

Dr	Bank	28,750,000	
	Cr Loan		28,750,000

Interest payment of $CU250m \times 11.5\%$

5. Year 4: The entity recognizes the following:

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Dr	Loan	26,675,979	
	Cr	Interest revenue	26,675,979

Interest accrual using the effective interest method CU231,965,030 × 11.5 percent

Dr	Bank	103,750,000	
	Cr	Loan	103,750,000

Interest payment of CU250m X 11.5 percent + CU75m capital repaid

6. Year 5: The entity recognizes the following:

Dr	Loan	17,812,466	
	Cr	Interest revenue	17,812,466

Interest accrual using the effective interest method CU154,891,009 × 11.5 percent

Dr	Bank	95,125,000	
	Cr	Loan	95,125,000

Interest payment of CU175m X 11.5 percent + CU75m capital repaid

7. Year 6: The entity recognizes the following:

Dr	Loan	8,921,525	
	Cr	Interest revenue	8,921,525

Interest accrual using the effective interest method CU77,578,475 × 11.5 percent

Dr	Bank	86,500,000	
	Cr	Loan	86,500,000

Interest payment of CU100m X 11.5 percent + CU75m capital repaid

Scenario 2: Fair Value through Surplus/Deficit

IE160. In addition to the terms outlined in paragraph IE157, the instrument provides the department of education the ability to call the instrument at any time for an amount that does not substantially reflect payment of outstanding principal and interest. After assessing the substance of the concessionary loan, the department of education determines the classification of the financial asset in accordance with paragraph 39-44. Because the call feature in this example precludes the cash flows of this instrument from being solely payments of principal and interest, the department of education concludes the financial asset is classified at fair value through surplus/deficit.

IE161. The journal entries to account for the concessionary loan when classified at amortized are as follows:

1. On initial recognition, the entity recognizes the following:

Dr	Loan	236,989,595	
Dr	Expense	13,010,405	
	Cr	Bank	250,000,000

Recognition of the advance of the loan at fair value

Paragraph AG123(b) is considered in recognizing an expense for the off-market portion of the loan deemed to be a non-exchange expense.

2. Year 1: The entity recognizes the following

Dr	Loan	27,253,803	
	Cr	Interest revenue	27,253,803

Interest accrual of CU236,989,595 × 11.5%

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

Dr	Bank	28,750,000	
	Cr Loan		28,750,000

Interest payment of CU250m × 11.5%

3. Year 2: The entity recognizes the following:

Dr	Loan	27,081,741	
	Cr Interest revenue		27,081,741

Interest accrual of CU235,493,398 × 11.5%

Dr	Bank	28,750,000	
	Cr Loan		28,750,000

Interest payment of CU250m × 11.5%

Dr	Loan	2,766,221	
	Cr Fair value adjustment		2,766,221

Fair value adjustment (CU231,058,918⁴⁷ – CU235,493,398 – CU27,081,741 + CU28,750,000)

4. Year 3: The entity recognizes the following:

Dr	Loan	26,571,776	
	Cr Interest revenue		26,571,776

Interest accrual of CU231,058,918 × 11.5%

Dr	Bank	28,750,000	
	Cr Loan		28,750,000

Interest payment of CU250m × 11.5%

Dr	Loan	2,620,867	
	Cr Fair value adjustment		2,620,867

Fair value adjustment (CU226,259,827⁴⁷ – CU231,058,918 – CU26,571,776 + CU28,750,000)

5. Year 4: The entity recognizes the following:

Dr	Loan	26,019,880	
	Cr Interest revenue		26,019,880

Interest accrual of CU226,259,827 × 11.5%

Dr	Bank	103,750,000	
	Cr Loan		103,750,000

Interest payment of CU250m X 11.5 percent + CU75m capital repaid

Dr	Fair value adjustment	1,472,217	
	Cr Loan		1,472,217

Fair value adjustment (CU150,001,924⁴⁷ - CU226,259,827 – CU26,019,880 + CU103,750,000)

6. Year 5: The entity recognizes the following:

Dr	Loan	17,250,221	
	Cr Interest revenue		17,250,221

⁴⁷ See table 4 in this example for reference to fair values.

EXPOSURE DRAFT 62, FINANCIAL INSTRUMENTS

Interest accrual of CU150,001,924 × 11.5 percent

Dr	Bank	95,125,000	
	Cr Loan		95,125,000

Interest payment of CU175m X 11.5 percent + CU75m capital repaid

Dr	Fair value adjustment	3,750,048	
	Cr Loan		3,750,048

Fair value adjustment (CU75,877,193⁴⁷ – CU150,001,924 – CU17,250,221 + CU95,125,000)

7. Year 6: The entity recognizes the following:

Dr	Loan	8,725,877	
	Cr Interest revenue		8,725,877

Interest accrual of CU75,877,193 × 11.5%

Dr	Bank	86,500,000	
	Cr Loan		86,500,000

Interest payment of CU100m X 11.5 percent + CU75m capital repaid

Dr	Fair value adjustment	1,896,930	
	Cr Loan		1,896,930

Fair value adjustment (CU0⁴⁷ – CU75,877,193 – CU8,725,877+ CU86,500,000)

*Calculations***Table 1: Amortization Schedule (Using Contractual Repayments at 11.5 Percent Interest)**

	Year 0 CU'000	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000	Year 6 CU'000
Capital	250,000	250,000	250,000	250,000	250,000	175,000	100,000
Interest	–	28,750	28,750	28,750	28,750	20,125	11,500
Payments	–	28,750	28,750	28,750	103,750	95,125	86,500
Balance	250,000	250,000	250,000	250,000	175,000	100,000	25,000

Table 2: Discounting Contractual Cash Flows (Based on a Market Rate of 11.5 Percent)

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU	Year 6 CU
Capital balance	250,000,000	250,000,000	250,000,000	175,000,000	100,000,000	25,000,000
Interest payable	28,750,000	28,750,000	28,750,000	28,750,000	20,125,000	11,500,000
Total payments (capital and interest)	28,750,000	28,750,000	28,750,000	103,750,000	95,125,000	86,500,000
Present value of payments	25,784,753	23,125,339	20,740,215	67,125,670	55,197,618	45,016,000
Total present value of payments						<u>236,989,595</u>
Proceeds paid						250,000,000
Less: Present value of outflows (fair value of loan on initial recognition)						<u>236,989,595</u>
Off-market portion of loan to be recognized as expense						<u>13,010,405</u>

Table 3: Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU	Year 6 CU
Capital	236,989,595	235,493,398	233,825,139	231,965,030	154,891,009	77,578,475
Interest accrual	27,253,803	27,081,741	26,889,891	26,675,979	17,812,466	8,921,525
Interest	28,750,000	28,750,000	28,750,000	28,750,000	20,125,000	11,500,000
Capital payments	-	-	-	75,000,000	75,000,000	75,000,000
Balance	235,493,398	233,825,139	231,965,030	154,891,009	77,578,475	–

Table 4: Fair Value of Loan

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU	Year 6 CU
Fair value	236,989,595	235,493,398	231,058,918	226,259,827	150,001,924	75,877,193
Market interest rate (beginning of year)	11.5%	11.5%	12%	13%	14%	14%
Market interest	11.5%	12%	13%	14%	14%	14%

rate (end of year)						
Interest Accrual (11.5%)	27,253,803	27,081,741	26,571,776	26,019,880	17,250,221	8,725,877
Interest	28,750,000	28,750,000	28,750,000	28,750,000	20,125,000	11,500,000
Capital payments	-	-	-	75,000,000	75,000,000	75,000,000
Fair value adjustment	-	(2,766,221)	(2,620,867)	1,472,217	3,750,048	1,896,930
Balance	235,493,398	231,058,918	226,259,827	150,001,924	75,877,193	-

Financial Guarantee (Paragraphs AG128-AG133)

Example 22—Financial Guarantee Contract Provided at Nominal Consideration

IE162. Entity C is a major motor vehicle manufacturer in Jurisdiction A. On January 1, 20X1 Government A (the issuer) enters into a financial guarantee contract with Entity B (the holder) to reimburse Entity B against the financial effects of default by Entity C (the debtor) for a 5 year loan of 50 million Currency Units (CUs) repayable in two equal installments of 25 million CUs in 20X3 and 20X5. Entity C provides nominal consideration of 5,000 CUs to Government A. At initial recognition, Government A measures the financial guarantee contract at fair value. Applying a valuation technique, Government A determines the fair value of the financial guarantee contract to be 5,000,000 CUs.

IE163. On December, 31 20X1, having reviewed the financial position and performance of Entity C and having evaluated forward looking information including expected automotive industry trends, Government A determines there has been no significant increase in credit risk since initial recognition. In applying the measurement requirements of 45(c), Government A measures the financial guarantee contract at the higher of:

- (i) The amount of the loss allowance calculated in accordance with this standard; and
- (ii) The amount initially recognized, less the cumulative amount of revenue recognized.

Government A measures the loss allowance at an amount equal to the 12 month expected credit losses. Government A calculates the amount of loss allowance to be less than the amount initially recognized. Government A therefore does not recognize an additional liability in its statement of financial position. Government A makes the disclosures relating to fair value and credit risk in IPSAS 30, *Financial Instruments: Disclosures* in respect of the financial guarantee contract. In its statement of financial performance Government A recognizes revenue of 100,000 CUs in respect of the initial fair value of the instrument (total consideration of 5,000,000 CUs / 5 years).

IE164. In 20X2 there has been a downturn in the motor manufacturing sector affecting Entity C. Although it has met its obligations for interest payments, Entity C is seeking bankruptcy protection and is expected to default on its first repayment of principal. Negotiations are advanced with a potential acquirer (Entity D), which will restructure Entity C. Entity D has indicated that it will assume responsibility for the final installment of the loan with Entity B, but not the initial installment. Government A determines there has been a significant increase in credit risk since initial recognition of the financial guarantee contract and measures the loss allowance associated with the financial guarantee contract at an amount equal to the lifetime expected credit losses. Government A calculates the lifetime expected credit losses to be \$25.5 million CUs and recognizes

an expense for, and increases its liability by, 22.5 million CUs (expected loss of 25 million CUs on the first installment, 500,000 CUs on the final installment, less remaining 3 million CUs balance on financial guarantee).

IE165. The journal entries at initial acquisition and at the reporting dates are as follows:

1.	On initial recognition, the entity recognizes the following:			
Dr	Bank	5,000		
Dr	Expense	4,995,000		
	Cr	Financial guarantee contract		5,000,000

2.	Year 1: The entity recognizes the following			
Dr	Financial guarantee contract	1,000,000		
	Cr	Revenue		1,000,000

Revenue of 500,000 CUs is recognized over a 5 year period

3.	Year 2: The entity recognizes the following:			
Dr	Financial guarantee contract	1,000,000		
	Cr	Revenue		1,000,000

Revenue of 500,000 CUs is recognized over a 5 year period

Dr	Expense	22,500,000		
	Cr	Financial guarantee contract		22,500,000

Lifetime expected credit losses of \$25.5 million CUs less 3,000,000 CUs recognized as a liability

Fair Value Measurement Considerations (Paragraphs 64-66)

IE166. Illustrative examples 23-26 demonstrate different valuation techniques for valuing unquoted equity instruments. When selecting an appropriate valuation technique, professional judgment is exercised in considering the requirements in AG145 – AG151.

Example 23—Valuation of Unquoted Equity Instruments (Transaction Price Paid for an Identical or Similar Instrument)

IE167. In 20X0, a Sovereign Wealth Fund bought ten equity shares of Entity D, a private company, representing ten per cent of the outstanding voting shares of Entity D, for CU1,000. The Sovereign Wealth Fund prepares annual financial statements and is required to measure the fair value of its non-controlling equity interest in Entity D as at 31 December 20X2 (i.e. the measurement date).

IE168. During December of 20X2, Entity D raised funds by issuing new equity capital (ten shares for CU1,200) to other investors. The Sovereign Wealth Fund concludes that the transaction price of the new equity capital issue for CU1,200 represents fair value at the date those shares were issued.

IE169. Both the Sovereign Wealth Fund and the other investors in Entity D have shares with the same rights and conditions. Between the new equity capital issue to other investors and the measurement date, there have been no significant external or internal changes in the environment in which Entity D operates. As a result, the Sovereign Wealth Fund concludes that CU1,200 is the amount that is most representative of the fair value of its non-controlling equity interest in Entity D at the measurement date.

Analysis

IE170. When an investor has recently made an investment in an instrument that is identical to the unquoted equity instrument being valued, the transaction price can be a reasonable starting point for measuring the fair value of the unquoted equity instrument at the measurement date, if that transaction price represented the fair value of the instrument at initial recognition. An investor must, however, use all information about the performance and operations of an investee that becomes reasonably available to the investor after the date of initial recognition up to the measurement date, because such information might have an effect on the fair value of the unquoted equity instrument of the investee at the measurement date.

Example 24—Valuation of Unquoted Equity Instruments (Discounted Cash Flow)

IE171. As part of an initiative to encourage the use of renewable energy, Government A has a five per cent non-controlling equity interest in Entity R, a private company developing highly efficient solar panels in Government A's jurisdiction. Government A derives Entity R's indicated fair value of equity by deducting the fair value of debt (in this case assumed to be CU240 million) from the enterprise value of CU1,121.8 million as shown in the table below. Government A has concluded that there are no relevant non-operating items that need to be adjusted from Entity R's expected free cash (FCF).

IE172. Entity R's value was computed by discounting the expected free cash flows (i.e. post-tax cash flows before interest expense and debt movements, using an unlevered tax rate) by an assumed weighted average cost of capital (WACC) of 8.9 per cent. The WACC computation included the following variables: cost of equity capital of 10.9 per cent, cost of debt capital of 5.7 per cent, effective income tax rate of 30 per cent, debt to total capital ratio of 28.6 per cent and equity to total capital ratio of 71.4 per cent.

	Year 0 CU'000	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000
FCF ⁴⁸	-	100	100	100	100	100
Terminal value ⁴⁹						1,121.8
DCF Method using enterprise value less fair value of debt						
Discount factors ⁵⁰		0.9182	0.8430	0.7740	0.7107	0.6525
Present value of FCF and terminal value ⁵¹		91.8	84.3	77.4	71.1	797.2
Enterprise value	1,121.8					

⁴⁸ FCF represent cash flows before interest expense and debt movements. The tax charge has been computed considering no deduction for interest expense.

⁴⁹ The terminal value has been computed assuming the yearly cash flows amounting to CU100 million would grow in perpetuity at a rate of zero (i.e. assuming that the impact of inflation on future cash flows is expected to be offset by market shrinkage).

⁵⁰ The discount factors have been computed using the formula: $1/(1 + WACC)^n$ year. This formula, however, implies that the cash flows are expected to be received at the end of each period. Sometimes it might be more appropriate to assume that cash flows are received more or less evenly throughout the year (mid-year discounting convention). Using the mid-year discounting convention, the discount factor for year 'n' would have been computed as follows: $1/(1 + WACC)^{(n - 0.5)}$.

⁵¹ The present value amounts have been computed by multiplying the FCF and terminal value by the corresponding discount factors.

	Year 0 CU'000	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000
Less fair value of debt	(240.0)					
Indicated fair value of equity	881.8					

IE173. This example assumes that all unquoted equity instruments of Entity R have the same features and give the holders the same rights. However, Government A considers that the indicated fair value of equity obtained above (CU881.8 million) must be further adjusted to consider:

- a non-controlling interest discount because Government A's interest in Entity R is a non-controlling equity interest and Government A has concluded that there is a benefit associated with control. For the purposes of this example, it has been assumed that the non-controlling interest discount is CU8.00 million;⁵² and
- a discount for the lack of liquidity, because Government A's interest in Entity R is unquoted. For the purposes of this example, it has been assumed that the discount for the lack of liquidity amounts to CU4.09 million.⁵¹

IE174. As a result, Government A concludes that CU32 million is the price that is most representative of the fair value of its five per cent non-controlling equity interest in Entity R at the measurement date, as shown below:

	CU'000
Indicated fair value of equity x 5 percent	
(i.e. CU881.8 x 5 percent)	44.09
Non-controlling interest discount	(8.00)
Discount for lack of liquidity	(4.09)
Fair value of 5 percent non-controlling equity interest	32.00

Example 25—Valuation of Unquoted Equity Instruments (Constant Growth with Limited information)

IE175. Entity S is a private company. Public Investment Fund T has a ten per cent non-controlling equity interest in Entity S. Entity S's management has prepared a two-year budget. However, Entity S's management shared with the manager of Public Pension Plan T materials from its annual Board meetings, at which management discussed the assumptions to back up the expected growth plan for the next five years.

IE176. On the basis of the information obtained from the Board meeting, Public Investment Fund T has extrapolated the two-year budget by reference to the basic growth assumptions discussed in the Board meeting and has performed a discounted cash flow calculation.

⁵² The process shown above is not the only possible method that a public sector entity could apply to measure the fair value of its non-controlling equity interest. As a result, the adjustments above should not be considered to be a comprehensive list of all applicable adjustments. The necessary adjustments will depend on the specific facts and circumstances. In addition, the amounts of the adjustments above are not supported by detailed calculations. They have been included for illustrative purposes only.

IE177. On the basis of Entity S's management's two-year detailed budget, sales and EBIT would reach CU200 and CU50, respectively, in 20X3. Public Investment Fund T understands that Entity S's management expects sales to achieve further growth of five per cent per annum until 20X8 with the same EBIT margin (as a percentage of sales) as in 20X3. Consequently, Public Investment Fund T projects the EBIT of Entity S as follows:⁵³

	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000	Year 6 CU'000	Year 7 CU'000
Sales	150	200	210	221	232	243	255
EBIT margin	23%	25%	25%	25%	25%	25%	25%
EBIT	35	50	53	55	58	61	64

IE178. Public Investment Fund T is also aware that the management of Entity S expects the entity to reach a stable growth stage by 20X8. To calculate the terminal value, using the constant growth discount model, Public Investment Fund T assumes a long-term terminal growth rate of two per cent on the basis of the long-term outlook of Entity S, its industry and the economy in the country where Entity S operates. If Entity S has not reached the stable growth stage by the end of the projection period, Public Investment Fund T would need to extend the projection period until the stable growth stage is reached and calculate the terminal value at that point.⁵⁴

IE179. Finally, Public Investment Fund T cross-checks this valuation by comparing Entity S's implied multiples to those of its comparable company peers.⁵⁵

Example 26—Valuation of Unquoted Equity Instruments (Adjusted Net Assets)

IE180. State Government A has a ten per cent non-controlling equity interest in Entity V, a private company. There is no controlling shareholder for Entity V, which is a payroll services provider for its investors, including State Government A. Entity V's transactions, and therefore service fees, depend on the total number of employees of its investors (which are all the State Governments of Jurisdiction Z) and, as a result, Entity V does not have its own growth strategy. Entity V has a very low profit margin and it does not have comparable public company peers.

IE181. State Government A needs to measure the fair value of its non-controlling equity interest in Entity V as of December 31, 20X1 (i.e. the measurement date). State Government A has Entity V's latest statement of financial position, which is dated September 30, 20X1.

IE182. The following are the adjustments performed by State Government A to the latest statement of financial position of Entity V:

⁵³ To derive Entity S's FCF for use in the discounted cash flow method, Public Investment Fund T used Entity S's two-year budget and its understanding of the investee's asset and capital structures, reinvestment requirements and working capital needs.

⁵⁴ This example illustrates a two-stage model in which the first stage is delineated by a finite number of periods (20X2–20X8) and after this first stage the example assumes a period of constant growth for which Public Investment Fund T calculates a terminal value for Entity S. In other cases an investor might conclude that a multiple-stage model rather than a two-stage model would be more appropriate. A multiple-stage model would generally have a period after the discrete projection period in which growth might be phased down over a number of years before the constant growth period for which a terminal value can be estimated.

⁵⁵ This example assumes that the fair value conclusion would have included any necessary adjustments (for example, non-controlling interest discount, discount for the lack of liquidity etc.) that market participants would incorporate when pricing the equity instruments at the measurement date.

- Entity V's major asset is an office building that was acquired when Entity V was founded 25 years ago. The fair value of the building was measured by a valuation specialist at CU2,500 at the measurement date. This value compares to a book value of CU1,000.
- During the three-month period from September 30, 20X1 to the measurement date, the fair value of Entity V's investments in public companies changed from CU500 to CU600.
- State Government A observes that Entity V measures its current assets and current liabilities at fair value. The volume of operations of Entity V is so flat that the investor estimates that the amounts of the current assets and current liabilities shown in Entity V's statement of financial position as of September 30, 20X1 are most representative of their fair value at the measurement date, with the exception of an amount of CU50 included in Entity V's trade receivables that became unrecoverable after September 30, 20X1.
- On the basis of Entity V's business model and profitability, State Government A estimates that unrecognized intangible assets would not be material.
- State Government A does not expect that Entity V's cash flows for the quarter ended December 31, 20X1 are material.
- State Government A does not expect any major sales of assets from Entity V. As a result, it concludes that there are no material tax adjustments that need to be considered when valuing Entity V.

Entity V – Statement of financial position (CU)

	Sept 30, 20X1	Adjustments	Estimated Dec 31, 20x1
ASSETS			
Non-current assets			
Property, plant and equipment	2,000	1,500	3,500
Investments in equity instruments	500	100	600
	2,500	1,600	4,100
Current assets			
Trade receivables	500	(50)	450
Cash and cash equivalents	500	-	500
	1,000	(50)	950
Total Assets	3,500	1,550	5,050
EQUITY AND LIABILITIES			
Total net assets/equity	2,500	1,550	4,050
Current liabilities	1,000	0	1,000
Total net assets/equity and liabilities	3,500	1,550	5,050

- IE183. Before considering any adjustments (for example, discount for the lack of liquidity, non-controlling interest discount), the indicated fair value of State Government A's ten per cent non-controlling equity interest in Entity V is CU405 (10 percent x CU4,050 = CU405). For the purpose of this example, it has been assumed that the discount for the lack of liquidity amounts to CU40 and that the non-controlling interest discount amounts to CU80.
- IE184. On the basis of the facts and circumstances described above, State Government A concludes that the price that is most representative of fair value for its ten per cent non-controlling equity interest in Entity V is CU285 at the measurement date (CU405 – (CU40+ CU85 = CU285).⁵⁶

Example 27—Valuation of Unquoted Equity Instruments with Non-Exchange Component

- IE185. National Government A purchased 1,000 shares of International Investment Bank B on 1 July 20X6 for CU5,000, or CU5 per share. Because National Government A is a non-controlling shareholder, it does not receive the Bank's budgets or cash flow forecasts. National Government A prepares annual financial statements and is measuring the fair value of its non-controlling equity interest in the International Investment Bank on December 31, 20X6 (i.e. the measurement date).
- IE186. The amount paid for the unquoted equity instruments (CU5,000) in July 20X6 is a reasonable starting point for measuring the fair value of the investor's non-controlling equity interest in International Investment Bank B at the measurement date. However, National Government A is required to assess whether the amount paid needs to be adjusted if there is evidence that other factors exist or if other evidence indicates that the transaction price is not representative of fair value at the measurement date. For example, in some circumstances a public sector entity may transfer consideration in excess of the fair value of the shares acquired, to provide a subsidy to the recipient. In these circumstances, National Government A adjusts the transaction price accordingly and recognizes an expense for the concessionary portion of the consideration because the transaction includes a payment for the equity instrument and subsidy.

Example 28—Valuation of Unquoted Equity Instruments Arising from a Non-Exchange Transaction

- IE187. On January 1, 20X1, National Government A transfers CU1000 to International Development Bank B. In exchange, Bank B issues 100 common shares with a par value of CU8. In transferring the CU1000, National Government A granted a concession of CU200, as evidenced in the transaction documentation.
- IE188. When accounting for the transaction, National Government A identifies two components embedded in the transfer of CU1000. The first component is a non-exchange expense of CU200. National Government A applies the guidance in paragraphs AG125-AG127 when accounting for this component.
- IE189. The second component is the 100 common shares in Bank B. [Draft] IPSAS [X] (ED 62) requires, at initial recognition, financial instruments be measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, directly attributable transaction costs.

⁵⁶ The process shown above is not the only possible method that a public sector entity could apply to measure the fair value of its non-controlling equity interest. As a result, the adjustments above should not be considered to be a comprehensive list of all applicable adjustments. The necessary adjustments will depend on the specific facts and circumstances. In addition, the amounts of the adjustments above are not supported by detailed calculations. They have been included for illustrative purposes only.

- IE190. As the best evidence of fair value at initial recognition is normally the transaction price, National Government A determines the transaction price of CU800, as evidenced in the transaction document (100 common shares x par value of CU8/share), is the appropriate value at initial recognition.
- IE191. In addition to the transaction documentation, National Government concludes CU8 per share is the fair value of each share based on other similar transactions Bank B had with other national governments. In each transaction, Bank B issued common shares for CU8.

Example 29—Valuation of Debt Obligations: Quoted Price

- IE199. On January 1, 20X1, State Government B issues at par a CU2 million BBB-rated exchange-traded five-year fixed rate debt instrument with an annual 10 per cent coupon. State Government B designated this financial liability as at fair value through surplus or deficit.
- IE200. On December 31, 20X1, the instrument is trading as an asset in an active market at CU929 per CU1,000 of par value after payment of accrued interest. State Government B uses the quoted price of the asset in an active market as its initial input into the fair value measurement of its liability ($\text{CU}929 \times [\text{CU}2 \text{ million} \div \text{CU}1,000] = \text{CU}1,858,000$).
- IE201. In determining whether the quoted price of the asset in an active market represents the fair value of the liability, State Government B evaluates whether the quoted price of the asset includes the effect of factors not applicable to the fair value measurement of a liability. State Government B determines that no adjustments are required to the quoted price of the asset. Accordingly, State Government B concludes that the fair value of its debt instrument at December 31, 20X1, is CU1,858,000. State Government B categorizes and discloses the fair value measurement of its debt instrument within Level 1 of the fair value hierarchy in accordance with IPSAS 30, *Financial Instruments: Disclosures*.

Example 30—Valuation of Debt Obligations: Present Value Technique

- IE202. On January 1, 20X1, National Government C issues at par in a private placement a CU2 million BBB-rated five-year fixed rate debt instrument with an annual 10 per cent coupon. National Government C designated this financial liability as at fair value through surplus or deficit.
- IE203. At December 31, 20X1, National Government C still carries a BBB credit rating. Market conditions, including available interest rates, credit spreads for a BBB-quality credit rating and liquidity, remain unchanged from the date the debt instrument was issued. However, National Government C's credit spread has deteriorated by 50 basis points because of a change in its risk of non-performance. After taking into account all market conditions, Entity C concludes that if it was to issue the instrument at the measurement date, the instrument would bear a rate of interest of 10.5 per cent or National Government C would receive less than par in proceeds from the issue of the instrument.
- IE204. For the purpose of this example, the fair value of National Government C's liability is calculated using a present value technique. National Government C concludes that a market participant would use all the following inputs when estimating the price the market participant would expect to receive to assume National Government C's obligation:

- (a) the terms of the debt instrument, including all the following:
 - (i) coupon of 10 per cent;

- (ii) principal amount of CU2 million; and
 - (iii) term of four years.
- (b) the market rate of interest of 10.5 per cent (which includes a change of 50 basis points in the risk of non-performance from the date of issue).
- IE205. On the basis of its present value technique, National Government C concludes that the fair value of its liability at December 31, 20X1 is CU1,968,641.
- IE206. Entity C does not include any additional input into its present value technique for risk or profit that a market participant might require for compensation for assuming the liability. Because National Government C's obligation is a financial liability, National Government C concludes that the interest rate already captures the risk or profit that a market participant would require as compensation for assuming the liability. Furthermore, National Government C does not adjust its present value technique for the existence of a restriction preventing it from transferring the liability.

Classification of Financial Assets (Paragraphs 39-44)

Example 31—Capital Subscriptions Held with Redemption Features

- IE207. In order to participate and support the activities of International Development Bank A, Federal Government B invests and acquires a fixed number of subscription rights in International Development Bank A, based on Government B's proportional share of global Gross Domestic Product. Each subscription right costs CU1,000, provides Government B with the right to put the subscription rights back to Bank A in exchange for the initial amount invested (i.e. CU1,000 per subscription right). International Development Bank A has no obligation to deliver dividends on the subscription rights.
- IE208. Government B is evaluating the appropriate classification of the financial asset based on the terms of the subscription rights.
- IE209. In determining the classification of the financial asset, Government B concludes the subscription rights do not meet the definition of an equity instrument as defined in IPSAS 28, *Financial Instruments: Presentation*.⁵⁷ As a result, Government B concludes the election available in paragraph 43 to measure an equity instrument at fair value through net assets/equity is not available.
- IE210. Furthermore, as the contractual terms of the subscription rights fail to give rise on specified dates to cash flows solely for payments of principal and interest, the subscription rights cannot be classified as a debt instrument measured at amortized cost or fair value through net assets/equity. Government B concludes puttable subscription rights are required to be classified at fair value through surplus or deficit.

⁵⁷ Based on guidance in paragraphs 15, 16, 17 and 18 of IPSAS 30 it is possible the puttable subscription rights meet the requirements to be classified as an equity instrument from the Bank's perspective. However, instruments meeting the provisions of paragraphs 15, 16, 17 and 18 of IPSAS 30 do not meet the definition of an equity instrument in IPSAS 30.

Effective Interest Rate Method (Paragraphs 39-44)**Example 32—Measuring the Effective Interest Rate of a Bond Issued at a Discount with Transaction Costs**

- IE211. State Government A issues a 3-year bond with a face value of CU500,000. The instrument carries a fixed yield of 4 percent, with interest payments paid annually. The bond was issued at a discount of 2 percent and State Government A was required to pay the bond underwriters a fee equal to CU12,000 on the transaction date.
- IE212. In determining the amortized cost of the instrument, State Government A must calculate the effective interest rate. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the instrument to the gross carrying amount of the instrument.
- IE213. Assuming there are no expectations of prepayment, extension or other call options, the estimated future cash flows are CU20,000 per annum in interest payments ($\text{CU20,000} = \text{CU500,000} \times 4$ percent), with an additional CU500,000 principal payment made at maturity.
- IE214. The gross carrying amount of the bond on the transaction date is calculated based on the net proceeds received by State Government A. Since the bond was issued at a discount, before transaction costs, State Government A received CU490,000 ($\text{CU500,000} \times (1 - 2 \text{ percent})$). Taking transaction costs into account, the net proceeds on issue were CU478,000 ($\text{CU490,000} - \text{CU12,000}$).

Year	(a) Cash inflows	(b) Cash outflows (transaction costs and interest)	(c) Cash outflows (principal)	(d = a – b – c) Net cash flows
Year 1 (beginning)	500,000	12,000	10,000	478,000
Year 1 (end)	-	20,000	-	(20,000)
Year 2	-	20,000	-	(20,000)
Year 3	-	20,000	-	(20,000)
Year 4	-	20,000	-	(20,000)
Year 5	-	20,000	500,000	(520,000)

- IE215. The effective interest rate of the bond is calculated by determining the rate that exactly discounts the estimated cash flows of CU20,000 per annum, plus the principal repayment at maturity, to the gross amount of CU478,000. Essentially, the effective interest rate determines the rate of interest incurred based on the net proceeds received by State Government A.
- IE216. In this example, the effective interest rate is 5.02 percent. This is appropriate as the bond yield was stated to be 4 percent on a principal amount of CU500,000. However, in substance, State Government A only receives CU478,000 and continues to make annual interest payments of

CU20,000. As such, as the transaction costs and discount increase, the more the effective interest rate will diverge from the contractual rate.

Effective interest rate = 5.02				
Year	(a)	(b)	(c)	(d = a + b – c)
	Opening balance	Interest expense	Interest/principal payment	Ending balance
Year 1	478,000	23,980	20,000	481,980
Year 2	481,980	24,180	20,000	486,160
Year 3	486,160	24,389	20,000	490,549
Year 4	490,549	24,610	20,000	495,159
Year 5	495,159	24,841	520,000	-

IMPLEMENTATION GUIDANCE

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Implementation Guidance

This guidance accompanies, but is not part of, [draft] IPSAS [X] (ED 62).

Section A: Scope

A.1 Practice of Settling Net: Forward Contract to Purchase a Commodity

Entity XYZ enters into a fixed price forward contract to purchase one million barrels of oil in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the oil at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of oil. Is the contract accounted for as a derivative?

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of oil and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the oil and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under [draft] IPSAS [X] (ED 62). Instead, it is accounted for as an executory contract (unless the entity irrevocably designates it as measured at fair value through surplus or deficit in accordance with paragraph 6 of [draft] IPSAS [X] (ED 62)).

A.2 Option to Put a Non-Financial Asset

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for CU150 million. The current value of the building is CU175 million.⁵⁸ The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (paragraph 5 of [draft] IPSAS [X] (ED 62); but see also paragraph 6 of [draft] IPSAS [X] (ED 62)).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery ([draft] IPSAS [X] (ED 62), paragraph 8). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from [draft] IPSAS [X] (ED 62) because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract instead of an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative. (But see also paragraph 6 of [draft] IPSAS [X] (ED 62)).

⁵⁸ In this guidance, monetary amounts are denominated in 'currency units' (CU).

Section B Definitions

B.1 Definition of a Financial Instrument: Gold Bullion

Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

B.2 Definition of a Derivative: Examples of Derivatives and Underlyings

What are examples of common derivative contracts and the identified underlying?

[draft] IPSAS [X] (ED 62) defines a derivative as follows:

A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

- (a) **Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (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 of contracts that would be expected to have a similar response to changes in market factors.**
- (c) **It is settled at a future date.**

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity instrument of another entity)
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity instrument of another entity)

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity instrument of another entity)

The above list provides examples of contracts that normally qualify as derivatives under [draft] IPSAS [X] (ED 62). The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions may apply, for example, if it is a weather derivative (see paragraph AG1 of [draft] IPSAS [X] (ED 62)), a contract to buy or sell a non-financial item such as commodity (see paragraphs 6–8 and AG8 of [draft] IPSAS [X] (ED 62)) or a contract settled in an entity's own shares (see paragraphs 25–29 of IPSAS 28). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.3 Definition of a Derivative: Settlement at a Future Date, Interest Rate Swap with Net or Gross Settlement

For the purpose of determining whether an interest rate swap is a derivative financial instrument under [draft] IPSAS [X] (ED 62), does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 percent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a CU100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 percent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.4 Definition of a Derivative: Prepaid Interest Rate Swap (Fixed Rate Payment Obligation Prepaid at Inception or Subsequently)

If a party prepays its obligation under a pay-fixed, receive-variable interest rate swap at inception, is the swap a derivative financial instrument?

Yes. To illustrate: Entity S enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 percent per year. Entity S prepays its fixed obligation under the swap of CU50 million (CU100 million × 10 percent × 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the CU100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfills the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” provision of [draft] IPSAS [X] (ED 62). Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under [draft] IPSAS [X] (ED 62).

B.5 Definition of a Derivative: Prepaid Pay-Variable, Receive-Fixed Interest Rate Swap

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criterion of a derivative.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 percent times the swap's notional amount, i.e. CU10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 percent on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate

swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criterion of [draft] IPSAS [X] (ED 62). Therefore, the contract is not accounted for as a derivative under [draft] IPSAS [X] (ED 62). By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a Derivative: Offsetting Loans

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of contractual par amount at inception of the two loans, since A and B have a netting agreement. Is this a derivative under [draft] IPSAS [X] (ED 62)?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- They are entered into at the same time and in contemplation of one another;
- They have the same counterparty;
- They relate to the same risk; and
- There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in [draft] IPSAS [X] (ED 62) does not require net settlement.

B.7 Definition of a Derivative: Option Not Expected to be Exercised

The definition of a derivative in [draft] IPSAS [X] (ED 62) requires that the instrument “is settled at a future date”. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a Derivative: Foreign Currency Contract Based on Sales Volume

A South African entity, Entity XYZ, whose functional currency is the South African rand, sells electricity to Mozambique denominated in US dollars. XYZ enters into a contract with an investment bank to convert US dollars to rand at a fixed exchange rate. The contract requires XYZ to remit US dollars based on its sales volume in Mozambique in exchange for rand at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment

provision. [draft] IPSAS [X] (ED 62) does not exclude from its scope derivatives that are based on sales volume.

B.9 Definition of a Derivative: Prepaid Forward

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is CU50 per share; the one-year forward price of T is CU55 per share. XYZ is required to prepay the forward contract at inception with a CU50 million payment. The initial investment in the forward contract of CU50 million is less than the notional amount applied to the underlying, one million shares at the forward price of CU55 per share, i.e. CU55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

While this instrument does not meet the definition of a derivative in its entirety, it meets the classification criteria of a financial asset to be measured at fair value through surplus or deficit. As the contractual terms of the forward contract do not include a requirement for Entity XYZ to receive cash flows that are solely payments of principal and interest, the instrument fails the conditions to be measured at amortized cost.

B.10 Definition of a Derivative: Initial Net Investment

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.11 Definition of Held for Trading: Portfolio with a Recent Actual Pattern of Short-Term Profit-Taking

The definition of a financial asset or financial liability held for trading states that “a financial asset or financial liability is classified as held for trading if it is ... 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”. What is a “portfolio” for the purposes of applying this definition?

Although the term “portfolio” is not explicitly defined in [draft] IPSAS [X] (ED 62), the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (paragraph 9 of [draft] IPSAS [X] (ED 62)). If there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.12 Definition of Gross Carrying Amount: Perpetual Debt Instruments with Fixed or Market-Based Variable Rate

Sometimes entities purchase or issue debt instruments that are required to be measured at amortized cost and in respect of which the issuer has no obligation to repay the gross carrying amount. The interest rate may be fixed or variable. Would the difference between the initial amount paid or received and zero (“the maturity amount”) be amortized immediately on initial recognition for the purpose of determining amortized cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayment of the gross carrying amount, there is no amortization of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortized cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the gross carrying amount in each period.

B.13 Definition of Gross Carrying Amount: Perpetual Debt Instruments with Decreasing Interest Rate

If the stated rate of interest on a perpetual debt instrument decreases over time, would the gross carrying amount equal the contractual par amount in each period?

No. From an economic perspective, some or all of the contractual interest payments are repayments of the gross carrying amount. For example, the interest rate may be stated as 16 percent for the first ten years and as zero percent in subsequent periods. In that case, the initial amount is amortized to zero over the first ten years using the effective interest method, since a portion of the contractual interest payments represents repayments of the gross carrying amount. The gross carrying amount is zero after year ten because the present value of the stream of future cash payments in subsequent periods is zero (there are no further contractual cash payments in subsequent periods).

B.14 Example of Calculating the Gross Carrying Amount: Financial Asset

How is the gross carrying amount calculated for financial assets measured at amortized cost in accordance with [draft] IPSAS [X] (ED 62)?

The gross carrying amount is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the gross carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how the gross carrying amount is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a contractual par amount of CU1,250 and carries fixed interest of 4.7 percent that is paid annually ($\text{CU1,250} \times 4.7 \text{ percent} = \text{CU59}$ per year). The contract also specifies that the borrower has an option to prepay the instrument at par and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay (and, therefore, the entity determines that the fair value of the prepayment feature is insignificant when the financial asset is initially recognized).

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of ten percent

annually. The table below provides information about the gross carrying amount, interest revenue and cash flows of the debt instrument in each reporting period.

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Gross carrying amount at the beginning of the year	Interest revenue	Cash flows	Gross carrying amount at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086	109	59	1,136
20X3	1,136	113	59	1,190
20X4	1,190	119	1,250 + 59	–

On the first day of 20X2 the entity revises its estimate of cash flows. It now expects that 50 percent of the contractual par amount will be prepaid at the end of 20X2 and the remaining 50 percent at the end of 20X4. In accordance with paragraph AG158 of [draft] IPSAS [X] (ED 62), the gross carrying amount of the debt instrument in 20X2 is adjusted. The gross carrying amount is recalculated by discounting the amount the entity expects to receive in 20X2 and subsequent years using the original effective interest rate (10 percent). This results in the new gross carrying amount in 20X2 of CU1,138. The adjustment of CU52 (CU1,138 – CU1,086) is recorded in surplus or deficit in 20X2. The table below provides information about the gross carrying amount, interest revenue and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Gross carrying amount at the beginning of the year	Interest revenue	Cash flows	Gross carrying amount at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086 + 52	114	625 + 59	568
20X3	568	57	30	595
20X4	595	60	625 + 30	–

B.15 Example of Calculating the Gross Carrying Amount: Debt Instruments with Stepped Interest Payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively (“stepped interest”) over the term of the debt instrument. If a debt instrument with stepped interest is issued at CU1,250 and has a maturity amount of CU1,250, would the gross carrying amount equal CU1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount.

The following example illustrates how the gross carrying amount is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument (“stepped interest”).

On January 1, 20X0, Entity A issues a debt instrument for a price of CU1,250. The contractual par amount is CU1,250 and the debt instrument is repayable on December 31, 20X4. The rate of interest is specified in the debt agreement as a percentage of the contractual par amount as follows: 6.0 percent in 20X0 (CU75), 8.0 percent in 20X1 (CU100), 10.0 percent in 20X2 (CU125), 12.0 percent in 20X3 (CU150), and 16.4 percent in 20X4 (CU205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is ten percent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining the gross carrying amount in each period. In each period, the gross carrying amount at the beginning of the period is multiplied by the effective interest rate of ten percent and added to the gross carrying amount. Any cash payments in the period are deducted from the resulting number. Accordingly, the gross carrying amount in each period is as follows:

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Gross carrying amount at the beginning of the year	Interest revenue	Cash flows	Gross carrying amount at the end of the year
20X0	1,250	125	75	1,300
20X1	1,300	130	100	1,330
20X2	1,330	133	125	1,338
20X3	1,338	134	150	1,322
20X4	1,322	133	1,250 + 205	—

B.16 Regular Way Contracts: No Established Market

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. [draft] IPSAS [X] (ED 62) refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace is not limited

to a formal stock exchange or organized over-the-counter market. Instead, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.17 Regular Way Contracts: Forward Contract

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for CU10 per share. The contract is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.18 Regular Way Contracts: Which Customary Settlement Provisions Apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases one million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.19 Regular Way Contracts: Share Purchase by Call Option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.20 Recognition and Derecognition of Financial Liabilities Using Trade Date or Settlement Date Accounting

[draft] IPSAS [X] (ED 62) has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. [draft] IPSAS [X] (ED 62) does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in paragraphs 10 and 35 of [draft] IPSAS [X] (ED 62) apply. Paragraph 10 of [draft] IPSAS [X] (ED 62) states that financial liabilities are recognized on the date the entity 'becomes a party to the contractual provisions of the instrument'. Such contracts generally are not recognized unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of [draft] IPSAS [X] (ED 62). Paragraph 35 of [draft] IPSAS [X] (ED 62) specifies that financial liabilities are derecognized only when they are extinguished, i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Section C Embedded derivatives

C.1 Embedded Derivatives: Separation of Host Debt Instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgment of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid contract, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of CU40,000 annually and a contractual payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid contract.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid contract. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid contract. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 Embedded Derivatives: Separation of Embedded Option

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid contract. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid contract?

No. The economic behavior of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid contract, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, capton, floortion or swaption feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behavior of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behavior of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid contract.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid contract. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid contract, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid contract.

C.3 Embedded Derivatives: Equity Kicker

In some instances, investment entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an “equity kicker”) in addition to the contractual payments. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognized in surplus or deficit (paragraph 49(c) of [draft] IPSAS [X] (ED 62)), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (paragraph 49(a) of [draft] IPSAS [X] (ED 62)). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in

the price of the shares of the borrower, it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (paragraph 49(b) and paragraph 9 of [draft] IPSAS [X] (ED 62)). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. Paragraph AG7 of [draft] IPSAS [X] (ED 62) states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.4 Embedded Derivatives: Synthetic Instruments

Entity A issues a five-year floating rate debt instrument. At the same time, it enters into a five-year pay-fixed, receive-variable interest rate swap with Entity B. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument. Entity A contends that separate accounting for the swap is inappropriate since paragraph AG106(a) of [draft] IPSAS [X] (ED 62) requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of contractual interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ("synthetic instrument" accounting) for the purpose of applying [draft] IPSAS [X] (ED 62). Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.5 Embedded Derivatives: Purchases and Sales Contracts in Foreign Currency Instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under [draft] IPSAS [X] (ED 62)?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contract as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in surplus or deficit unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.6 Embedded Foreign Currency Derivatives: Unrelated Foreign Currency Provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the

scope of [draft] IPSAS [X] (ED 62) because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (paragraphs 5 and AG8 of [draft] IPSAS [X] (ED 62)) and the entity has not irrevocably designated it as measured at fair value through surplus or deficit in accordance with paragraph 6 of [draft] IPSAS [X] (ED 62). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under paragraph 49 of [draft] IPSAS [X] (ED 62), is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (paragraph AG106(d) of [draft] IPSAS [X] (ED 62)).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from paragraph AG106(d) of [draft] IPSAS [X] (ED 62) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under paragraph 49 of [draft] IPSAS [X] (ED 62).

C.7 Embedded Foreign Currency Derivatives: Currency of International Commerce

Paragraph AG106(d) of [draft] IPSAS [X] (ED 62) refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.8 Embedded Derivatives: Holder Permitted, but not Required, to Settle Without Recovering Substantially All of its Recognized Investment

If the terms of a combined contract permit, but do not require, the holder to settle the combined contract in a manner that causes it not to recover substantially all of its recognized investment and the issuer does not have such a right (for example, a puttable debt instrument), does the contract satisfy the condition in paragraph AG106(a) of [draft] IPSAS [X] (ED 62) that the holder would not recover substantially all of its recognized investment?

No. The condition that "the holder would not recover substantially all of its recognized investment" is not satisfied if the terms of the combined contract permit, but do not require, the investor to settle the combined

contract in a manner that causes it not to recover substantially all of its recognized investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that “the holder would not recover substantially all of its recognized investment” applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognized investment.

Section D Recognition and Derecognition

D.1 Initial Recognition

D.1.1 Recognition: Cash Collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A’s assets. Should Entity A recognize the cash collateral it has received as an asset?

Yes. The ultimate realization of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realized by Entity A. Therefore, Entity A recognizes the cash as an asset and a payable to Entity B while Entity B derecognizes the cash and recognizes a receivable from Entity A.

D.2 Regular Way Purchase or Sale of a Financial Asset

D.2.1 Trade Date vs Settlement Date: Amounts to be Recorded for a Purchase

How are the trade date and settlement date accounting principles in [draft] IPSAS [X] (ED 62) applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in [draft] IPSAS [X] (ED 62) for a purchase of a financial asset. On December 29, 20X1, an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On December 31, 20X1 (financial year-end) and on 4 January 20X2 (settlement date) the fair value of the asset is CU1,002 and CU1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

Settlement date accounting			
Balances	Financial assets measured at amortized cost	Financial assets measured at fair value through net assets/equity	Financial assets measured at fair value through surplus/deficit
December 29, 20X1			
Financial asset	—	—	—
Financial liability	—	—	—
December 31, 20X1			

Settlement date accounting			
Receivable	—	2	2
Financial asset	—	—	—
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(2)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(2)
January 4, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,003	1,003
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(3)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(3)

Trade date accounting			
Balances	Financial assets measured at amortized cost	Financial assets measured at fair value through net assets/equity	Financial assets measured at fair value through surplus or deficit
December 29, 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
December 31, 20X1			
Receivable	—	—	—
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Net assets/equity (fair value adjustment)	—	(2)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(2)

Trade date accounting			
January 4, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,003	1,003
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(3)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(3)

D.2.2 Trade Date vs Settlement Date: Amounts to be Recorded for a Sale

How are the trade date and settlement date accounting principles in [draft] IPSAS [X] (ED 62) applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in [draft] IPSAS [X] (ED 62) for a sale of a financial asset. On December 29, 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its gross carrying amount is CU1,000. On December 31, 20X2 (financial year-end), the fair value of the asset is CU1,012. On January 4, 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any loss allowance or interest revenue on the financial asset is disregarded for the purpose of this example).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement date accounting			
Balances	Financial assets measured at amortized cost	Financial assets measured at fair value through net assets/equity	Financial assets measured at fair value through surplus or deficit
December 29, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,010	1,010
Net assets/equity (fair value adjustment)	—	10	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	10

Settlement date accounting			
December 31, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,010	1,010
Net assets/equity (fair value adjustment)	—	10	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	10
January 4, 20X3			
Net assets/equity (fair value adjustment)	—	—	—
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
Trade date accounting			
Balances	Financial assets measured at amortized cost	Financial assets measured at fair value through net assets/equity	Financial assets measured at fair value through surplus or deficit
December 29, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	—	—	—
Net assets/equity (fair value adjustment)	—	—	—
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
December 31, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	—	—	—
Net assets/equity (fair value adjustment)	—	—	—
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
January 4, 20X3			
Net assets/equity (fair value adjustment)	—	—	—

Trade date accounting			
Accumulated surplus or deficit (through surplus or deficit)	10	10	10

D.2.3 Settlement Date Accounting: Exchange of Non-Cash Financial Assets

If an entity recognizes sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognized in accordance with paragraph 102 of [draft] IPSAS [X] (ED 62)?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under paragraph 102 of [draft] IPSAS [X] (ED 62) if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognized on the trade date as described in paragraph AG19 of [draft] IPSAS [X] (ED 62). In that case, the entity recognizes a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on December 29, 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is measured at amortized cost, in exchange for Bond B, which meets the definition of held for trading and is measured at fair value. Both assets have a fair value of CU1,010 on December 29, while the amortized cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for financial assets measured at amortized cost and trade date accounting for assets that meet the definition of held for trading. On December 31, 20X2 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On January 4, 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

December 29, 20X2

Dr	Bond B	CU1,010	
	Cr Payable		CU1,010

December 31, 20X2

Dr	Trading loss	CU1	
	Cr Bond B		CU1

January 4, 20X3

Dr	Payable	CU1,010	
Dr	Trading loss	CU2	

Cr	Note Receivable A	CU1,000
Cr	Bond B	CU2
Cr	Realisation gain	CU10

Section E Measurement

E.1 Initial Measurement of Financial Assets and Financial Liabilities

E.1.1 Initial Measurement: Transaction Costs

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value through surplus or deficit. How should this requirement be applied in practice?

For financial assets not measured at fair value through surplus or deficit, transaction costs are added to the fair value at initial recognition. For financial liabilities, transaction costs are deducted from the fair value at initial recognition.

For financial instruments that are measured at amortized cost, transaction costs are subsequently included in the calculation of amortized cost using the effective interest method and, in effect, amortized through surplus or deficit over the life of the instrument.

For financial instruments that are measured at fair value through net assets/equity in accordance with either paragraphs 41 and 108 or paragraphs 43 and 103 of [draft] IPSAS [X] (ED 62), transaction costs are recognized in net assets/equity as part of a change in fair value at the next remeasurement. If the financial asset is measured in accordance with paragraphs 41 and 108 of [draft] IPSAS [X] (ED 62), those transaction costs are amortized to surplus or deficit using the effective interest method and, in effect, amortized through surplus or deficit over the life of the instrument.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.2 Gains and Losses

E.2.1 [draft] IPSAS [X] (ED 62) and IPSAS 4—Financial Assets Measured at Fair Value Through Net Assets/Equity: Separation of Currency Component

A financial asset measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62) is treated as a monetary item. Therefore, the entity recognizes changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit in accordance with paragraphs 27(a) and 32 of IPSAS 4 and other changes in the carrying amount in net assets/equity in accordance with [draft] IPSAS [X] (ED 62). How is the cumulative gain or loss that is recognized in net assets/equity determined?

It is the difference between the amortized cost of the financial asset⁵⁹ and the fair value of the financial asset in the functional currency of the reporting entity. For the purpose of applying paragraph 32 of IPSAS 4 the asset is treated as an asset measured at amortized cost in the foreign currency.

To illustrate: on December 31, 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a contractual par amount of FC1,250, carries fixed interest of 4.7 percent that is paid annually ($FC1,250 \times 4.7$ percent = FC59 per year), and has an effective interest rate of 10 percent. Entity A classifies the bond as subsequently measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62), and thus recognizes gains and losses in net assets/equity. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 ($= FC1,000 \times 1.5$).

Dr	Bond	LC1,500	
	Cr	Cash	LC1,500

On December 31, 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 ($= FC1,060 \times 2$). The amortized cost is FC1,041 ($= LC2,082$). In this case, the cumulative gain or loss to be recognized in net assets/equity and accumulated in equity is the difference between the fair value and the amortized cost on December 31, 20X2, i.e. LC38 ($= LC2,120 - LC2,082$).

Interest received on the bond on December 31, 20X2 is FC59 ($= LC118$). Interest revenue determined in accordance with the effective interest method is FC100 ($= FC1,000 \times 10$ percent). The average exchange rate during the year is FC1 to LC1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (see paragraph 25 of [draft] IPSAS [X] (ED 62)). Thus, reported interest revenue is LC175 ($= FC100 \times 1.75$) including accretion of the initial discount of LC72 ($= [FC100 - FC59] \times 1.75$). Accordingly, the exchange difference on the bond that is recognized in surplus or deficit is LC510 ($= LC2,082 - LC1,500 - LC72$). Also, there is an exchange gain on the interest receivable for the year of LC15 ($= FC59 \times [2.00 - 1.75]$).

Dr	Bond	LC620	
Dr	Cash	LC118	
	Cr	Interest revenue	LC175
	Cr	Exchange gain	LC525
	Cr	Fair value change in net assets/equity	LC38

⁵⁹ The objective of this example is to illustrate the separation of the currency component for a financial asset that is measured at fair value through net assets/equity in accordance with paragraph 41 of [draft] IPSAS [X] (ED 62). Consequently, for simplicity, this example does not reflect the effect of the impairment requirements in paragraphs 71-90 of [draft] IPSAS [X] (ED 62).

On December 31, 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 ($= \text{FC1,070} \times 2.50$). The amortized cost is FC1,086 ($= \text{LC2,715}$). The cumulative gain or loss to be accumulated in net assets/equity is the difference between the fair value and the amortized cost on December 31, 20X3, i.e. negative LC40 ($= \text{LC2,675} - \text{LC2,715}$). Thus, the amount recognized in net assets/equity equals the change in the difference during 20X3 of LC78 ($= \text{LC40} + \text{LC38}$).

Interest received on the bond on December 31, 20X3 is FC59 ($= \text{LC148}$). Interest revenue determined in accordance with the effective interest method is FC104 ($= \text{FC1,041} \times 10$ percent). The average exchange rate during the year is FC1 to LC2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (see paragraph 25 of IPSAS 4). Thus, recognized interest revenue is LC234 ($= \text{FC104} \times 2.25$) including accretion of the initial discount of LC101 ($= [\text{FC104} - \text{FC59}] \times 2.25$). Accordingly, the exchange difference on the bond that is recognized in surplus or deficit is LC532 ($= \text{LC2,715} - \text{LC2,082} - \text{LC101}$). Also, there is an exchange gain on the interest receivable for the year of LC15 ($= \text{FC59} \times [2.50 - 2.25]$).

Dr	Bond	LC555	
Dr	Cash	LC148	
Dr	Fair value change in net assets/equity	LC78	
	Cr	Interest revenue	LC234
	Cr	Exchange gain	LC547

E.2.2 [draft] IPSAS [X] (ED 62) and IPSAS 4—Exchange Differences Arising on Translation of Foreign Entities: Net Assets/Equity or Surplus or Deficit?

Paragraphs 37 and 57 of IPSAS 4 state that all exchange differences resulting from translating the financial statements of a foreign operation should be recognized in net assets/equity until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets measured at fair value through surplus or deficit and financial assets that are measured at fair value through net assets/equity in accordance with [draft] IPSAS [X] (ED 62).

[draft] IPSAS [X] (ED 62) requires that changes in fair value of financial assets measured at fair value through surplus or deficit should be recognized in surplus or deficit and changes in fair value of financial assets measured at fair value through net assets/equity should be recognized in net assets/equity.

If the foreign operation is a controlled entity whose financial statements are consolidated with those of its controlling entity, in the consolidated financial statements how are [draft] IPSAS [X] (ED 62) and paragraph 44 of IPSAS 4 applied?

[draft] IPSAS [X] (ED 62) applies in the accounting for financial instruments in the financial statements of a foreign operation and IPSAS 4 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign controlled entity (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which meets the definition of held for trading and is therefore measured at fair value through surplus or deficit in accordance with [draft] IPSAS [X] (ED 62).

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 ($= \text{LCY100} \times 2.00$) in the consolidated financial statements.

At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognizes the trading asset at LCY110 in its statement of financial position and recognizes a fair value gain of LCY10 in its surplus or deficit. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 ($= \text{LCY110} \times 3.00$) in the currency of Country X. Therefore, Entity A recognizes the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of changes in net assets/equity of B "at the exchange rates at the dates of the transactions" (paragraph 44(b) of IPSAS 4). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ($[(3.00 + 2.00) / 2 = 2.50]$, in accordance with paragraph 25 of IPSAS 4). Therefore, while the fair value of the trading asset has increased by LCX130 ($= \text{LCX330} - \text{LCX200}$), Entity A recognizes only LCX25 ($= \text{LCY10} \times 2.5$) of this increase in consolidated surplus or deficit to comply with paragraph 44(b) of IPSAS 4. The resulting exchange difference, i.e. the remaining increase in the fair value of the debt instrument ($\text{LCX130} - \text{LCX25} = \text{LCX105}$), is accumulated in net assets/equity until the disposal of the net investment in the foreign operation in accordance with paragraph 57 of IPSAS 4.

E.2.3 [draft] IPSAS [X] (ED 62) and IPSAS 4—Interaction Between [draft] IPSAS [X] (ED 62) and IPSAS 4

[Draft] IPSAS [X] (ED 62) includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in surplus or deficit. IPSAS 4 includes rules about the reporting of foreign currency items and the recognition of exchange differences in surplus or deficit. In what order are IPSAS 4 and [draft] IPSAS [X] (ED 62) applied?

Statement of Financial Position

Generally, the measurement of a financial asset or financial liability at fair value or amortized cost is first determined in the foreign currency in which the item is denominated in accordance with [draft] IPSAS [X] (ED 62). Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IAS 21 (paragraph AG221 of [draft] IPSAS [X] (ED 62)). For example, if a monetary financial asset (such as a debt instrument) is measured at amortized cost in accordance with [draft] IPSAS [X] (ED 62), amortized cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognized using the closing rate in the entity's financial statements (paragraph 27 of IPSAS 4). That applies regardless of whether a monetary item is measured at amortized cost or fair value in the foreign currency (paragraph 28 of IPSAS 4). A non-monetary financial asset (such as an investment in an equity instrument) that is measured at fair value in the foreign currency is translated using the closing rate (paragraph 27 (c) of IPSAS 4).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under [draft] IPSAS [X] (ED 62) (or IPSAS 29 if an entity chooses as its accounting policy to continue to apply the hedge accounting requirements in IPSAS 29), the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognized using a historical rate under IPSAS 4 (paragraph 134 of [draft] IPSAS [X] (ED 62) or paragraph 99 of IPSAS 29), i.e. the foreign currency amount is recognized using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (paragraph 27(b) of IPSAS 4).

Surplus or Deficit

The recognition of a change in the carrying amount of a financial asset or financial liability in surplus or deficit depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognizing changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.2.2).

Any exchange difference arising on recognizing a *monetary item* at a rate different from that at which it was initially recognized during the period, or recognized in previous financial statements, is recognized in surplus or deficit in accordance with IPSAS 4 (paragraph AG221 of [draft] IPSAS [X] (ED 62), paragraphs 32 and 37 of IPSAS 4), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges (paragraph 137 of [draft] IPSAS [X] (ED 62) or paragraph 106 of IPSAS 29). Differences arising from recognizing a monetary item at a foreign currency amount different from that at which it was previously recognized are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognized in surplus or deficit in accordance with [draft] IPSAS [X] (ED 62). For example, although an entity recognizes gains and losses on financial assets measured at fair value through net assets/equity in net assets/equity (paragraphs 108 and AG222 of [draft] IPSAS [X] (ED 62)), the entity nevertheless recognizes the changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit (paragraph 27(a) of IPSAS 4).

Any changes in the carrying amount of a *non-monetary item* are recognized in surplus or deficit or in net assets/equity in accordance with [draft] IPSAS [X] (ED 62). For example, for an investment in an equity instrument that is presented in accordance with paragraph 103 of [draft] IPSAS [X] (ED 62), the entire change in the carrying amount, including the effect of changes in foreign currency rates, is presented in net assets/equity (paragraph AG223 of [draft] IPSAS [X] (ED 62)). If the non-monetary item is designated as a cash flow hedge of an unrecognized firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges (paragraph 137 of [draft] IPSAS [X] (ED 62) or paragraph 106 of IPSAS 29).

When some portion of the change in carrying amount is recognized in net assets/equity and some portion is recognized in surplus or deficit, for example, if the amortized cost of a foreign currency bond measured at fair value through net assets/equity has increased in foreign currency (resulting in a gain in surplus or deficit) but its fair value has decreased in foreign currency (resulting in a loss recognized in net

assets/equity), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognized in surplus or deficit or in net assets/equity.

E.2.4—Valuation of Unquoted Equity Instruments

What valuation technique is most appropriate to apply when determining the fair value of these unquoted equity instruments?

Public sector entities have a wide range of valuation techniques available when determining the fair value of an unquoted equity instrument. [draft] IPSAS [X] (ED 62) does not prescribe the use of a specific valuation technique, but instead encourages the use of professional judgment and the consideration of all the facts and circumstances surrounding the selection of an appropriate measurement technique. Figure 1 illustrates various valuation techniques that may be applicable based on the transactions facts and circumstances. This is not an exhaustive list.

Figure 1 – Valuation approaches and valuation techniques	
Valuation approach	Valuation techniques
Market approach	<ul style="list-style-type: none"> • Transaction price paid for an identical or similar instrument of an investee (see illustrative example 23) • Comparable company valuation multiples
Other approaches	<ul style="list-style-type: none"> • Discounted cash flow method (see illustrative example 24) • Dividend discount model • Constant growth model (see illustrative example 25) • Capitalization model • Adjusted net asset method (see illustrative example 26)

The economic characteristics of unquoted equity instruments and the information that is reasonably available to a public sector entity are two of the factors that should be considered when selecting the most appropriate valuation technique. For example, an entity is likely to place more emphasis on the comparable company valuation multiples technique when there are sufficiently comparable company peers or when the background or details of the observed transactions are known. Similarly, a public sector entity is likely to place more emphasis on the discounted cash flow method when, for example:

- The cash flows of a public sector entity present unique characteristics such as periods of unequal rates of growth (for example, a period of high growth that stabilizes later to more steady levels of growth).
- Alternatively, when measuring the fair value of unquoted equity instruments, a public sector entity might conclude that, on the basis of the specific facts and circumstances (for example,

the nature of the investment, the history and stage of the development of the investment, the nature of the investment's assets and liabilities, its capital structure etc.),

- (c) It is appropriate to apply the adjusted net asset method. Consequently, given specific facts and circumstances, one valuation technique might be more appropriate than another.

Some of the factors that a public sector entity will need to consider when selecting the most appropriate valuation technique(s) include (this list is not exhaustive):

1. The information that is reasonably available to a public sector entity;
2. The market conditions;
3. The investment horizon and investment type (for example, the market sentiment when measuring the fair value of a short-term financial investment might be better captured by some valuation techniques than by others);
4. The life cycle of the investment (i.e. what may trigger value in different stages of an entity's life cycle might be better captured by some valuation techniques than by others);
5. The nature of an investment's business (for example, the volatile or cyclical nature of an investee's business might be better captured by some valuation techniques than others); and
6. The industry in which an entity operates.

The fair value measurement of technique must reflect current market conditions. An entity might ensure that the valuation techniques reflect current market conditions by calibrating them at the measurement date. At initial recognition, if the transaction price represented fair value and an investor will use a valuation technique to measure fair value in subsequent periods that uses unobservable inputs, the entity must calibrate the valuation technique so that it equals the transaction price (if the transaction contains a non-exchange component, recalibrate to the fair value of the equity instrument). The use of calibration when measuring the fair value of the unquoted equity instruments at the measurement date is a good exercise for an entity to ensure that the valuation technique reflects current market conditions and to determine whether an adjustment to the valuation technique is necessary (for example, there might be a characteristic of the instrument that is not captured by the valuation technique or a new fact that has arisen at the measurement date that was not present at initial recognition).

In some circumstances, an entity may have to apply more than one valuation technique when determining fair value.

Examples of various types of techniques for measurement of the fair value of unquoted equity instruments, are provided in Illustrative Examples 23 - 26.

E.2.5—Cost as a Proxy for Fair Value of Equity Instruments

Can the cost of the equity instrument be used by default for subsequent measurement?

No. Investments in equity instruments must be measured at fair value. However, as noted in paragraph AG136 cost may be an appropriate estimate of fair value because there is insufficient recent information available to measure fair value or because there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

Section F Other

F.1 [draft] IPSAS [X] (ED 62) and IPSAS 2—Hedge Accounting: Statements of Cash Flows

How should cash flows arising from hedging instruments be classified in statements of cash flows?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in IPSAS 2 has not been updated to reflect [draft] IPSAS [X] (ED 62), the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments under [draft] IPSAS [X] (ED 62).

Section G Concessionary Loans / Equity

G.1 Sequencing of “Solely Payments of Principal and Interest” Evaluation for a Concessionary Loan

If an entity issues a concessionary loan (financial asset) when does it assess classification for subsequent measurement purposes?

An entity firstly assesses whether the substance of the concessionary loan is in fact a loan, a grant, a contribution from owners or a combination thereof, by applying the principles in IPSAS 28 and paragraphs 42–58 of IPSAS 23. If an entity has determined that the transaction, or part of the transaction, is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition. An entity determines the fair value of the loan by using the principles in AG140–AG152.

After initial recognition at fair value, an entity subsequently assesses the classification of concessionary loans in accordance with paragraphs 39–44 and measures concessionary loans in accordance with paragraphs 59–63.

G.2 Concessionary Loans and “Solely Payments of Principal and Interest” Evaluation

Can a concessionary loan satisfy the SPPI criteria?

Yes. When the payments of the loan, based on its fair value determined at initial recognition, reflect solely payments of principal and interest.

However, if a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, a contingent repayment feature specific to the borrower), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraphs 40(b) and 41(b). To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows.

G.3 Valuation of Non-Exchange Component

Can the non-exchange component of an equity transaction equal the transaction cost?

No. To the extent an entity receives an equity instrument, such as common shares, in exchange for consideration, the equity instrument will have some value on initial recognition and must be measured at fair value.

At initial recognition, the entity must evaluate the substance of the arrangement and assess whether a portion of the consideration provided is a non-exchange component such as a grant or subsidy.

Section H Effective Interest Rate Method

H.1 Requirement to Use the Effective Interest Rate Method

When transaction costs and any premium or discount on issuance are insignificant, measuring the amortized cost of an instrument using the effective interest rate produces similar results as using the straight line method.

In circumstances where measuring the gross amount of an instrument using the effective interest rate method yields immaterial differences as compared to applying the straight line method, is the effective interest rate method required to be used?

Measuring the amortized cost of an instrument requires the use of the effective interest rate method. However, in practice there may be scenarios where applying the straight line method yields materially the same result.

Paragraph 10 of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, indicates “IPSASs set out accounting policies that the IPSASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events, and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial...”

When an alternative technique – in this case the straight line method – yields materially the same result as measuring amortized cost using the effective interest rate method, management need not apply the effective interest rate method as required by [draft] IPSAS [X] (ED 62), *Financial Instruments*.

The following example illustrates why differences arise when measuring the gross amount of a debt instrument using the effective interest rate method compared to the straight line method. National Government A issues a bond with a face value of CU100,000. The bond yield of 10 percent is paid annually until maturity in 5 years. The bond was issued at a discount of 3 percent and National Government A had to pay CU2,000 in transaction costs.

Under both measurement methodologies, National Government A received CU95,000 on issuance of the instrument ($\text{CU95,000} = \text{CU100,000} - \text{CU2,000} - \text{CU100,000} \times 3\%$).

Straight Line Method

Measuring the gross amount of the instrument using the straight line method requires amortizing the discount and transaction costs evenly until maturity.

Year	(a)	(b = $100,000 \times 10\%$)	(c)	(d)	(e = a + b + c – d)
	Gross carrying amount at the beginning of the year	Interest revenue	Amortization of transaction costs and discount	Cash flows	Gross carrying amount at the end of the year
1	95,000	10,000	1,000	10,000	96,000
2	96,000	10,000	1,000	10,000	97,000

Year	(a)	(b = 100,000 × 10%)	(c)	(d)	(e = a + b + c – d)
	Gross carrying amount at the beginning of the year	Interest revenue	Amortization of transaction costs and discount	Cash flows	Gross carrying amount at the end of the year
3	97,000	10,000	1,000	10,000	98,000
4	98,000	10,000	1,000	10,000	99,000
5	99,000	10,000	1,000	110,000	–

Effective Interest Rate Method

Measuring the gross amount of the instrument using the effective interest rate method requires calculating the rate that exactly discounts the estimate future cash payments through the expected life of the instrument to the gross carrying amount of the instrument. Discounting the estimated cash flows of the bond yields an effective interest rate of 11.37%.

Year	(a)	(b = a × 11.37%)	(c)	(d = a + b – c)
	Gross carrying amount at the beginning of the year	Interest revenue	Cash flows	Gross carrying amount at the end of the year
1	95,000	10,797	10,000	95,797
2	95,797	10,888	10,000	96,685
3	96,685	10,989	10,000	97,673
4	97,673	11,101	10,000	98,774
5	98,774	11,226	110,000	–

When evaluating whether measuring the gross amount of the bond using the straight line method yields an immaterial difference compared to applying the effective instrument, the gross amount is compared at each measurement date as detailed in the table below.

Year	Straight Line Method	Effective Interest Rate Method	
	Gross carrying amount at the beginning of the year	Gross carrying amount at the beginning of the year	Difference
1	95,000	95,000	-
2	96,000	95,797	203

Year	Straight Line Method	Effective Interest Rate Method	
	Gross carrying amount at the beginning of the year	Gross carrying amount at the beginning of the year	Difference
3	97,000	96,685	315
4	98,000	97,673	327
5	99,000	98,774	226

The measurement difference between the two methods is a result of the transaction costs and the discount on issuance of the bond. As the costs approach zero, the difference between measuring the bond using the straight line method or the effective interest rate method will become smaller. As the costs increase, the difference will grow in size.

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EXPOSURE DRAFT NZASB 2016-7

PBE IFRS 9 FINANCIAL INSTRUMENTS

(ED NZASB 2016-7)

Invitation to Comment

June 2016

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Information for Respondents

Invitation to Comment

The NZASB¹ is seeking comments on the specific matters raised in this Invitation to Comment. We will consider all comments before finalising a new PBE Standard based on IFRS 9 *Financial Instruments*.

If you want to comment, please supplement your opinions with detailed comments, whether supportive or critical of the proposals, as both supportive and critical comments are essential to a balanced view.

Comments are most useful if they indicate the specific paragraph to which they relate, contain a clear rationale and, where applicable, provide a suggestion for an alternative. Feel free to provide comments only for those questions, or issues that are relevant to you.

Submissions should be sent to:

Chief Executive
External Reporting Board
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Wellington 6142
New Zealand

Email: submissions@xrb.govt.nz
(please refer to *PBE Financial Instruments* in the subject line)

We would appreciate receiving a copy of your submission in electronic form (preferably Microsoft Word format) as that helps us to efficiently collate and analyse comments.

Please note in your submission on whose behalf the submission is being made (for example, own behalf, a group of people, or an entity).

The closing date for submissions is **30 September 2016**.

Publication of Submissions, the Official Information Act and the Privacy Act

We intend publishing all submissions on the XRB website (xrb.govt.nz), unless the submission may be defamatory. If you have any objection to publication of your submission, we will not publish it on the internet. However, it will remain subject to the Official Information Act 1982 and, therefore, it may be released in part or in full. The Privacy Act 1993 also applies.

If you have an objection to the release of any information contained in your submission, we would appreciate you identifying the parts of your submission to be withheld, and the grounds under the Official Information Act 1982 for doing so (e.g. that it would be likely to unfairly prejudice the commercial position of the person providing the information).

¹ The NZASB is a sub-Board of the External Reporting Board (XRB Board), and is responsible for setting accounting standards.

List of Abbreviations

The following abbreviations are used in this Invitation to Comment.

ED	Exposure Draft
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
IPSASB	International Public Sector Accounting Standards Board
IPSAS	International Public Sector Accounting Standard
NZASB	New Zealand Accounting Standards Board, a sub-Board of the External Reporting Board
PBE	Public Benefit Entity
PBE IFRS	Public Benefit Entity International Financial Reporting Standard
PBE IPSAS	Public Benefit Entity International Public Sector Accounting Standard

Questions for Respondents

	Paragraphs
1. Do you support the NZASB's proposal to issue a PBE Standard based on IFRS 9 in advance of the IPSASB completing its project on financial instruments, taking into account the factors discussed in the <i>PBE Policy Approach</i> ? If not, please explain why not and indicate any alternative course of action that you think would be more appropriate.	1–17
2. If a PBE Standard based on IFRS 9 were to be issued by the end of 2016, and you are the head of a mixed group or a member of a mixed group:	
(a) do you think it is likely that you or any PBEs within the mixed group would wish to early-adopt PBE IFRS 9; and	1–21
(b) if so, do you think that the expected issue date of late 2016 would provide sufficient lead-in time for a PBE within a mixed group to voluntarily adopt the proposed PBE Standard?	
3. Do you agree with the modifications made by the NZASB in developing the proposed PBE Standard? If not, please explain why not and identify what you think would be more appropriate. Respondents may find it helpful to consider the matters outlined in Tables 2-4.	24–33
4. Do you agree with the proposed RDR concessions in relation to PBE IPSAS 30 (refer Appendix D of the Exposure Draft)? If you disagree, please provide reasons and indicate what concessions you consider would be appropriate.	34–36
5. Do you agree with the proposal that the effective date of the proposed PBE IFRS 9 be 1 January 2021, with early adoption permitted (bearing in mind the NZASB's intention to defer the effective date of PBE IFRS 9 until a future IPSAS based on IFRS 9 is effective)?	37–39
6. Do you have any other comments on the Exposure Draft?	

1. Introduction

1.1 Background

IFRS 9 and mixed group issues

1. The NZASB is proposing to issue a new PBE Standard on the recognition and measurement of financial instruments. The Exposure Draft is based on IFRS 9 *Financial Instruments*, which was issued by the IASB in 2014 as a replacement for its existing standard, IAS 39 *Financial Instruments: Recognition and Measurement*.
2. The current PBE Standard dealing with the recognition and measurement of financial instruments is PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*. PBE IPSAS 29 is based on a standard issued by the IPSASB, which in turn is based on IAS 39. Hence, the requirements in PBE IPSAS 29 are largely based on IAS 39.
3. Compared with IAS 39, IFRS 9 introduces a number of changes to the recognition and measurement of financial instruments, including new classification and measurement requirements for financial assets, new hedging requirements and new impairment requirements for financial assets. The new requirements in IFRS 9 are expected to lead to higher quality financial reporting and, in some cases, to improve the cost-benefit aspects of accounting for financial instruments. For example, the hedging requirements in IFRS 9 are less restrictive than the requirements in IAS 39 (and PBE IPSAS 29) and allow an entity to better reflect the impact of its hedging activities on its financial performance. The IPSASB intends to develop a new financial instruments' standard based on IFRS 9, but the IPSASB's project is currently at an early stage (as discussed further in paragraph 6 below).
4. IFRS 9 has been incorporated into the for-profit sector standards in New Zealand as NZ IFRS 9 *Financial Instruments*. The effective date of IFRS 9 (and NZ IFRS 9) is annual periods beginning on or after 1 January 2018, with early application permitted. Once NZ IFRS 9 becomes effective, the differences summarised in paragraph 3 above would result in significant differences between NZ IFRS and PBE Standards, unless a similar change is made to PBE Standards.
5. Differences between the two suites of standards can result in additional compliance costs for "mixed groups", in particular, groups that are headed by a PBE that is required to consolidate one or more for-profit entities when preparing its group financial statements.² This is a particular concern where those differences primarily result from differences in the timing of when new requirements are introduced into the two suites of standards – rather than differences that are necessary to reflect differences in user information needs or other differences between the PBE and for-profit sectors.
6. The NZASB has been considering the impact of these differences on PBE mixed groups and, in particular, the cost of determining the adjustments required for the preparation of consolidated financial statements. The NZASB has been monitoring this issue for some time, with the hope that the IPSASB would develop an IPSAS based on IFRS 9 in time for the NZASB to incorporate that new IPSAS into PBE Standards before the effective date of NZ IFRS 9. However, the NZASB has observed that although the IPSASB has commenced its Financial Instruments

² Mixed group issues can also arise when there is a PBE within a group headed by a for-profit entity.

Update Project³, the IPSASB's expected completion date is after the effective date of NZ IFRS 9 in the for-profit sector.

The PBE Policy Approach

7. The NZASB applies the *Policy Approach to Developing the Suite of PBE Standards (PBE Policy Approach)*⁴ when considering whether a new or amended IFRS should be incorporated in PBE Standards. In most cases, application of the *PBE Policy Approach* results in the NZASB deciding to wait for the IPSASB to consider the new or amended IFRS. This is because PBE Standards are based on IPSASs, in accordance with the XRB's financial reporting strategy. Examples of instances in which the NZASB has agreed to wait for the IPSASB to consider changes in IFRS include:
 - (a) interests in other entities (IFRSs 10–12). The NZASB has recently consulted on proposals to adopt IPSASs 34 to 38 (refer to EDs NZASB 2016 1-5), which are based on IFRSs 10–12; and
 - (b) revenue (IFRS 15). The NZASB is assisting the IPSASB with a project to develop new and amended revenue standards and will consult on any proposals for new and revised revenue standards in due course.
8. However, the *PBE Policy Approach* allows for the possibility that there may be circumstances in which the NZASB needs to take earlier action, instead of its usual process of waiting for the IPSASB. In particular, the NZASB considers whether to take action in the following combination of circumstances:
 - (a) there is a major change to an IFRS for which there is an existing IPSAS on that same topic;
 - (b) from a New Zealand perspective, the IPSASB is unlikely to address that change in an acceptable time frame;
 - (c) the introduction of new PBE requirements based on that new or amended IFRS would lead to higher quality financial reporting in the PBE sector; and
 - (d) the benefits of introducing those new PBE requirements would outweigh the costs, including considering the impact on mixed groups.
9. As noted earlier, the introduction of IFRS 9 into the for-profit sector will result in major changes to the recognition and measurement of financial instruments, and the IPSASB is unlikely to issue an equivalent standard before IFRS 9 becomes effective in the for-profit sector.
10. After considering the above factors, the NZASB has decided to depart from its usual process of waiting for the IPSASB to consider the new IFRS before developing a PBE Standard. The NZASB has therefore decided to issue an exposure draft of a PBE Standard based on IFRS 9, with the intention of being able to make a PBE Standard available for early adoption when NZ IFRS 9 becomes effective for for-profit entities (from 1 January 2018).
11. This decision to develop a PBE Standard in advance of the IPSASB completing its financial instruments project has not been taken lightly. Although the NZASB

³ Information on the IPSASB's project is available at <https://www.ipsasb.org/projects/financial-instruments-update-project-0>

⁴ The XRB's *PBE Policy Approach* is available at https://www.xrb.govt.nz/Site/Financial_Reporting_Strategy/Accounting_Standards_Framework.aspx

considers that there are advantages of developing a PBE Standard based on IFRS 9, especially for mixed groups, as discussed above, there are also some disadvantages associated with this approach. The NZASB has identified two main concerns with this approach. The first is that the NZASB cannot guarantee that it will make exactly the same modifications to IFRS 9 as the IPSASB (for example, there are a number of terminology differences that need to be addressed and changes required to ensure the coherence of the suite of standards). The second issue is that the IPSASB's project is likely to consider a broader range of topics (for example, it is likely to consider accounting for public sector securitisations, a topic which is not currently addressed in IPSASs).

12. Once the IPSASB issues a new standard, the NZASB will need to consider any such differences and decide whether further changes are required to PBE Standards. This means that PBEs would likely need to consider two sets of changes: the adoption of a PBE Standard incorporating IFRS 9 requirements and, subsequently, the adoption of a revised PBE Standard reflecting additional changes made by the IPSASB.
13. In order to minimise any such differences between the NZASB's standard and a standard subsequently issued by the IPSASB, the NZASB:
 - (a) proposes to incorporate the modifications that the IPSASB made when developing IPSAS 29 in the proposed PBE Standard. There were relatively few such modifications and the NZASB expects that the IPSASB would make the same changes in a new IPSAS;
 - (b) proposes a narrower scope project than the IPSASB's Financial Instruments Update project. The NZASB has focused on the changes to recognition and measurement, which are contained in IFRS 9. It is not proposing to incorporate changes relating to other aspects of accounting for financial instruments, which the IPSASB will consider in its project. For example, the IASB has made changes to its standard dealing with the presentation of financial instruments, IAS 32 *Financial Instruments: Presentation*. These changes to other IFRSs are independent of the changes introduced by IFRS 9 and, therefore, do not need to be incorporated into PBE Standards in order to address the issues created by the introduction of IFRS 9 in the for-profit sector. Hence, the NZASB will wait for the IPSASB to consider these other changes to IFRSs; and
 - (c) will monitor the IPSASB's project, including feedback on the IPSASB's (forthcoming) proposals. In addition, the work done by the NZASB and the feedback from New Zealand constituents may inform the IPSASB's thinking.
14. The NZASB is also proposing to align the effective date of the new PBE Standard with the expected effective date of a new IPSAS. This would mean that PBEs could choose whether to early adopt the new PBE Standard or wait for a revised PBE Standard that is aligned with any new IPSAS. The feasibility of this option depends on when the IPSASB completes its project.
15. The following diagram illustrates how the effective date of NZ IFRS 9 and the likely timing of the IPSASB's project have influenced the NZASB's decision to issue an exposure draft now.

Diagram 1 Possible timeline for new standards

Dec 2016	2017	Jan 2018	Mar 2018	Sept 2018	July 2019	Jan 2020/2021
For Profit Standards						
		NZ IFRS 9 effective from 1 January 2018				
PBE Standards						
Scenario A: NZASB develops PBE IFRS 9 now						
		Mixed group issues can be avoided by early adoption of PBE IFRS 9				
NZASB issues PBE IFRS 9	Early adoption of PBE IFRS 9 permitted					Possible effective date of PBE IFRS 9
IPSASB issues ED IPSAS X			IPSASB issues IPSAS X	NZASB considers how best to align PBE IFRS 9 and IPSAS X. This may result in a second ED being issued.	Possible effective date of IPSAS X	
Scenario B: NZASB waits for IPSASB						
		Mixed group issues occur			Mixed group issues can be avoided by early adoption of PBE IPSAS X	
IPSASB issues ED IPSAS X			IPSASB issues IPSAS X			Possible effective date of IPSAS X
				NZASB issues ED PBE IPSAS X	NZASB issues PBE IPSAS X with early adoption permitted	Possible effective date of PBE IPSAS X

Notes:

1. This diagram is constructed from the best available information at the time of writing. Professional advice should be sought before taking any action based on any of the estimated dates. NZ IFRS 9 is effective for annual periods beginning on or after 1 January 2018. All other dates are subject to change.
2. "IPSAS X" is used to refer to the expected IPSAS based on IFRS 9.

1.2 Purpose of this Invitation to Comment

16. The purpose of this Invitation to Comment is to seek comments on the proposal to issue a PBE Standard based on IFRS 9 that would be available for adoption by PBEs at the same time as NZ IFRS 9 becomes effective for for-profit entities (from 1 January 2018). The proposed standard would be applicable to Tier 1 and Tier 2 PBEs.
17. We are not seeking feedback on the underlying requirements of IFRS 9. However, we are interested in your comments on the modifications made to the requirements of IFRS 9 in developing the proposed PBE Standard.

1.3 Timeline and next steps

18. Submissions on the Exposure Draft are due by **30 September 2016**. Information on how to make submissions is provided on page 4 of this Invitation to Comment.
19. After the consultation period ends, the NZASB will consider both (i) constituents' comments on the Exposure Draft, and (ii) the progress that the IPSASB has made on its project. Taking these matters into account, the NZASB will consider whether to progress the Exposure Draft to a final PBE Standard. This could lead to the issue of a new PBE Standard in December 2016.
20. Alternatively, the NZASB might decide not to progress the Exposure Draft to a final PBE Standard. For example, if the IPSASB's project proceeds more quickly than expected, the NZASB may change its plans and wait for the completion of the IPSASB's project. (At the time of writing, the NZASB does not anticipate that the IPSASB's project will be completed in time to address the issues likely to be faced by New Zealand's mixed groups from 1 January 2018.)
21. If the IPSASB's project proceeds according to the IPSASB's projected timeline and the NZASB decides to finalise and issue PBE IFRS 9, the NZASB will assess the best course of action once a final IPSAS has been issued. This is likely to involve a separate consultation process in New Zealand to consider alignment of PBE IFRS 9 with the IPSASB's final standard.

Questions for Respondents

1. Do you support the NZASB's proposal to issue a PBE Standard based on IFRS 9 in advance of the IPSASB completing its project on financial instruments, taking into account the factors discussed in the *PBE Policy Approach*? If not, please explain why not and indicate any alternative course of action that you think would be more appropriate.
2. If a PBE Standard based on IFRS 9 were to be issued by the end of 2016, and you are the head of a mixed group or a member of a mixed group:
 - (a) do you think it is likely that you or any PBEs within the mixed group would wish to early-adopt PBE IFRS 9; and
 - (b) if so, do you think that the expected issue date of late 2016 would provide sufficient lead-in time for a PBE within a mixed group to voluntarily adopt the proposed PBE Standard?

2. Development of the Exposure Draft

2.1 Overview

22. This Invitation to Comment seeks feedback on ED NZASB 2016-7 PBE IFRS 9 *Financial Instruments*.
23. In order to assist constituents in forming an opinion on the proposals, the NZASB has organised the discussion of the Exposure Draft as follows:
- (a) approach taken to developing the Exposure Draft;
 - (b) impact of adopting IFRS 9 requirements;
 - (c) incorporating PBE-specific guidance currently in PBE IPSAS 29;
 - (d) other changes proposed by the NZASB; and
 - (e) proposed RDR concessions.

2.2 Approach taken to developing the Exposure Draft

24. In developing the proposed PBE IFRS 9, the NZASB has:
- (a) carried forward the modifications made by the IPSASB when it developed IPSAS 29, to the extent that these continue to be appropriate (see section 2.4 below for more information); and
 - (b) made limited changes to the requirements of IFRS 9 and the consequential amendments arising from IFRS 9, to ensure the coherence of the suite of PBE Standards (see section 2.5 below for more information).
25. These modifications to the requirements of IFRS 9 are limited, given the NZASB's reasons for developing the proposed PBE IFRS 9 (as discussed above). Therefore, the NZASB has not considered other possible modifications that the IPSASB might decide to make, such as:
- (a) additional terminology changes (that is, changes that are additional to existing terminology differences between NZ IFRS and PBE Standards). For example, IFRS 9 uses the term "business model". This term has not previously been used in IPSASs and it is possible that the IPSASB might consider an alternative term to be more appropriate. At this stage the NZASB has elected to retain the IFRS 9 terminology, rather than making a change now that might require further change subsequently, to align with any future IPSAS;
 - (b) additional guidance, which the IPSASB might include to assist application of the standard in the public sector; and
 - (c) related amending standards issued by the IASB but not yet considered by the IPSASB. For example, the Exposure Draft and its consequential amendments do not include the amendments made by *Offsetting Financial Assets and Financial Liabilities* (Amendments to IAS 32) and *Disclosures – Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7).

26. The NZASB's proposals would result in substantial alignment between NZ IFRS and PBE Standards on accounting for the recognition and measurement of financial instruments.

2.3 Impact of adopting IFRS 9 requirements

27. Most of the differences between the proposed PBE IFRS 9 and PBE IPSAS 29 result from the proposal to develop a PBE Standard based on IFRS 9. The main differences between the requirements in PBE IPSAS 29 and the proposed requirements in PBE IFRS 9 are summarised in Table 1 below.

Table 1

PBE IPSAS 29	Proposed PBE IFRS 9
<p><i>Financial asset classifications</i> (classified based on a range of factors)</p> <ul style="list-style-type: none"> • Fair value through surplus or deficit • Held-to-maturity investments • Loans and receivables • Available-for-sale financial assets <p><i>Financial liability classifications</i></p> <ul style="list-style-type: none"> • Amortised cost • Fair value through surplus or deficit <p><i>Impairment</i></p> <ul style="list-style-type: none"> • Incurred loss model 	<p><i>Financial asset classifications</i> (classified based on the entity's business model and nature of the financial instrument's contractual cash flows)</p> <ul style="list-style-type: none"> • Amortised cost • Fair value through other comprehensive revenue or expense (for certain debt instruments) • Fair value through other comprehensive revenue or expense (for certain equity instruments) • Fair value through surplus or deficit <p><i>Financial liability classifications</i></p> <ul style="list-style-type: none"> • Same classifications as PBE IPSAS 29 • Change in the entity's own credit risk presented in other comprehensive revenue and expense <p><i>Impairment</i></p> <ul style="list-style-type: none"> • Expected credit loss model
<p><i>Hedge accounting</i></p> <ul style="list-style-type: none"> • More restrictive than IFRS 9/NZ IFRS 9 • For example, PBE IPSAS 29 allows components of financial items to be hedged, but not components of non-financial items (except for foreign currency risk) 	<p><i>Hedge accounting</i></p> <ul style="list-style-type: none"> • Hedge accounting requirements aligned more closely with risk management • Allows more hedging instruments and hedged items to qualify for hedge accounting

28. The categories of financial assets in IFRS 9, and the requirements for classifying financial assets into those categories, are different to the categories of financial assets in IAS 39 and PBE IPSAS 29. Entities adopting the proposed PBE IFRS 9 will need to determine the appropriate classification of their financial assets. This could be a significant exercise for some entities.
29. Compared to an incurred loss model, an expected loss model will require entities to exercise more judgement about future events. This may require that entities change their systems and processes. For example, entities would have to make a

provision for potential credit losses over the next 12 months, and where credit risks are deemed to have increased significantly, the entity would have to record the lifetime expected credit loss.

2.4 Incorporating PBE-specific guidance currently in PBE IPSAS 29

30. In developing the proposed PBE IFRS 9, the NZASB has incorporated the main public sector modifications made by the IPSASB when it developed IPSAS 29. These modifications and the way in which they have been incorporated in the proposed PBE Standard are set out in Table 2 below.

Table 2

IPSAS 29/PBE IPSAS 29 modifications	Impact on proposed PBE IFRS 9
<p>Scope modification– Financial guarantee contracts</p> <p>IPSAS 28 and IPSAS 29 permit financial guarantee contracts to be accounted for as insurance contracts so long as the issuer elects to do so and uses accounting applicable to insurance contracts (paragraphs 3 and AG5–9). Unlike IFRS 9 and IAS 39, IPSAS 28 and IPSAS 29 do not require an explicit assertion that the financial guarantees are insurance contracts.</p> <p>When the NZASB issued PBE IPSAS 28 and PBE IPSAS 29, it kept the IPSAS 29 election for new transactions, but required entities that had previously made such an election to continue their existing treatment for existing financial guarantee contracts.</p>	<p>The scope of PBE IFRS 9 has been aligned with the scope of PBE IPSAS 29 in respect of financial guarantee contracts.</p>
<p>Non-exchange revenue transactions</p> <p>PBE IPSAS 29 excludes certain rights and obligations that fall within the scope of PBE IPSAS 23.</p> <p>It requires that financial assets arising from non-exchange revenue transactions be measured at fair value in accordance with the principles in PBE IPSAS 23 and taking account of transaction costs where appropriate (paragraph AG81).</p>	<p>The scope of PBE IFRS 9 has been aligned with the scope of PBE IPSAS 29 in respect of certain rights and obligations that fall within the scope of PBE IPSAS 23.</p> <p>The treatment of financial assets arising from non-exchange revenue transactions has been aligned with PBE IPSAS 29 (for example, see paragraphs B5.1.0 and B5.1.2H–B5.1.2M).</p>

IPSAS 29/PBE IPSAS 29 modifications	Impact on proposed PBE IFRS 9
Concessionary loans PBE IPSAS 29 contains application guidance on the recognition and measurement of concessionary loans, including how to account for the difference between the fair value of the loan and the transaction price (refer paragraphs AG84–AG91 and IE40–IE41).	PBE IFRS 9 contains equivalent application guidance (refer paragraphs B5.1.2A–B5.1.2G).
Financial guarantees PBE IPSAS 29 contains application guidance on the recognition and measurement of financial guarantee contracts entered into at no or nominal value (refer paragraphs AG92–AG97).	PBE IFRS 9 contains equivalent application guidance (refer paragraphs B5.1.2H–B5.1.2M).

2.5 Other changes proposed by the NZASB

31. In developing the proposed PBE IFRS 9 the NZASB has made changes to the requirements of IFRS 9, and the consequential amendments arising from IFRS 9, to ensure the coherence of the suite of PBE Standards. These changes were based on a consideration of:
- (a) the New Zealand specific changes made by the NZASB when it developed PBE IPSAS 29;
 - (b) the links between the proposed PBE IFRS 9 and those PBE Standards that differ from the for-profit equivalent standard; and
 - (c) other proposals currently subject to due process.
32. These changes are summarised in Table 3 below.

Table 3

<p><i>Fair value measurement</i></p> <p>IFRS 9 does not include guidance on the fair value measurement of financial instruments, because this guidance is now in IFRS 13 <i>Fair Value Measurement</i>. There is no equivalent to IFRS 13 in IPSASs or the suite of PBE Standards. The NZASB has therefore included the fair value measurement guidance currently in PBE IPSAS 29 in the proposed PBE IFRS 9 and deleted references to IFRS 13 (see section 5.1A).</p> <p>The term ‘fair value’ continues to be defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”.</p> <p>The IPSASB does not have any plans to develop a standard based on IFRS 13. It intends to consider the impact of its Conceptual Framework on the measurement requirements in standards over the longer term.</p>

Differences in revenue standards

The IASB revised its revenue standards and issued IFRS 15 *Revenue from Contracts with Customers* in May 2014. IFRS 15 made a number of changes to IFRS 9.

The IPSASB is currently working on developing new and revised revenue standards and may adopt the requirements in IFRS 15 for some transactions. However, the IPSASB's project is considering a broad range of issues and changes to standards are not expected for some time.

The NZASB has therefore modified some of the requirements in IFRS 9 for impairment of receivables, removed references to contract assets and replaced references to IFRS 15 with references to the current PBE Standards dealing with revenue (for example, see paragraphs 5.5.15 and 5.5.16).

Leases

IFRS 16 *Leases* amended IFRS 9 (with an effective date of 1 January 2019). The NZASB has not incorporated the IFRS 16 amendments to IFRS 9 in the proposed PBE IFRS 9. The IPSASB has not developed a standard based on IFRS 16. The IPSASB is considering whether to undertake a project to develop a standard based on IFRS 16.

Hedges of a Net Investment in a Foreign Operation

Although the IASB has a separate Interpretation (IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*) dealing with this topic the requirements in IFRIC 16 were included in PBE IPSAS 29 as integral guidance. Therefore, the NZASB has also incorporated the requirements of IFRIC 16 in the proposed PBE IFRS 9 as integral guidance.

Interests in other entities

The NZASB has recently consulted on proposals to issue new PBE Standards dealing with interests in other entities (refer to EDs NZASB 2016 1-5). Following consideration of comments from constituents, the NZASB expects to finalise these PBE Standards by the end of 2016. These standards would be available for early adoption, but it is possible that an entity could early apply the proposed PBE IFRS 9 before the mandatory effective date of the proposed new standards on interests with other entities.

The NZASB's approach to this matter has been to replace references to the IASB's standards on interests in other entities with the corresponding proposed PBE Standards and to add footnotes to highlight that entities may need to refer to earlier standards. The NZASB has also:

- (a) added additional guidance to address the likely different requirements in PBE Standards, compared with NZ IFRS, in relation to an entity that controls an investment entity but is not itself an investment entity (see paragraph 6.3.5); and
- (b) included proposed amendments to PBE IPSASs 6 to 8 (see Appendix D of the Exposure Draft).

The impact of this Exposure Draft on the forthcoming PBE IPSASs 34 to 38 will be considered before the NZASB finalises those standards.

33. We are interested in your views on the NZASB's modifications made in developing the proposed PBE IFRS 9. In order to assist you in providing feedback on these modifications we have identified paragraphs that you might be interested in looking at more closely (refer to the Appendix to this Invitation to Comment).

Question for Respondents

3. Do you agree with the modifications made by the NZASB in developing the proposed PBE Standard? If not, please explain why not and identify what you think would be more appropriate. Respondents may find it helpful to consider the matters outlined in Tables 2-4.

2.6 Proposed RDR concessions

34. Although the proposed PBE IFRS 9 deals with recognition and measurement rather than disclosure, it would result in consequential amendments to the disclosure requirements in other standards, mainly PBE IPSAS 30 *Financial Instruments: Disclosures*.
35. The proposed amendments to other standards, including PBE IPSAS 30, are set out in Appendix D to the Exposure Draft. There are a number of new disclosure requirements being proposed in respect of PBE IPSAS 30. The proposed Reduced Disclosure Regime (RDR) concessions for these new disclosure requirements in PBE IPSAS 30 have been aligned with the anticipated for-profit disclosure concessions in respect of these disclosure requirements.⁵

Question for Respondents

4. Do you agree with the proposed RDR concessions in relation to PBE IPSAS 30 (refer Appendix D of the Exposure Draft)? If you disagree, please provide reasons and indicate what concessions you consider would be appropriate.

2.7 Effective date and other comments

36. The proposed effective date in the Exposure Draft is 1 January 2021, with early adoption permitted. This date is tentative and would be reviewed prior to issuing any standard.
37. This proposed effective date was deliberately set for some time in the future. At this stage it is too early to predict the effective date of a new IPSAS with any certainty. The NZASB's intention is to delay the effective date of a new PBE Standard until the effective date of a new IPSAS. This would allow PBEs not wanting to early adopt the new requirements in PBE IFRS 9 to transition directly from the existing PBE IPSAS 29 to a final PBE Standard converged with the new IPSAS.
38. If the completion date of the IPSASB's project changes, the NZASB would reassess the effective date of the new PBE Standard.
39. The Exposure Draft does not include the non-integral illustrative examples and implementation guidance that accompanies NZ IFRS 9. At this stage the nature and

⁵ There are currently no RDR concessions in NZ IFRS 9 in respect of the additional disclosures added as a consequence of IFRS 9. The NZASB has been working on a joint project with the Australian Accounting Standards Board to review all RDR concessions in NZ IFRS and Australian Accounting Standards. The NZASB plans to issue an exposure draft seeking feedback on changes to for-profit RDR concessions later this year. The proposed RDR concessions for the additional disclosures in PBE IPSAS 30 have been aligned with the expected RDR concessions in the forthcoming for-profit exposure draft. This approach to determining RDR concessions for Tier 2 PBEs is consistent with the approach applied by the NZASB when it developed the PBE Standards. In the longer term, the NZASB intends to review its approach to determining RDR concessions for Tier 2 PBEs.

extent of any modifications that the IPSASB might make to the non-integral guidance to IFRS 9 issued by the IASB are not known. The NZASB therefore considers it prudent to wait until the IPSASB has finalised its financial instruments project, rather than propose modifications now that might require further change subsequently, to align with any future IPSAS.

40. The non-inclusion of non-integral guidance is consistent with the NZASB's approach in developing PBE IFRS 3 *Business Combinations* and PBE IFRS 5 *Non-current Assets Held for Sale and Discounted Operations*.
41. Illustrative examples and implementation guidance on the application of IFRS 9 are available in the additional material for NZ IFRS 9 on the XRB website at www.xrb.govt.nz.

Questions for Respondents

5. Do you agree with the proposal that the effective date of the proposed PBE IFRS 9 be 1 January 2021, with early adoption permitted (bearing in mind the NZASB's intention to defer the effective date of PBE IFRS 9 until a future IPSAS based on IFRS 9 is effective)?
6. Do you have any other comments on the Exposure Draft?

3. Appendix

In order to assist constituents commenting on the proposals in ED NZASB 2016-7, Table 4 identifies those paragraphs that were inserted, deleted or significantly modified compared to the equivalent requirements in IFRS 9.

Table 4

Reference	Comments
2.1(e), B2.5(a)	The scope of the proposed PBE IFRS 9 has been aligned with the scope of PBE IPSAS 29 in respect of financial guarantee contracts.
2.1(j), B2.6A	The scope of the proposed PBE IFRS 9 has been aligned with the scope of PBE IPSAS 29 in respect of certain rights and obligations that fall within the scope of PBE IPSAS 23 <i>Revenue from Non-Exchange Transactions</i> .
2.1(k)	The scope of the proposed PBE IFRS 9 has been aligned with the scope of PBE IPSAS 29 in respect of certain rights and obligations under service concession arrangements to which PBE IPSAS 32 <i>Service Concession Arrangements: Grantor</i> applies.
5.1A.1–5.1A.3, B5.1A.1–B5.1A.13	The fair value measurement guidance from PBE IPSAS 29 has been inserted into the proposed PBE IFRS 9.
5.5.15–5.5.16	The simplified approach for receivables and lease receivables in IFRS 9 has been extended to include all receivables within the scope of the proposed PBE IFRS 9, including receivables that result from transactions that are within the scope of PBE IPSAS 23. IFRS 9 makes a distinction between receivables with or without a significant financing component. The simplified approach <i>must</i> be applied to receivables without a significant financing component under IFRS 9. This distinction (between receivables with or without a significant financing component) comes from IFRS 15, and therefore has been removed from the proposed PBE IFRS 9. The effect of this deletion is that the simplified approach is now an accounting policy choice under PBE IFRS 9 for all receivables.
6.3.5	This is additional guidance to address the likely different requirements in PBE Standards, compared with NZ IFRS, in relation to an entity that controls an investment entity, but is not itself an investment entity.
B5.1.0, B5.1.2H–B5.1.2M	The guidance for financial assets arising from non-exchange revenue transactions from PBE IPSAS 29 has been inserted into the proposed PBE IFRS 9.
B5.1.2A–B5.1.2G	The guidance for concessionary loans from PBE IPSAS 29 has been inserted into the proposed PBE IFRS 9.



EXTERNAL REPORTING BOARD

Te Kāwai Ārahi Pūrongo Mōwaho

Policy Approach to Developing the Suite of PBE Standards

September 2013

Approved by the XRB Board for application by the New Zealand
Accounting Standards Board from 1 October 2013

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Preface

1. In May 2013, the New Zealand Accounting Standards Board (NZASB) issued the PBE Standards – a new suite of standards for Tier 1 and Tier 2 public benefit entities. That initial set of standards, developed in accordance with the External Reporting Board's (XRB Board's) Accounting Standards Framework, can be regarded as the "foundation suite" of PBE Standards. It is expected that the foundation suite will be enhanced and developed over time.
2. This Policy Approach paper has been developed by the XRB Board and the NZASB to assist the NZASB in making consistent decisions when developing the suite of PBE Standards i.e. when considering enhancements and developments to the suite of PBE Standards in the future.
3. While primarily based on International Public Sector Accounting Standards, the foundation suite of PBE Standards was developed using a range of source standards: International Public Sector Accounting Standards, selected NZ IFRSs and domestic standards developed within New Zealand. Developments are likely to arise from each of these sources as changes are made to the international standards and as issues specific to New Zealand emerge.
4. Without a policy such as this, it would be possible for significant fluctuations in the NZASB's approach to developing the suite of PBE Standards to emerge over time. This Policy Approach paper therefore provides constituents with some certainty about the likely future direction of the PBE Standards suite, and provides a basis for assessing proposals for changes to the PBE Standards as they are issued by the NZASB. It also assists constituents to understand the likely implications of future changes to the PBE Standards suite for public benefit entities (PBE) groups containing for-profit entities (commonly referred to as "mixed groups").

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Summary

The Development Principle

In accordance with the Accounting Standards Framework, the primary purpose of developing the suite of PBE Standards is to better meet the needs of the PBE user groups (as a whole). In considering whether to initiate a development, the NZASB shall consider the following factors:

- (a) Whether the potential development will lead to higher quality financial reporting by public sector PBEs and not-for-profit entities, including public sector PBE groups and not-for-profit groups, than would be the case if the development was not made; and
- (b) Whether the benefits of a potential development will outweigh the costs, considering as a minimum:
 - (i) *relevance to the PBE sector as a whole*: for example, where the potential development arises from the issue of a new or amended IFRS, whether the type and incidence of the affected transactions in the PBE sector are similar to the type and incidence of the transactions addressed in the change to the NZ IFRS;
 - (ii) *relevance to the not-for-profit or public sector sub-sectors*: whether there are specific user needs in either of the sub-sectors, noting that IPSAS are developed to meet the needs of users of the financial reports of public sector entities;
 - (iii) *coherence*: the impact on the entire suite of PBE Standards (e.g. can the change be adopted without destroying the coherence of the suite);
 - (iv) *the impact on mixed groups*; and
- (c) In the case of a potential development arising from the issue of a new or amended IFRS, the IPSASB's likely response to the change (e.g. whether the IPSASB is developing an IPSAS on the topic).

Application of the Development Principle

The paper includes a series of rebuttable presumptions in applying the development principle:

- (a) The NZASB will adopt a new or amended IPSAS.
- (b) The NZASB will not include an NZ IFRS that the IASB has issued on a new topic in the suite of PBE Standards unless the IPSASB addresses the issue.
- (c) In considering a change to an NZ IFRS that relates to a topic for which there is an existing PBE standard based on an IPSAS, the NZASB shall consider the factors in the development principle in determining whether to initiate a development of the PBE Standards. Particular emphasis in this case needs to be placed on the IPSASB's likely response to the change.
- (d) The NZASB will not incorporate minor amendments to NZ IFRS into the equivalent PBE Standard in advance of the IPSASB considering the change.

1. Introduction

1. This paper addresses the approach to developing and enhancing the suite of PBE Standards, now that the transition suite for public sector PBEs is completed. References to PBEs in this paper include references to all PBEs: public sector PBEs and not-for-profit entities, and public sector PBE groups and not-for-profit groups.
2. Triggers for possible changes to the standards are likely to come from three sources:
 - (a) the IPSASB issuing a new IPSAS or a change to an existing IPSAS (section 4.1);
 - (b) the IASB issuing a new IFRS or a change to an existing IFRS (section 4.2); and
 - (c) domestic developments within New Zealand, including both exogenous events such as changes to the legislative framework and endogenous events where the NZASB considers that developments are warranted (section 4.3).
3. This paper considers the implications of the Accounting Standards Framework for developing the suite of PBE Standards and identifies an approach to be taken for each of the triggers for possible changes to PBE Standards.

2. Basis for Development of PBE Standards

4. The multi-standards approach in the Accounting Standards Framework is designed to better meet the needs of users of the financial statements of PBEs. In its decision to base the development of standards for Tier 1 and Tier 2 entities on IPSAS, the XRB Board decided the following:
 149. The XRB therefore proposes that a set of PBE Accounting Standards (PAS) be developed and that they use IPSAS as their base. PAS would modify IPSAS for any recognition, measurement or disclosure matters considered inappropriate in the New Zealand context at this time. Such modifications would only be made where the IPSAS requirement in question would have a material impact on the financial position or performance being reported, and that impact would adversely detract from the financial statements' usefulness to users. Based on work to date, the number of modifications is expected to be relatively few.
 150. The XRB also proposes that PAS include other relevant standards (including domestic standards) appropriate for New Zealand and/or to address topics not covered in IPSAS.
 151. Thirdly, the XRB proposes PAS be modified to make them relevant, applicable and understandable to not-for-profit sector preparers and users. This is necessary because IPSASB has developed IPSAS for public sector entities. Some modification is desirable to enhance their usefulness in the not-for-profit context.(Accounting Standards Framework, paragraphs 149 – 151)
5. This paper uses the term 'development' to encompass any change to the suite of PBE Standards.
6. In considering the appropriateness of potential developments of the suite of PBE Standards, it is necessary to consider these developments in the context of the Accounting Standards Framework, including the impact of any developments on the quality of the financial reporting arising from those standards and the trade-off between the benefits of improvements in the quality of the resulting financial reports and the associated costs.

2.1 Quality of Financial Reporting

7. The suite of PBE Standards is designed to meet users' needs by providing high quality financial reporting by PBEs. It follows that any development of PBE Standards should aim to improve the quality of financial reporting. The quality of financial reporting relies on meeting the needs of users of PBE general purpose financial reports (including financial statements), while endeavouring to ensure that the costs arising from a development do not outweigh the benefits.
8. In this context, high quality financial reporting is assessed by reference to the conceptual framework for PBEs (as it applies from time to time), with primary emphasis on the objective of financial reporting and then the qualitative characteristics. A standard is more likely to lead to higher quality financial reporting if it adheres closely to the conceptual framework.
9. The categories of users of financial statements of PBEs and for-profit entities are different. The IASB's emerging Conceptual Framework identifies users of IFRS as

suppliers of resources to the entity, and notes that the decisions that they make are related to providing resources to the entity.¹

10. In contrast, the IPSASB considers that the objective of financial reporting is to serve a wider group of users, being resource providers and service recipients and their representatives. The IPSASB notes that information is needed for both accountability and decision-making purposes².
11. A development of the suite of PBE Standards will improve the quality of financial reports prepared in compliance with PBE Standards if it improves the accounting for specific transactions by better meeting the objective of financial reporting and the associated qualitative characteristics of financial reporting.
12. Further, high quality financial reporting depends on consistent treatment of similar transactions. For example, it would usually be inappropriate to require different measurement for similar liabilities in similar circumstances. As a result, any development of PBE Standards (including the conceptual framework for PBEs) should ensure that the suite is maintained as a coherent whole.
13. It follows that any developments should ensure that the needs of users are better met than they were prior to the development. Alternatively, the cost-benefit test (see next section) may be met where the needs of users are equally as well served, with a consequent benefit in some other way such as a reduction in the costs of preparing the financial statements.

2.2 Costs and Benefits

14. In considering a potential development of the suite of PBE Standards, the primary purpose and benefit is to improve the information provided to users of PBE financial statements.
15. Benefits need to be considered in relation to the suite of standards as a whole, in addition to the implications for a specific area of financial reporting. The benefit of aligning the PBE Standards with NZ IFRS to the extent possible is that this will reduce differences between the financial statements of PBEs and for-profit entities. This benefit is particularly relevant to entities that are members of mixed groups³ and users of PBE financial statements whose familiarity with financial statements arises from experience in the for-profit sector. However, for other preparers that are not part of a mixed group, there may be additional preparation costs as a result of changes in accounting standards that might not otherwise arise.
16. The PBE Standards are largely based on IPSAS in accordance with the Accounting Standards Framework and, therefore, careful consideration is required before making any change to a PBE standard based on an IPSAS in circumstances other than as a consequence of the IPSASB issuing a new or amended IPSAS (as

¹ New Zealand Equivalent to the IASB *Conceptual Framework for Financial Reporting 2010*, paragraph OB2.

² IPSASB, *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*, January 2013, paragraphs 2.1–2.4.

³ For the purposes of this paper, a mixed group is a PBE group that includes at least one material for-profit subsidiary where that for-profit subsidiary applies accounting policies that differ from those of the mixed group and that may need to be adjusted under the consolidation standards.

discussed further below in paragraph 28). In addition, the benefit of using IPSAS to the extent possible is that IPSAS are a suite of standards that comprise a coherent package. It also reduces standard-setting costs as the IPSASB documents are readily available for application in New Zealand with little additional work. Reducing the time spent on setting the base standards releases resources for working with the international standard setters and for necessary domestic projects.

17. In developing a coherent suite of PBE Standards, it will generally be relatively low cost to add additional guidance for all PBEs, or for sub-groups of PBEs such as not-for-profit entities. However, it is expected that recognition and measurement requirements will be common to all PBEs. Further, using recognition and measurement requirements developed from a number of sources creates the potential for inconsistencies within the suite of PBE Standards, such as applying different measurement requirements to similar liabilities. Care should be taken to minimise the impact of such inconsistencies, if they cannot be eliminated.
18. At times, there is a tension between reducing the costs borne by preparers within mixed groups – that is the elimination of differences between PBE Standards and NZ IFRS that are not sector-specific – and improving the suite of PBE Standards taken as a whole. This policy takes the view that reducing the costs on preparers within mixed groups should be considered to the extent that these costs can be reduced whilst meeting the needs of the wider range of users of financial statements of public sector PBEs and not-for profit entities (including public sector and not-for-profit groups) through a complete and coherent suite of PBE Standards.

3. The Development Principle

19. In accordance with the Accounting Standards Framework, the primary purpose of developing the suite of PBE Standards is to better meet the needs of PBE user groups (as a whole). In considering whether to initiate a development, the NZASB shall consider the following factors:
- (a) Whether the potential development will lead to higher quality financial reporting by public sector PBEs and not-for-profit entities, including public sector PBE groups and not-for-profit groups, than would be the case if the development was not made; and
 - (b) Whether the benefits of a potential development will outweigh the costs, considering as a minimum:
 - (i) *relevance to the PBE sector as a whole*: for example, where the potential development arises from the issue of a new or amended IFRS, whether the type and incidence of the affected transactions in the PBE sector are similar to the type and incidence of the transactions addressed in the change to the NZ IFRS;
 - (ii) *relevance to the not-for-profit or public sector sub-sectors*: whether there are specific user needs in either of the sub-sectors, noting that IPSAS are developed to meet the needs of users of the financial reports of public sector entities;
 - (iii) *coherence*: the impact on the entire suite of PBE Standards (e.g. can the change be adopted without destroying the coherence of the suite);
 - (iv) *the impact on mixed groups*; and
 - (c) In the case of a potential development arising from the issue of a new or amended IFRS, the IPSASB's likely response to the change (e.g. whether the IPSASB is developing an IPSAS on the topic).
20. The NZASB will need to exercise its judgement in balancing the factors in the development principle because, in many cases, there will need to be a trade-off between these factors. This policy provides a basis for making such a trade-off decision: it cannot replace the application of judgement by the NZASB with a series of bright-line rules.

4. Application of the Development Principle

21. The following sections are designed to assist in the application of the factors in the development principle. They consider, in turn, potential developments of the suite of PBE Standards that might arise from developments in IPSAS and NZ IFRS as well as addressing issues that might arise within New Zealand. Although this paper treats each of these developments separately, it is likely that specific developments will need to be considered from a number of perspectives. For example, the NZASB may have planned to continue to update PBE IAS 34 *Interim Financial Reporting* in line with developments of NZ IAS 34 *Interim Financial Reporting* to retain consistent interim reporting across all sectors (section 4.2). However, if the IPSASB were to issue a standard addressing interim reporting, this new IPSAS would be considered as a development resulting from an enhancement to IPSAS (section 4.1).

4.1 New or Amended IPSAS

22. **There is a rebuttable presumption that the NZASB will adopt a new or amended IPSAS. It is expected that such changes will lead to higher quality financial reporting by PBEs in New Zealand and the factors in the development principle are presumed to be met.**
23. This rebuttable presumption is based on the expectation that the IPSASB has considered the needs of the wide range of users of public sector financial statements in developing and enhancing the suite of IPSAS.
24. Depending on the circumstances, it may be appropriate to amend a recently issued or newly amended IPSAS in the process of adoption in New Zealand. Examples of possible amendments include:
- (a) improving the quality of the IPSAS in the New Zealand context by, for example, adding guidance to enable not-for-profit entities and public sector PBEs to apply the standard consistently or adding guidance to assist not-for-profit entities in applying the standard, given that the standard has been developed for application by public sector PBEs;
 - (b) amendments necessary to maintain the coherence of the suite of PBE Standards;
 - (c) excluding options that are not relevant in the New Zealand context; or
 - (d) amending the scope of an IPSAS if the IPSAS conflicts with a legislative requirement, or a legislative requirement addresses the same issue for public sector entities. However, in these circumstances, it may be appropriate to adopt the IPSAS for not-for-profit entities.

4.2 New or Amended NZ IFRS

25. New or amended NZ IFRS will require the NZASB to consider whether to initiate a development of the PBE standards in the following circumstances:⁴
- (a) an IFRS that the IPSASB has used as the basis for an IPSAS is changed;
 - (b) the IASB issues an IFRS on a new topic; and
 - (c) there is a change to an NZ IFRS that has been used as the basis for a PBE Standard⁵.

4.2.1 An IFRS that the IPSASB has used as the basis for an IPSAS is changed

26. As noted earlier, the PBE Standards are primarily based on IPSAS. In turn, many IPSAS are primarily based on IFRS. Examples of such standards are PBE IPSAS 16 *Investment Property* and PBE IPSAS 17 *Property, Plant and Equipment*, which are based on IAS 40 *Investment Property* and IAS 16 *Property, Plant and Equipment*, respectively. Accordingly, there are likely to be many instances in which a new or amended NZ IFRS relates to a topic covered by an existing IPSAS standard that has been incorporated into the PBE standards.
27. **In considering a change to an NZ IFRS that relates to a topic for which there is an existing PBE standard based on an IPSAS, the NZASB shall consider the factors in the development principle in determining whether to initiate a development of the PBE Standards. Particular emphasis in this case needs to be placed on the IPSASB's likely response to the change.**
28. Given the presumption in paragraph 22 that any standard issued by the IPSASB will be included in the PBE Standards, there are considerable potential costs and risks associated with "getting ahead of the IPSASB". Therefore, the NZASB needs to decide whether to develop a PBE standard ahead of the IPSASB or to wait for the IPSASB's response. If the issue is already on the IPSASB's active work plan, the NZASB would normally wait for the IPSASB to complete its work, unless the NZASB is of the view that there is an urgent need for action in New Zealand or the NZASB is of the view that the IPSAS is unlikely to be appropriate in the New Zealand context.
29. **Furthermore, in the case of minor amendments to an NZ IFRS, there is a rebuttable presumption that the change should not be incorporated into the equivalent PBE Standard in advance of the IPSASB considering the change.** This is because minor amendments are less likely to meet the cost-benefit test, particularly when the potential costs and risks associated with getting ahead of the IPSASB are taken into account.

⁴ An amendment to an NZ IFRS can fall into more than one of the above categories, for example, an NZ IFRS on a new topic might also result in changes to other NZ IFRS that fall into category (a) and/or (c).

⁵ The NZ IFRS applying to PBEs were "frozen" in 2011, pending the establishment of the XRB and the anticipated development of PBE Standards. The "frozen" NZ IFRS that the NZASB has included in the PBE Standards are PBE IFRS 3 *Business Combinations*, PBE IFRS 4 *Insurance Contracts*, PBE IFRS 5 *Non-current Assets Held For Sale and Discontinued Operations*, PBE IAS 12 *Income Taxes* and PBE IAS 34 *Interim Financial Reporting*, together with NZ IFRIC 12 *Service Concession Arrangements* and NZ-SIC 29 *Service Concession Arrangements: Disclosures* (which are the basis for PBE IFRS 45 *Service Concession Arrangements: Operator*).

30. Where there is a major change to an IFRS for which there is an existing IPSAS and where the IPSASB is unlikely to address the change in an acceptable time frame, the NZASB could either develop a domestic modification to the PBE Standard or assist the IPSASB to develop an IPSAS. Options for assisting the IPSASB include offering to provide staff resources for the IPSASB or partnering with the IPSASB to update a specific IPSAS in the light of the major change. It may be more effective to assist the IPSASB because any uncertainties about the IPSASB's approach to the issue will be resolved sooner rather than later. However, the level of effort required to develop an IPSAS based on an IFRS for international use is likely to be significantly higher than developing a PBE Standard based on an IFRS or its equivalent NZ IFRS for use in New Zealand. The IPSASB's due process, multi-constituency reach and less regular meetings leads to a standards development process for the IPSASB that is more time consuming and complex.

4.2.2 The IASB issues an IFRS on a new topic

31. An example of a new topic is where the IASB is considering issuing a standard on rate-regulated activities.
- 32. There is a rebuttable presumption that the NZASB will not include an NZ IFRS that the IASB has issued on a new topic in the suite of PBE Standards unless the IPSASB addresses the issue.**
33. As noted in paragraph 35, some NZ IFRS were included in the suite of PBE Standards to maintain current practice until the IPSASB addresses the related issues. This rationale does not apply to an NZ IFRS on a new topic. Also, given the PBE standards are primarily based on IPSAS in accordance with the Accounting Standards Framework, adding further PBE standards based on NZ IFRS is unlikely to be consistent with the objectives of that Framework.
34. In considering whether to rebut the presumption, the NZASB should consider whether the new standard both leads to a major improvement in the quality of financial reporting and fills a gap in the suite of PBE Standards (as distinct from a gap in NZ IFRS). This is unlikely to arise.

4.2.3 An NZ IFRS that the NZASB has included in the PBE Standards is changed

35. The NZASB has included selected "frozen" NZ IFRS in the suite of PBE Standards (see footnote 5) in order to maintain current practice until the IPSASB addresses the related issues.
- 36. In considering a change to an NZ IFRS that is included in the suite of PBE Standards, the NZASB shall consider the factors in the development principle in determining whether to initiate a development of the PBE Standards.**
37. However, in situations where there is no equivalent IPSAS on the topic and the IPSASB is not expected to create such a standard in the foreseeable future, the IPSASB's likely response to the change would be less relevant. This will impact on the overall assessment of the costs and benefits of including the NZ IFRS development in the PBE standards. This is because the potential problems

associated with “getting ahead of the IPSASB” (as discussed in paragraph 28 above) are less likely to arise.

38. An implication of this policy is that those PBE Standards based on a “frozen” NZ IFRS (see footnote 5) may need to be updated to align with the current equivalent NZ IFRS.

4.3 Domestic Developments

39. Domestic developments include developing standards to meet specific requirements in New Zealand.
40. The suite of PBE Standards contains standards directly addressing issues relevant to New Zealand, including PBE FRS 42 *Prospective Financial Statements* and PBE FRS 43 *Summary Financial Statements*. Further domestic standards may be developed where a need arises when an issue of importance in New Zealand is not addressed in a standard issued by the IPSASB (section 4.1) or the IASB (section 4.2).
- 41. In determining whether to initiate the development of a domestic standard for inclusion in the PBE suite, the NZASB will consider the factors in the development principle. Assuming the NZASB determines that the development of a domestic standard would improve the quality of financial reporting by PBEs, the NZASB will first consider whether there is an international pronouncement addressing the relevant issue that is applicable in the New Zealand context.**
42. The Accounting Standards Framework presumes that New Zealand will be a standards-taker rather than a standards-maker whenever possible, for a range of reasons, including:
- (a) the quality derived by an international due process;
 - (b) the prospect of international comparability; and
 - (c) the limited resources available for the domestic development of standards.
43. It follows that the NZASB will develop domestic standards or guidance that result in a material improvement in information available to users of financial statements when:
- (a) there is no other source of material available internationally; or
 - (b) the available international guidance is not targeted specifically towards addressing New Zealand issues.



EXPLANATORY GUIDE A8 FINANCIAL REPORTING BY NOT-FOR-PROFIT ENTITIES: THE REPORTING ENTITY (EG A8)

Issued October 2014

This Explanatory Guide provides guidance for not-for-profit entities in determining the boundaries of the reporting entity that is required to prepare financial statements or a performance report in compliance with generally accepted accounting practice (GAAP) or a performance report in compliance with a non-GAAP Standard issued by the External Reporting Board or its sub-Board, the New Zealand Accounting Standards Board.

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Introduction

1. The objective of this Explanatory Guide is to help not-for-profit (NFP) entities that are required to prepare financial statements or a performance report that comply with generally accepted accounting practice (GAAP)¹ or a performance report that complies with a non-GAAP standard to work out the boundary of the reporting entity. Identifying the boundary of the reporting entity requires consideration of (i) whether branches are part of the reporting entity, (ii) whether branches are separate reporting entities, and (iii) whether the reporting entity has a relationship for financial reporting purposes with any other entities (see Explanatory Guide A9 *Financial Reporting by Not-for-profit Entities: Identifying Relationships for Financial Reporting Purposes* (EG A9)). Reporting entities are then able to determine which activities, transactions and balances to include in their financial statements or performance report, hereafter referred to as “financial statements”.
2. The financial statements of a reporting entity should reflect all the transactions, balances and activities of that entity to enable users of those financial statements to make appropriate decisions about resource allocation and to hold management of the entity to account.
3. GAAP comprises accounting standards issued by the External Reporting Board (XRB) or its sub-Board, the New Zealand Accounting Standards Board (NZASB) for NFP entities reporting in accordance with Tier 1, Tier 2 or Tier 3 PBE Accounting Standards. Non-GAAP standards for entities reporting in accordance with Tier 4 PBE Accounting Standards are also issued by the XRB or the NZASB.
4. There can be a tension between preparing financial statements that comply with GAAP or a non-GAAP standard (financial reporting) and the way in which entities register with the Department of Internal Affairs, Charities Services. For example, several entities registered as a ‘group’ under the Charities Act 2005 may not be a ‘group’ for financial reporting purposes. Similarly, entities may register separately under the Charities Act 2005 but for financial reporting purposes some, or all, of those entities may be components of an NFP entity or a group. In circumstances where a reporting entity controls one or more other entities for financial reporting purposes, the controlling entity in that group is required to prepare consolidated financial statements in accordance with GAAP.
5. In light of this tension, entities may want to think about their reporting obligations and how best to register in order to minimise the compliance costs of preparing financial statements that comply with GAAP or a non-GAAP standard.
6. This Explanatory Guide is not a substitute for the relevant PBE Accounting Standards – its purpose is to help NFP entities in deciding what transactions, balances and activities need to be included in the financial statements of a reporting entity.

Objective of Financial Statements

7. The objective of financial statements is to provide information about the financial position, financial and service performance and cash flows of an entity that is useful to a wide range of users (for example, taxpayers, donors, lenders, suppliers, members and employees) in making and evaluating decisions about the allocation of resources and for the entity to demonstrate accountability for the resources entrusted to it.
8. For decision-making and accountability purposes the financial statements should provide:²
 - (a) Information about the sources, allocation and uses of financial resources;
 - (b) Information about how the entity financed its activities and met its cash requirements;
 - (c) Information that is useful in evaluating the entity’s ability to finance its activities and to meet its liabilities and commitments;
 - (d) Information about the financial condition of the entity and changes to that financial condition; and

¹ Generally accepted accounting practice is defined in section 8 of the Financial Reporting Act 2013: Financial statements, group financial statements, a report, or other information complies with generally accepted accounting practice only if the report, statements or information comply with:

- (a) applicable financial reporting standards; and
- (b) in relation to matters for which no provision is made in applicable financial reporting standards, an authoritative notice.

² See paragraph 15 of PBE IPSAS 1 *Presentation of Financial Statements*.

- (e) Aggregate information that is useful in evaluating the entity's performance in terms of service costs, efficiency and accomplishments.
- 9. Although financial statements do not provide all the information that users may need to make decisions (since they largely portray the financial effects of past events), it is important that they include all the transactions, balances and activities of the reporting entity to enable users of those financial statements to make appropriate decisions. Incorrect or inappropriate decisions are likely to be made if some of the relevant information is not included in the reporting entity's financial statements.
- 10. Financial statements show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Users of a reporting entity's financial statements may also be interested in how well the entity has demonstrated its accountability in relation to a range of obligations including the entity's compliance with legislation, regulations, common law and contractual arrangements.

The Reporting Entity

- 11. A reporting entity is an entity whose financial statements, group financial statements, reports, or other information is required by any enactment to comply, or be prepared in accordance, with GAAP or a non-GAAP standard³.
- 12. For example, an entity that is registered as a charitable entity⁴ under the Charities Act 2005 is a reporting entity because charitable entities are required to prepare financial statements in accordance with GAAP (or a non-GAAP standard)⁵ and to file those financial statements with the Department of Internal Affairs, Charities Services. As mentioned above, this requirement to prepare financial statements in accordance with GAAP or a non-GAAP standard may be in tension with the way in which an entity registers under the Charities Act 2005 and, therefore, lead to a reconsideration of the way an entity is registered.

Registration Under the Charities Act 2005

- 13. One of the tensions between financial reporting and the way in which an entity registers under the Charities Act 2005 is the use of the term 'parent'.
- 14. The Charities Act 2005 permits entities that are affiliated or closely related to register as a 'single entity'⁶ and Charities Services decides how those entities are to report⁷. For the purposes of the Charities Act 2005, the entity that requests the registration and treatment of several entities as a single entity is described as the 'parent' entity. This is the entity that Charities Services deals with for the purposes of the Charities Act 2005.
- 15. The term 'parent' entity in the Charities Act 2005 is not necessarily the same as a 'parent' entity (or 'controlling entity' as it is referred to in PBE Accounting Standards⁸) for the purpose of preparing financial statements in accordance with GAAP. A 'parent' or 'controlling entity' for financial reporting purposes is an entity which has one or more controlled entities⁹ (see EG A9 for guidance on determining whether an entity has a control relationship with another entity for financial reporting purposes). Appendix A of PBE IPSAS 6 *Consolidated and Separate Financial Statements* (Not-for-profit) (PBE IPSAS 6 (NFP)) provides guidance for NFP entities when assessing whether an entity controls another entity for financial reporting purposes. PBE IPSAS 6 (NFP) also outlines the procedures needed to prepare consolidated financial statements.
- 16. Where an entity controls one or more entities (whether registered charities or otherwise) for financial reporting purposes this is referred to as a 'group'¹⁰ or an 'economic entity'¹¹. Under GAAP, the entity that controls one or more entities is required to prepare consolidated financial statements (also known as group financial statements) as if all the entities in the group or economic entity were one entity.

³ Section 5 of the Financial Reporting Act 2013

⁴ 'Charitable entity' is the term defined in section 4 of the Charities Act 2005. The term 'charitable entity' in this Explanatory Guide has the same meaning as 'registered charity'.

⁵ Section 42A of the Charities Act 2005

⁶ Section 44 of the Charities Act 2005

⁷ Section 46(1A) of the Charities Act 2005

⁸ Paragraph 7 of PBE IPSAS 6 *Consolidated and Separate Financial Statements* (Not-for-profit)

⁹ Paragraph 7 of PBE IPSAS 6 *Consolidated and Separate Financial Statements* (Not-for-profit)

¹⁰ In the For-profit Accounting Standards

¹¹ In the PBE Accounting Standards

17. A reporting entity may also want to consider whether it is controlled by another entity for financial reporting purposes. Where this is the case, it may be appropriate for the entity to look at how it is registered with Charities Services and whether that registration is suited to the purpose and operation of the entity and the entity that controls it (taking into account the compliance costs of preparing GAAP-compliant financial statements).

Identifying the Reporting Entity

18. For financial reporting purposes, a reporting entity can be a single entity or several entities that are an economic entity (group) and therefore required to prepare a set of financial statements as if they were one entity.
19. Although this guidance applies to identifying the boundary of single reporting entities and group reporting entities, it can sometimes be helpful to firstly establish the boundary of the single entity and secondly, establish if the single entity controls other entities or is itself controlled by another entity for financial reporting purposes.
20. The reporting entity is relatively simple to identify if it has legal status, such as it is registered as a company, a charitable trust or an incorporated society. In such cases, all of the transactions are entered into in the legal name (or trading name if different) of the entity, the assets are owned by the entity and the entity is responsible for the liabilities it incurs.
21. However, where an NFP entity is unincorporated, that is, it has no legal status¹² (for example, an unincorporated trust), identification of the reporting entity may not be so straightforward. For example, an NFP entity consisting of many branches may consider itself to be one reporting entity. As one reporting entity, it would need to identify and collate all of the transactions undertaken by it (and the many branches), or on its behalf, for inclusion in its financial statements. Conversely, branches affiliated to, but not part of, an NFP entity may be constituted and registered as separate reporting entities. This means that each branch would include only transactions undertaken by it, or on its behalf, in its own financial statements.
22. Appendix A contains illustrative examples of determining the transactions, balances and activities to be included in the financial statements of the reporting entity when the reporting entity has legal status and when the reporting entity has no legal status.

What Should be Included in the Financial Statements of a Reporting Entity?

23. The financial statements of a reporting entity should include all of the transactions, balances and activities of the reporting entity based on the definitions of assets, liabilities, equity, revenue and expenses in the Public Benefit Entities' *Framework* (PBE *Framework*) (see paragraphs 49–80 for definitions of, and guidance about, assets, liabilities, equity, revenue and expenses).

Branches and Similar Networks

24. Many NFP organisations operate through branches or similar networks. Where the branch is a component of the reporting entity (for example, an internal subdivision of the reporting entity), the activities of the branch are included in the financial statements of the reporting entity. This does not prevent the branch from preparing financial statements or reports about its activities to meet the information needs of its stakeholders. Those financial statements or reports may be prepared by the branch using accounting standards issued by the XRB or NZASB or they may be prepared solely to meet the specific information needs of stakeholders of that branch in a form that is appropriate for those stakeholders.
25. Where a branch of an NFP organisation is established as a separate legal entity, GAAP requires the NFP organisation to consider its relationship, if any, with that branch for financial reporting purposes and account for that relationship accordingly (see EG A9 for further guidance on the nature of relationships for financial reporting purposes). Similar to a branch that is an internal subdivision of a reporting entity, the branch that is a separate legal entity may decide to prepare reports about its activities to meet the information needs of its stakeholders even if it does not have statutory reporting obligations.
26. In some cases, NFP organisations may pay a subscription or fee to a national organisation as a means of funding that national organisation. The national organisation then has responsibility for establishing the

¹² An entity that has no legal status is a reporting entity when it is registered under the Charities Act 2005 or under any other legislation that requires it to prepare financial statements that comply with GAAP.

broad parameters under which the NFP organisations operate. Depending on the circumstances, the NFP organisations may be:

- (a) Part of the national organisation, in which case the transactions and activities of the NFP organisations are included in the financial statements of the national organisation;
 - (b) A separate legal entity with a relationship with the national organisation for financial reporting purposes, in which case that relationship needs to be determined so that it can be properly accounted for;
 - (c) A separate legal entity with no relationship with the national organisation for financial reporting purposes, in which case the NFP organisations will be required to prepare their own GAAP-compliant financial statements if they are registered under the Charities Act 2005.
27. In some cases, NFP organisations are established as separate legal entities. However, they are unable to change their constitutions or founding documents without the approval of the national organisation. In such cases, the national organisation may have a relationship with those NFP organisations for financial reporting purposes (see EG A9 for further guidance on the nature of relationships for financial reporting purposes).
28. As noted in paragraph 26(a) above, in some cases NFP organisations might be part of a national organisation. However, NFP organisations are unlikely to be part of a national organisation if:
- (a) NFP organisations can choose whether or not to be a member of the national organisation;
 - (b) The national organisation does not have access to the resources of the NFP organisations or control over the activities of those NFP organisations; and
 - (c) The NFP organisations are not responsible for the obligations of the national organisation.

Umbrella Organisations

29. Some entities are described as ‘umbrella’ organisations, which may have organisations or individuals as members. In some cases, the members may belong to the umbrella organisation in the same way that people join a sporting body or other NFP entity (that is, the members pay a subscription or fee in return for access to services or benefits). Relationships entered into solely for services generally mean that the member organisations are not part of the umbrella organisation for financial reporting purposes.

What should be Included in the Financial Statements of a Reporting Entity?

30. If it is unclear what is to be included in the financial statements of a reporting entity (for example, when the entity has no legal status), the following guidance assists in determining which transactions, balances and activities should be included.
- (a) All transactions and activities undertaken using the reporting entity’s identity (for example, charity registration, legal name where the entity has legal status) are considered to be activities and transactions of the reporting entity.
 - (b) Transactions undertaken and balances held in the name of the reporting entity (for example, balances held in trust on behalf of the reporting entity) are considered to be transactions and balances of the reporting entity.
 - (c) Funds and associated transactions are considered to be funds and associated transactions of the reporting entity if they are solicited in the name of, and with the approval of, the reporting entity (for example, a fundraising event in the name of the reporting entity) by a third party fundraiser acting as an agent of the reporting entity.

Financial Reporting in Accordance with GAAP or a Non-GAAP Standard

31. Applicable financial reporting standards (GAAP or a non-GAAP standard) contain the recognition, measurement, presentation and disclosure requirements for the items to be included in the financial statements.
32. Section 41(2)(b) of the Charities Act 2005 requires the annual return of a charitable entity to be accompanied by a copy of the financial statements and section 42A requires those financial statements to

- comply with GAAP (for a specified NFP entity¹³) or a non-GAAP standard (for entities other than a specified NFP entity).
33. Section 44 of the Charities Act 2005 permits the registration of several entities that are affiliated or closely related as a 'single entity'. Where several entities are registered as a 'single entity', the financial statements that accompany the annual return are prepared either (i) on a consolidated basis in respect of the single entity¹⁴, or (ii) separately in respect of each entity that forms part of the single entity¹⁵. Charities Services determines the manner in which those financial statements are to be prepared¹⁶, but the financial statements must still comply with GAAP or a non-GAAP standard.
 34. A charitable entity may want to register in the manner that reflects its financial reporting requirements under GAAP or a non-GAAP standard in order to reduce complexity and compliance costs. This involves identifying any relationships that the entity has with other entities for financial reporting purposes, looking at both (i) whether the entity controls any other entities, and (ii) whether the entity is controlled by another entity. The outcome of this assessment might result in some entities deciding to change the manner in which they are registered with Charities Services.
 35. Appendix A provides examples of the financial reporting requirements for registered charities in different circumstances.

¹³ A specified not-for-profit entity is an entity in respect of an accounting period if, in each of the 2 preceding accounting periods of the entity, the total operating payments of the entity are \$125,000 or more (section 46 of the Financial Reporting Act 2013).

¹⁴ Although several entities might be registered as a 'single entity', they may not necessarily be a group or an economic entity for financial reporting purposes.

¹⁵ Section 46(1A) of the Charities Act 2005

¹⁶ Section 46(1B) of the Charities Act 2005

Appendix A

Illustrative Examples of Determining the Activities, Transactions and Balances to be Included in the Financial Statements of the Reporting Entity

Where the Entity has Legal Status

Local Golf Club (Inc) is registered as an incorporated society under the Incorporated Societies Act 1908 and is also registered as a charitable entity under the Charities Act 2005. The entity is able to transact, purchase assets and incur liabilities in its own name. The members of Local Golf Club (Inc) are not responsible for the debts of the entity. A consequence of the entity having legal status is that the activities and transactions undertaken by the entity are easily identifiable because they are undertaken in the entity's legal name.

Local Golf Club (Inc) is therefore a reporting entity for the purposes of preparing its financial statements.

Where the Entity does not have Legal Status

A national charitable organisation is registered as a charitable entity under the Charities Act 2005. The organisation comprises a Head Office and ten branches that operate independently of the Head Office but within the terms of the Constitution of the organisation. Each branch maintains separate accounting records on an accruals basis and bank accounts in its own name. The organisation and its branches are treated as a single entity under the Charities Act 2005 and prepare financial statements on a consolidated basis.

Branch A establishes a sub-committee to raise funds specifically to send delegates to an international conference in Australia. A new bank account is opened in the name of the treasurer of the sub-committee in trust for the delegates that will attend the conference. Funds raised are deposited into this account and expenses in respect of the fundraising events are paid out of this bank account. The delegates agree that they will contribute any difference between the funds raised and the costs of attending the conference. At the reporting date, this bank account has a nil balance and is in the process of being closed because the fundraising is complete and the delegates have attended the conference.

The transactions in the bank account form part of the transactions of Branch A and are included in the financial statements of Branch A. Although the bank account was opened in the name of the treasurer of the sub-committee in trust for the delegates, attendance at the conference is on behalf of, and for the benefit of, Branch A. These transactions are also transactions of the national charitable organisation and are included in the financial statements of the single reporting entity prepared in accordance with the relevant accounting standards.

If these transactions are not included in the financial statements, those financial statements do not reflect the total activities of Branch A, or of the national organisation, for the reporting period.

Registration under the Charities Act 2005

NFP entities A, B, C and D were established to collect and distribute donations of food, clothing and furniture to families in need. The governing bodies of the entities meet on a regular basis to share experiences and keep each other informed of their activities and needs. The entities work together co-operatively to meet the needs of the families who contact them. When an entity is in urgent need of items that it doesn't have, the entity contacts the other entities to source those items where possible. Two possible situations are outlined below.

Separate Registration

NFP entities A, B, C and D are registered as separate entities with Charities Services. It is determined that Entity C controls all of the other entities for financial reporting purposes.

In this situation:

- (a) Entity C is required to prepare consolidated financial statements in accordance with PBE IPSAS 6 *Consolidated and Separate Financial Statements* (Not-for-profit) (PBE IPSAS 6 (NFP)); and
- (b) Entities A, B and D are required to prepare their own financial statements that comply with the relevant GAAP.

It is also appropriate for entities A, B, C and D to consider whether they have a relationship with any other entities for financial reporting purposes (see Explanatory Guide A9 *Financial Reporting by Not-for-profit Entities: Identifying Relationships for Financial Reporting Purposes* (EG A9)).

Registration as a Single Entity

NFP entities A, B, C and D are registered as a 'single entity' with Charities Services. One of those entities must be identified as the 'parent' entity for the purposes of the Charities Act 2005. In this case, Entity D has been identified as the 'parent'.

Entity D is therefore responsible for filing the annual returns and the financial statements in respect of all of those entities.

Charities Services decides whether the financial statements of the 'single entity' are prepared on a consolidated basis or separately for each entity that forms part of the single entity. However the financial statements of the 'single entity' are prepared (that is, on a consolidated basis or separately for each entity) they are required to comply with GAAP or a non-GAAP standard.

Example 1

Charities Services decides that Entity D must prepare financial statements for the entities on a consolidated basis. In this case, all of the transactions and activities of entities A, B, C and D must be included in the financial statements, prepared as if entities A, B, C and D were a single entity. When preparing those financial statements, Entity D will need to determine whether any of the entities has a relationship with any of the other entities for financial reporting purposes (see EG A9), because this will impact on how the financial statements are prepared. In particular, even though Entity D is identified as the 'parent' entity for the purposes of the Charities Act 2005, it might not be a 'parent' (controlling entity) for financial reporting purposes.

For example, if Entity C controls entities A, B and D for financial reporting purposes, then Entity C will be the 'parent' (controlling entity) for financial reporting purposes. In this case, the transactions of entities A, B and D will be consolidated into Entity C when preparing the financial statements, using the procedures described in PBE IPSAS 6 (NFP). Entity D, as the 'parent' under the Charities Act 2005, files those consolidated financial statements with Charities Services.

In circumstances such as this, Entity D may want to discuss with Charities Services how the single entity and its members can file their annual return and accompanying financial statements.

Example 2

Charities Services decides that separate financial statements must be prepared for each of entities A, B, C and D. In this case, when the financial statements for each entity are prepared, each entity must consider whether it has a relationship with any of the other entities for financial reporting purposes (see EG A9). For example, if Entity D concludes that it has control over entities A and B for financial reporting purposes, but does not have a relationship with Entity C for financial reporting purposes, then the transactions and activities of entities A and B must be included in the financial statements of Entity D, using the procedures described in PBE IPSAS 6 (NFP). In addition, financial statements must be prepared and filed for each of entities A, B and C.

Entity D may want to discuss with Charities Services how entities A, B and D can file their annual return and accompanying financial statements.



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EXPLANATORY GUIDE A9 FINANCIAL REPORTING BY NOT-FOR-PROFIT ENTITIES: IDENTIFYING RELATIONSHIPS FOR FINANCIAL REPORTING PURPOSES (EG A9)

Issued October 2014

This Explanatory Guide provides guidance for not-for-profit entities in determining whether a reporting entity has a relationship with another entity for financial reporting purposes and, if so, the nature of that relationship for the purpose of accounting for that relationship in the reporting entity's financial statements prepared in compliance with standards issued by the External Reporting Board or its sub-Board, the New Zealand Accounting Standards Board.

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Introduction

1. The objective of this Explanatory Guide is to help not-for-profit (NFP) entities that are required to prepare financial statements that comply with generally accepted accounting practice (GAAP)¹ to determine whether the reporting entity has a relationship with another entity for financial reporting purposes. If such a relationship exists, the nature of that relationship needs to be determined so that it can be accounted for in the financial statements of the reporting entity.
2. This Explanatory Guide was developed to explain the types of relationships that exist between entities for financial reporting purposes. If a NFP reporting entity thinks, after reading this document, that it might have a relationship with another entity for financial reporting purposes, the entity should go to the relevant PBE Standard for further guidance in making its decision. A NFP entity applying the Tier 3 Standard, *Public Benefit Entity Simple Format Reporting - Accrual (Not-For-Profit)*, is also required to go to the relevant PBE Standard for further guidance.
3. The objective of financial statements is to provide information about the entity that is useful to a wide range of users for accountability and decision-making purposes. (See paragraph 7 of Explanatory Guide A8 *Financial Reporting by Not-for-Profit Entities: The Reporting Entity* (EG A8)). An entity that is required to prepare financial statements that comply with GAAP is a reporting entity.
4. The financial statements of a reporting entity should reflect all the activities and transactions of that entity, including the activities and transactions of some other entities with which the reporting entity has a relationship for financial reporting purposes.
5. When preparing financial statements, a reporting entity is required to:
 - (a) Determine the activities and transactions that should be included in those financial statements;
 - (b) Identify other entities with which it has a relationship for financial reporting purposes; and
 - (c) Where such a relationship exists, identify the nature of that relationship in order to account for the other entity appropriately in those financial statements.
6. Guidance for NFP entities on determining the activities and transactions that should be included in the reporting entity's financial statements is found in EG A8.

Identify Other Entities with which the Reporting Entity has a Relationship for Financial Reporting Purposes

7. PBE Standards contain requirements for the preparation of financial statements.
8. PBE Standards use the terms 'control', 'joint control' and 'significant influence' to describe a relationship that a reporting entity has with another entity for financial reporting purposes. The relationship depends on the extent to which the reporting entity is able to direct/influence the use of the resources and benefits derived from the activities of the other entity. This ability to direct/influence the use of the resources and benefits derived from the activities of another entity is often met by the reporting entity having the ability to govern, to some extent, the financial and operating policies of the other entity. This is because the benefits derived are usually the result of the financial and operating policies applied by an entity.

The Nature of a Relationship for Financial Reporting Purposes

9. Once a reporting entity has determined that it has a relationship with another entity for financial reporting purposes, it is necessary to consider the nature of that relationship and the appropriate accounting for that relationship in the reporting entity's financial statements. Determining the nature of this relationship for financial reporting purposes requires the application of judgement in the context of the particular circumstances of each entity. This is because relationships for financial reporting purposes arise in a variety of ways and the underlying circumstances differ.
10. Legal form may determine or affect the nature of relationships between entities for financial reporting purposes. However, relationships for financial reporting purposes can be created under any arrangement or mechanism and they are not restricted to relationships that arise through legal ownership. Therefore, in

¹ Generally accepted accounting practice is defined in section 8 of the Financial Reporting Act 2013 as compliance with applicable financial reporting standards and an authoritative notice if there is no provision in a financial reporting standard for the particular matter.

assessing the nature and extent of relationships between entities for financial reporting purposes, it is essential to consider the substance of the relationship.

11. The nature of a reporting entity's relationship with another entity for financial reporting purposes is likely to fall into one of the following four categories:
 - *Control relationship;*
 - *Joint control relationship;*
 - *Significant influence relationship; or*
 - *Other relationship.*
12. The way in which a reporting entity accounts for the above relationships varies to reflect the substance of the particular relationship.

Control Relationship

13. Control for financial reporting purposes is different from control as defined in legislation. Control is defined in the Companies Act 1993 in the context of a company having the power to appoint or remove all or a majority of the directors of another company². Control for financial reporting purposes can be achieved in ways other than the appointment or removal of all or a majority of the members of the governing body. Appendix A of PBE IPSAS 6 *Consolidated Financial Statements (Not-for-profit)* (PBE IPSAS 6 (NFP)) contains Application Guidance to assist a reporting entity in determining whether, for financial reporting purposes, it controls another entity.
14. Only one reporting entity can have a control relationship with another specific entity for financial reporting purposes (joint control is discussed below). PBE Standards refer to this type of relationship as 'control': the reporting entity (controlling entity (sometimes referred to as a 'parent entity')) 'controls' the other entity (controlled entity). Assessing whether a reporting entity has a control relationship with another entity for financial reporting purposes can be complex and subjective. A thorough assessment of the facts and circumstances is required in each case.
15. Control for financial reporting purposes is defined in PBE IPSAS 6 (NFP) as "the power to govern the financial and operating policies of another entity so as to benefit from its activities". In addition to having the capacity to direct the use of the resources and benefits derived from the activities of another entity, the reporting entity may also be exposed to the financial risk³ of that other entity.
16. 'Control' when used in the context of financial reporting has a power element and a benefit element to it. As well as having the capacity to direct the use of the resources from the activities of another entity (power element), the controlling entity must also have the ability to benefit, either directly or indirectly (for example, the other entity provides services that meet the service objectives of the controlling entity), from the activities of another entity. The power element and benefit element may also be present where the controlling entity has the ability to wind up an entity and obtain a significant level of the residual economic benefits. The residual economic benefits could go directly to the controlling entity or the controlling entity could determine that those benefits go to another entity.
17. Where a reporting entity controls another entity for financial reporting purposes, the reporting entity prepares consolidated financial statements in accordance with PBE IPSAS 6 (NFP) *Consolidated and Separate Financial Statements* (Not-for-profit).

Joint Control Relationship

18. The key characteristic of a joint control relationship for financial reporting purposes is the agreed sharing of control over an activity by two or more parties and/or exposure to financial risk regarding that activity. This is achieved by way of a binding arrangement⁴, which is an arrangement between the parties that confers the rights and obligations on the parties to it as if the arrangement were in the form of a contract. PBE Standards refer to this type of relationship as 'joint control': the agreed sharing of control over an activity by a binding arrangement.

² Section 7 of the Companies Act 1993.

³ Financial risk is the risk that the reporting entity will lose its 'investment' in the other entity or be required to meet the financial obligations of the other entity in the event that the other entity is dissolved or wound-up.

⁴ See paragraphs 7–10 of PBE IPSAS 8 *Interest in Joint Ventures* for more discussion regarding binding arrangements.

19. Joint control requires the parties to agree the terms and conditions of the activity and the services to be delivered. Joint control is not the same as an arrangement where two or more entities receive funding from another party to jointly deliver services in accordance with the terms of a funding agreement with that other party. The delivery of such services in return for the funding is a contractual relationship between the party providing the funding and the entities providing the services. Under a contractual relationship of this nature, the party providing the funding determines the services to be delivered under the contract.
20. Where there is a joint control relationship, the reporting entity applies PBE IPSAS 8 *Interests in Joint Ventures* and accounts for its involvement in the joint activity depending on whether the joint control relates to (i) operations or activities, (ii) assets, or (iii) an incorporated entity that has legal form.
21. Joint control can be sub-classified, with different accounting treatments for each type of classification as follows:
 - (a) *Joint control involving operations or activities.* Two entities agreeing to undertake a particular activity jointly, each contributing their expertise or experience where relevant to the joint objective. For example, two NFP entities combine their operations, resources and expertise to build, market and find tenants for low-cost accommodation. Since the reporting entity is undertaking its agreed component of the activity using its own resources, the entity accounts in its own financial statements for the expenses and liabilities that it incurs in its own name and for its share of the benefits derived from the activity.
 - (b) *Joint control involving assets.* Two entities agreeing to share the use of particular assets. For example, two NFP entities jointly purchase a property from which they each conduct their separate activities and also rent out the remaining unoccupied space of the building. The reporting entity recognises in its own financial statements its share of the joint assets, any liabilities that it has incurred in its own name and its share of any liabilities incurred jointly with the third party, its share of the benefits derived from the use of the shared assets, its share of expenses incurred jointly with the third party and expenses incurred directly in respect of its interest in the shared assets.
 - (c) *Joint control involving incorporated entities that have legal form.* For example, two entities holding an equal share in a company which provides counselling services. One of the following approaches may be adopted:
 - (i) *The equity method.* The reporting entity's interest in the other entity is initially recorded at cost. It is subsequently adjusted by the reporting entity's share of that other entity's change in net assets/equity since joint control was established. The reporting entity's statement of comprehensive revenue and expense reflects its share of the other entity's surplus or deficit for the period.
 - (ii) *Proportionate consolidation.* The reporting entity consolidates its share of the assets, liabilities, revenue and expenses of the other entity.

Significant Influence Relationship

22. In a significant influence relationship for financial reporting purposes, the reporting entity has the capacity to participate in, but not control or jointly control, decisions about the use of the resources and benefits derived from the other entity. PBE Standards refer to this type of relationship as 'significant influence'. Significant influence for financial reporting purposes relates to the reporting entity's ability to influence the financial and operating policies of another entity.
23. For significant influence to exist for financial reporting purposes, a reporting entity needs to have a financial interest in another entity. This enables the reporting entity to participate in the financial and operating policies of the other entity and exposes the reporting entity to some financial risk. This is termed an "ownership interest". In order for this to happen, the other entity needs to have a formal equity structure (for example, share capital) and the reporting entity needs to own some of that equity (that is, the reporting entity has a financial interest of an ownership nature in the other entity. In instances where a reporting entity "invests" in another entity by, for example, providing funding to develop assets, this does not result in the reporting entity having significant influence because the other entity may be able to obtain funding from other sources.⁵

⁵ See paragraphs 3 and 4 of PBE IPSAS 7 *Investments in Associates* for further guidance.

24. Where there is a significant influence relationship, the reporting entity applies PBE IPSAS 7 *Investments in Associates* and would apply the equity method to account for that other entity (see paragraph 21(c)(i) above).

Other Relationships

25. In a relationship that is not a control relationship or a joint control relationship or a significant influence relationship, the reporting entity has little or no capacity to direct/influence the resources and benefits of the other entity and has little or no exposure to any financial risk.
26. However, the reporting entity may have a relationship with another entity that is not one of control, joint control or significant influence. Examples of such relationships include:
- (a) The reporting entity has an investment in another entity and the benefits received comprise a return on that investment. The reporting entity applies PBE IPSAS 28 *Financial Instruments: Presentation*, PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and PBE IPSAS 30 *Financial Instruments: Disclosures* or PBE-SFR-A (NFP) *Public Benefit Entity Simple Format Reporting (Not-for-profit)*.
 - (b) The reporting entity receives substantial donations or grants from another entity. The reporting entity considers whether to apply PBE IPSAS 9 *Revenue from Exchange Transactions* or PBE IPSAS 23 *Revenue from Non-Exchange Transactions* or PBE-SFR-A (NFP) *Public Benefit Entity Simple Format Reporting (Not-for-profit)*.

APPENDIX A

Illustrative Decision Tree for Determining the Appropriate Accounting by a Reporting Entity for its Relationship for Financial Reporting Purposes with Another Entity

This flowchart is considered for each entity with which the reporting entity has a relationship for financial reporting purposes.

