Supporting Papers October 2018

EXPOSURE DRAFT

PUBLIC BENEFIT ENTITY INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARD 41 FINANCIAL INSTRUMENTS (PBE IPSAS 41)

Issued [Date]

This [draft][1] Standard was issued on [Date] by the New Zealand Accounting Standards Board of the External Reporting Board pursuant to section 12(a) of the Financial Reporting Act 2013.

This [draft] Standard is a disallowable instrument for the purposes of the Legislation Act 2012, and pursuant to section 27(1) of the Financial Reporting Act 2013 takes effect on [Date].

Reporting entities that are subject to this [draft] Standard are required to apply it in accordance with the effective date, which is set out in paragraphs [156 to 184.1] [proposed date – on or after 1 January 2022].

In finalising this [draft] Standard, the New Zealand Accounting Standards Board has carried out appropriate consultation in accordance with section 22(1) of the Financial Reporting Act 2013.

This [draft] New Zealand Tier 1 and Tier 2 Public Benefit Entity Accounting Standard has been issued as a result of a new International Public Sector Accounting Standard – IPSAS 41 *Financial Instruments*.

This [draft] Standard, when applied, supersedes parts of PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*. These parts are identified in Appendix D of the [draft] Standard.

This [draft] Standard, when applied, supersedes PBE IFRS 9 *Financial Instruments*.

This is not the official version of NZASB Exposure Draft 2018-5.

This version shows, in marked-up form, the changes proposed to the relevant underlying text. In the case of the body of the proposed PBE IPSAS 41 and the application guidance, the underlying text comes from IFRS 9 *Financial Instruments*.

This version includes shading to assist constituents in identifying the differences between PBE IFRS 9 and the proposed PBE IPSAS 41.

1 References to “this Standard” throughout this Exposure Draft should be read as referring to “this draft Standard”.

PBE IPSAS 41 FINANCIAL INSTRUMENTS

ISBN

PBE IPSAS 41 FINANCIAL INSTRUMENTS

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from paragraph

Public Benefit Entity International Public Sector Accounting Standard 41 *Financial Instruments* is set out in paragraphs 1–184.1 and Appendices A to D. All the paragraphs have equal authority. PBE IPSAS 41 should be read in the context of its objective, the NZASB's Basis for Conclusions on PBE IPSAS 41, the IPSASB's Basis for Conclusions on IPSAS 41, the *Public Benefit Entities' Conceptual Framework* and Standard XRB A1 *Application of the Accounting Standards Framework*. PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[2] The IPSASB Basis for Conclusions will be made available as additional material once PBE IPSAS 41 is issued. A complete copy of IPSAS 41 is available on the XRB website during the consultation period for this ED.

~~Chapter 1~~ Objective

1.~~1.1~~ 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.

~~Chapter 2~~ Scope

1.1 This Standard applies to Tier 1 and Tier 2 public benefit entities.

2.~~2.1~~ **This Standard shall be applied by all entities to all types of financial instruments except:**

(a) **Those interests in controlled entities~~subsidiaries~~, associates and joint ventures that are accounted for in accordance with PBE IPSAS 34 *Separate Financial Statements*, PBE IPSAS 35~~IFRS 10~~ *Consolidated Financial Statements*~~, IAS 27 *Separate Financial Statements*~~ or PBE IPSAS 36~~IAS 28~~ *Investments in Associates and Joint Ventures*. However, in some cases, PBE IPSAS 34, PBE IPSAS 35 or PBE IPSAS 36 ~~IFRS 10, IAS 27 or IAS 28~~ require or permit an entity to account for an interest in a controlled entity~~subsidiary~~, 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~~subsidiary~~, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in PBE IPSAS 28~~IAS 32~~ *Financial Instruments: Presentation*.**

(b) **Rights and obligations under leases to which PBE IPSAS 13~~IFRS 16~~ *Leases* applies. However:**

(i) **Finance lease receivables (i.e., net investments in finance leases) and operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of this Standard;**

(ii) **Lease liabilities recognised by a lessee are subject to the derecognition requirements in paragraph 35~~3.3.1~~ 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 PBE IPSAS 39~~IAS 19~~ *Employee Benefits* applies.**

(d) **Financial instruments issued by the entity that meet the definition of an equity instrument in PBE IPSAS 28~~IAS 32~~ (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 15~~16A~~ and 16~~B~~ or paragraphs 17~~16C~~ and 18~~16D~~ of PBE IPSAS 28~~IAS 32~~. 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 as defined in ~~a contract within the scope of~~ [proposed] PBE IFRS 17 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, or (ii) an investment contract with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to (i) a derivative that is embedded in a contract within the scope of PBE IFRS 17, if the derivative is not itself a contract within the scope of PBE IFRS 17; and (ii) an investment component that is separated from a contract within the scope of PBE IFRS 17, if PBE IFRS 17 requires such separation. Moreover, if an issuer of financial guarantee contracts has previously applied ~~asserted explicitly that it regards such contracts as insurance contracts and has used~~ accounting that is applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, the issuer may elect to apply either this Standard or PBE IFRS 17 to such financial guarantee contracts (see paragraphs AG5–AG6~~B2.5–B2.6~~). The issuer may make that election contract by contract, but the election for each contract is irrevocable.**

(f) **Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in an entity ~~business~~ combination within the scope of PBE IFRS 3**

***Business Combinations*[3] 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 ~~2.3~~. 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 ~~IFRS 2 *Share-based Payment*~~ applies, except for contracts within the scope of paragraphs 5–8~~2.4–2.7~~ 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 recognises as a provision in accordance with PBE IPSAS 19~~IAS 37~~ *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it recognised a provision in accordance with PBE IPSAS 19~~IAS 37~~.**

(j) **~~Rights and obligations within the scope of IFRS 15 *Revenue from Contracts with Customers* that are financial instruments, except for those that IFRS 15 specifies are accounted for in accordance with this Standard.~~The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions, to which PBE IPSAS 23 *Revenue from Non-Exchange Transactions* applies, except as described in paragraph AG6.**

(k) **Rights and obligations under service concession arrangements to which PBE IPSAS 32 *Service Concession Arrangements: Grantor* applies. However, financial liabilities recognised 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.~~2.2~~ **The impairment requirements of this Standard shall be applied to those rights arising from PBE IPSAS 9 *Revenue from Exchange Transactions* and PBE IPSAS 23 transactions which give rise to financial instruments ~~that IFRS 15 specifies are accounted for in accordance with this Standard~~ for the purposes of recognising impairment gains or losses.**

4.~~2.3~~ **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~~profit or loss~~ (see paragraph 46~~4.2.2~~). 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 instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).**

(c) **Commitments to provide a loan at a below-market interest rate (see paragraph 45~~4.2.1~~(d)).**

5.~~2.4~~ **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~~profit or loss~~ in accordance with paragraph 6 ~~2.5~~.**

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[3] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 2(f) would refer to "Any forward contract between an acquirer and a selling shareholder to buy or sell an acquired operation that will result in a PBE combination to which PBE IPSAS 40 *PBE Combinations* applies at a future acquisition date. …"

6.~~2.5~~ **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~~profit or loss~~ 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 recognising that contract because it is excluded from the scope of this Standard (see paragraph 5 ~~2.4~~).**

7.~~2.6~~ 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 ~~2.4~~ 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.

8.~~2.7~~ 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~~2.6~~(a) or 7~~2.6~~(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 amortised 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 amortisation 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 reorganisation;**

(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 amortised 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 AG156–AG158~~B5.4.1–B5.4.3~~), 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 recognised 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 amortised 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 amortised 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 AG156–AG158~~B5.4.1–B5.4.3~~), 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 ~~E~~expected credit loss~~es~~ is~~are~~ 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~~4.2.2 or 4.3.5~~.**

(c) **It is designated either upon initial recognition or subsequently as at fair value through surplus or deficit in accordance with paragraph 152~~6.7.1~~.**

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 amortised 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~~s~~ or loss~~es~~ is~~are gains or losses that are~~ recognised in surplus or deficit in accordance with paragraph 80~~5.5.8~~ and ~~that~~ arises from applying the impairment requirements in paragraphs 73–93~~Section 5.5~~.

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

A loss allowance is the allowance for expected credit losses on financial assets measured in accordance with paragraph 40~~4.1.2~~ and lease receivables, the accumulated impairment amount for financial assets measured in accordance with paragraph 41~~4.1.2A~~ 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 139~~6.5.10~~. 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 ~~a purchased or originated financial asset that is~~ credit-impaired on initial recognition.

Note: PBE IPSAS 41 refers to an entity's management model for financial assets. PBE IFRS 9 used the term business model. Subsequent uses of this term have not been shaded.

The r~~R~~eclassification date is the first day of the first reporting period following the change in management ~~business~~ 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 AG163~~B5.4.8~~). 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 following terms are defined in paragraph 11 of IAS 32, Appendix A of IFRS 7, Appendix A of IFRS 13 or Appendix A of IFRS 15 and are used in this Standard with the meanings specified in IAS 32, IFRS 7, IFRS 13 or IFRS 15:~~

~~(a) credit risk;~~[4]

~~(b) equity instrument;~~

~~(c) fair value;~~

~~(d) financial asset;~~

~~(e) financial instrument;~~

~~(f) financial liability;~~

~~(g) transaction price.~~

~~[4] This term (as defined in IFRS 7) is used in the requirements for presenting the effects of changes in credit risk on liabilities designated as at fair value throughprofit or loss (see paragraph 5.7.7).~~

Terms defined in other PBE Standards 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 PBE IPSAS 28 or PBE IPSAS 30 *Financial Instruments: Disclosures*: credit risk,[5] currency risk, liquidity risk, market risk, equity instrument, financial asset, financial instrument, financial liability and puttable instrument.

~~Chapter 3~~ Recognition and Derecognition

~~3.1~~ Initial Recognition

10.~~3.1.1~~ **An entity shall recognise 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~~B3.1.1~~ and AG16~~B3.1.2~~). When an entity first recognises a financial asset, it shall classify it in accordance with paragraphs 39–44~~4.1.1–4.1.5~~ and measure it in accordance with paragraphs 57 and 59~~5.1.1–5.1.3~~. When an entity first recognises a financial liability, it shall classify it in accordance with paragraphs 45 ~~4.2.1~~ and 46~~4.2.2~~ and measure it in accordance with paragraph 57~~5.1.1~~.**

Regular Way Purchase or Sale of Financial Assets

11.~~3.1.2~~ **A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see paragraphs AG17–AG20~~B3.1.3–B3.1.6~~).**

~~3.2~~ Derecognition of Financial Assets

12.~~3.2.1~~ In consolidated financial statements, paragraphs 13–20 ~~3.2.2–3.2.9~~, AG15~~B3.1.1~~, AG15~~B3.1.2~~ and AG21–AG38~~B3.2.1–B3.2.17~~ are applied at a consolidated level. Hence, an entity first consolidates all controlled entities~~subsidiaries~~ in accordance with PBE IPSAS 35~~IFRS 10~~ and then applies those paragraphs to the resulting economic entity~~group~~.

13.~~3.2.2~~ **Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 14–20 ~~3.2.3–3.2.9~~, 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 ~~3.2.3–3.2.9~~ 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 ~~3.2.3–3.2.9~~ 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 per cent share of all cash flows of a debt instrument, paragraphs 14–20 ~~3.2.3–3.2.9~~ are applied to 90 per cent 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 per cent share of interest cash flows from a financial asset, paragraphs 14–20~~3.2.3–3.2.9~~ are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a**

[5] This term (as defined in PBE 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 107).

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~~3.2.3–3.2.9~~ 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 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 14–20~~3.2.3–3.2.9~~ are applied to the financial asset (or a group of similar financial assets) in its entirety.**

In paragraphs 14–23 ~~3.2.3–3.2.12~~, 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.~~3.2.3~~ **An entity shall derecognise 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 ~~3.2.4~~ and 16~~3.2.5~~ and the transfer qualifies for derecognition in accordance with paragraph 17 ~~3.2.6~~.**

(See paragraph 11~~3.1.2~~ for regular way sales of financial assets.)

15.~~3.2.4~~ **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 ~~3.2.5~~.**

16.~~3.2.5~~ **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 PBE IPSAS 2 ~~IAS 7~~ *Cash Flow Statement*~~*s of Cash Flows*~~) 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.~~3.2.6~~ **When an entity transfers a financial asset (see paragraph 15 ~~3.2.4~~), 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 derecognise the financial asset and recognise 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 recognise 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 derecognise the financial asset and recognise 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 recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 27 ~~3.2.16~~).**

18.~~3.2.7~~ The transfer of risks and rewards (see paragraph 17 ~~3.2.6~~) 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 ~~3.2.5~~).

19.~~3.2.8~~ 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.~~3.2.9~~ Whether the entity has retained control (see paragraph 17~~3.2.6~~(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.~~3.2.10~~ **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 recognise 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 recognised 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 recognised 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~~3.2.13~~.**

22.~~3.2.11~~ **If, as a result of a transfer, a financial asset is derecognised 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 recognise the new financial asset, financial liability or servicing liability at fair value.**

23.~~3.2.12~~ **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 recognised in surplus or deficit~~profit or loss~~.

24.~~3.2.13~~ **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~~3.2.2~~(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 recognised and the part that is derecognised, 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 recognised. The difference between:

(a) **The carrying amount (measured at the date of derecognition) allocated to the part derecognised; and**

(b) **The consideration received for the part derecognised (including any new asset obtained less any new liability assumed)**

shall be recognised in surplus or deficit~~profit or loss~~.

25.~~3.2.14~~ When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognised and the part that is derecognised, the fair value of the part that continues to be recognised needs to be measured. When the entity has a history of selling parts similar to the part that continues to be recognised 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 recognised, 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 derecognised.

Transfers that do not Qualify for Derecognition

26.~~3.2.15~~ **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 recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any revenue~~income~~ on the transferred asset and any expense incurred on the financial liability.**

Continuing Involvement in Transferred Assets

27.~~3.2.16~~ **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 recognise 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~~B3.2.13~~).**

(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.~~3.2.17~~ **When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises 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 amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised 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.~~3.2.18~~ **The entity shall continue to recognise any revenue~~income~~ arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.**

30.~~3.2.19~~ **For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 10~~15.7.1~~, and shall not be offset.**

31.~~3.2.20~~ **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 recognise under continuing involvement, and the part it no longer recognises 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~~3.2.14~~ apply. The difference between:**

(a) **The carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised; and**

(b) **The consideration received for the part no longer recognised**

shall be recognised in ~~profit or loss~~surplus or deficit.

32.~~3.2.21~~ If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through surplus or deficit~~profit or loss~~ is not applicable to the associated liability.

All Transfers

33.~~3.2.22~~ **If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any revenue~~income~~ arising from the transferred asset with any expense incurred on the associated liability (see paragraph 47~~42~~ of PBE IPSAS 28~~IAS 32~~).**

34.~~3.2.23~~ **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 recognise 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 derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise 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 recognise the collateral as an asset.**

~~3.3~~ Derecognition of Financial Liabilities

35.~~3.3.1~~ **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, ~~or~~ cancelled or expires.**

36.~~3.3.2~~ **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.~~3.3.3~~ **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 recognised in ~~profit or loss~~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 PBE IPSAS 23.**

38.~~3.3.4~~ 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 recognised and the part that is derecognised 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 derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in ~~profit or loss~~surplus or deficit.

Note: Paragraph 38.1 is based on IFRS 9 paragraph 3.35, which was added by IFRS 17 *Insurance Contracts*.

38.1~~3.3.5~~ Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's financial liability (for example, a corporate bond issued). Despite the other requirements in this Standard for the derecognition of financial liabilities, an entity may elect not to derecognise its financial liability that is included in such a fund or is an underlying item when, and only when, the entity repurchases its financial liability for such purposes. Instead, the entity may elect to continue to account for that instrument as a financial liability and to account for the repurchased instrument as if the instrument were a financial asset, and measure it at fair value through surplus or deficit~~profit or loss~~ in accordance with this Standard. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See [proposed] PBE IFRS 17 for terms used in this paragraph that are defined in that Standard.)

~~Chapter 4~~ Classification

~~4.1~~ Classification of Financial Assets

39.~~4.1.1~~ **Unless paragraph 44 ~~4.1.5~~ applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive ~~income~~ revenue and expense or fair value through ~~profit or loss~~surplus or deficit on the basis of both:**

(a) **The entity's ~~business~~ management model for ~~managing the~~ financial assets and**

(b) **The contractual cash flow characteristics of the financial asset.**

40.~~4.1.2~~ **A financial asset shall be measured at amortised cost if both of the following conditions are met:**

(a) **The financial asset is held within a management~~business~~ 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~~B4.1.1–B4.1.26~~ provide guidance on how to apply these conditions.

41.~~4.1.2A~~ **A financial asset shall be measured at fair value through other comprehensive ~~income~~ revenue and expense if both of the following conditions are met:**

(a) **The financial asset is held within a management~~business~~ 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~~B4.1.1–B4.1.26~~ provide guidance on how to apply these conditions.

42.~~4.1.3~~ **For the purpose of applying paragraphs 40~~4.1.2~~(b) and 41~~4.1.2A~~(b):**

(a) **Principal is the fair value of the financial asset at initial recognition. Paragraph AG64~~B4.1.7B~~ 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~~B4.1.7A~~ and AG67–AG71~~B4.1.9A–B4.1.9E~~ provide additional guidance on the meaning of interest, including the meaning of the time value of money.**

43.~~4.1.4~~ **A financial asset shall be measured at fair value through ~~profit or loss~~surplus or deficit unless it is measured at amortised cost in accordance with paragraph 40~~4.1.2~~ or at fair value through other comprehensive ~~income~~ revenue and expense in accordance with paragraph 41~~4.1.2A~~. 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 ~~profit or loss~~surplus or deficit to present subsequent changes in fair value in other comprehensive ~~income~~ revenue and expense (see paragraphs 106–107~~5.7.5–5.7.6~~).**

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

44.~~4.1.5~~ **Despite paragraphs 39–43~~4.1.1–4.1.4~~, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through ~~profit or loss~~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 recognising the gains and losses on them on different bases (see paragraphs AG91–AG94~~B4.1.29–B4.1.32~~).**

~~4.2~~ Classification of Financial Liabilities

45.~~4.2.1~~ **An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:**

(a) **Financial liabilities at fair value through ~~profit or loss~~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~~3.2.15~~ and 28~~3.2.17~~ 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~~4.2.1~~(a) or (b) applies) subsequently measure it at the higher of:**

(i) **The amount of the loss allowance determined in accordance with paragraphs 73–93~~Section 5.5~~; and**

(ii) **The amount initially recognised (see paragraph 57~~5.1.1~~) less, when appropriate, the cumulative amount of amortisation~~income~~ recognised in accordance with the principles of PBE IPSAS 9~~IFRS 15~~.**

(d) **Commitments to provide a loan at a below-market interest rate. An issuer of such a commitment shall (unless paragraph 45~~4.2.1~~(a) applies) subsequently measure it at the higher of:**

(i) **The amount of the loss allowance determined in accordance with paragraphs 73–93~~Section 5.5~~; and**

(ii) **The amount initially recognised (see paragraph 57~~5.1.1~~) less, when appropriate, the cumulative amount of amortisation~~income~~ recognised in accordance with the principles of PBE IPSAS 9~~IFRS 15~~.**

(e) **Contingent consideration recognised by an acquirer in a business combination to which PBE IFRS 3 applies.[6] Such contingent consideration shall subsequently be measured at fair value with changes recognised in ~~profit or loss~~surplus or deficit.**

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

46.~~4.2.2~~ **An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through ~~profit or loss~~surplus or deficit when permitted by paragraph 51~~4.3.5~~, 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 recognising the gains and losses on them on different bases (see paragraphs AG91–AG94~~B4.1.29–B4.1.32~~); 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 PBE IPSAS 20~~IAS 24~~ *Related Party Disclosures*), for example, the entity's governing body~~board of directors~~ and chief executive officer (see paragraphs AG95–AG98~~B4.1.33–B4.1.36~~).**

~~4.3~~ Embedded Derivatives

47.~~4.3.1~~ 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.~~4.3.2~~ **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~~4.1.1–4.1.5~~ to the entire hybrid contract.**

Other Hybrid Contracts

49.~~4.3.3~~ **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~~B4.3.5~~ and AG106~~B4.3.8~~);**

(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 recognised in ~~profit or loss~~surplus or deficit (i.e., a derivative that is embedded in a financial liability at fair value through ~~profit or loss~~surplus or deficit is not separated).**

50.~~4.3.4~~ **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.**

[6] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 45 would refer to "Contingent consideration recognised by an acquirer in a PBE combination to which PBE IPSAS 40 applies."

51.~~4.3.5~~ **Despite paragraphs 49~~4.3.3~~ and 50~~4.3.4~~, 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 ~~profit or loss~~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 amortised cost.**

52.~~4.3.6~~ **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 ~~profit or loss~~surplus or deficit.**

53.~~4.3.7~~ 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~~4.3.6~~ applies and the hybrid contract is designated as at fair value through ~~profit or loss~~surplus or deficit.

~~4.4~~ Reclassification

54.~~4.4.1~~ **When, and only when, an entity changes its management~~business~~ model~~ for managing~~ financial assets it shall reclassify all affected financial assets in accordance with paragraphs 39–43~~4.1.1–4.1.4~~. See paragraphs 94–100~~5.6.1–5.6.7~~, AG111–AG113~~B4.4.1–B4.4.3~~ and AG220–AG221~~B5.6.1–B5.6.2~~ for additional guidance on reclassifying financial assets.**

55.~~4.4.2~~ **An entity shall not reclassify any financial liability.**

56.~~4.4.3~~ The following changes in circumstances are not reclassifications for the purposes of paragraphs 54–55~~4.4.1–4.4.2~~:

(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 152–155~~Section 6.7~~.

~~Chapter 5~~ Measurement

~~5.1~~ Initial Measurement

57.~~5.1.1~~ **Except for short-term~~trade~~ receivables and payables within the scope of paragraph 60~~5.1.3~~, 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 ~~profit or loss~~surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.**

58.~~5.1.1A~~ **However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph AG117~~B5.1.2A~~.**

59.~~5.1.2~~ When an entity uses settlement date accounting for an asset that is subsequently measured at amortised cost, the asset is recognised initially at its fair value on the trade date (see paragraphs AG17–AG20~~B3.1.3–B3.1.6~~).

> Note: Paragraph 60 establishes an option for the initial measurement of short-term receivables and payables. PBE IFRS 9 included an equivalent option in paragraph B5.1A.12.

60.~~5.1.3~~ Despite the requirement in paragraph 57~~5.1.1~~, at initial recognition, an entity may~~shall~~ measure short-term~~trade~~ receivables and payables at the original invoice amount if the effect of discounting is immaterial~~their transaction price (as defined in IFRS 15) if the trade receivables do not contain a~~

~~significant financing component in accordance with IFRS 15 (or when the entity applies the practical expedient in accordance with paragraph 63 of IFRS 15)~~.

Note: PBE IFRS 9 section 5.1A included three paragraphs dealing with fair value measurement considerations. PBE IPSAS 41 deals with these matters in paragraphs 66–68.

~~5.2~~ Subsequent Measurement of Financial Assets

61.~~5.2.1~~ **After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 39–44~~4.1.1–4.1.5~~ at:**

(a) **Amortised cost;**

(b) **Fair value through other comprehensive revenue and expense~~income~~; or**

(c) **Fair value through ~~profit or loss~~surplus or deficit.**

62.~~5.2.2~~ **An entity shall apply the impairment requirements in 73–93~~Section 5.5~~ to financial assets that are measured at amortised cost in accordance with paragraph 40~~4.1.2~~ and to financial assets that are measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~.**

63.~~5.2.3~~ **An entity shall apply the hedge accounting requirements in paragraphs 137–143~~6.5.8–6.5.14~~ (and, if applicable, paragraphs 99–105~~89–94~~ of PBE IPSAS 29~~IAS 39~~ *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.**[7]

~~5.3~~ Subsequent Measurement of Financial Liabilities

64.~~5.3.1~~ **After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 45–46~~4.2.1–4.2.2~~.**

65.~~5.3.2~~ **An entity shall apply the hedge accounting requirements in paragraphs 137–143~~6.5.8–6.5.14~~ (and, if applicable, paragraphs 99–105~~89–94~~ of PBE IPSAS 29~~IAS 39~~ 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

66. In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, PBE IPSAS 28 or PBE IPSAS 30, an entity shall apply paragraphs AG144–AG155 of Appendix A.

67. 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 business 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 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.

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[7] In accordance with paragraph 178~~7.2.21~~, an entity may choose as its accounting policy to continue to apply the hedge accounting requirements in PBE IPSAS 29~~IAS 39~~ instead of the requirements in paragraphs 113–155~~Chapter 6~~ of this Standard. If an entity has made this election, the references in this Standard to particular hedge accounting requirements in paragraphs 113–155~~Chapter 6~~ are not relevant. Instead the entity applies the relevant hedge accounting requirements in PBE IPSAS 29~~IAS 39~~.

68. 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.

~~5.4~~ Amortised Cost Measurement

Financial Assets

Effective Interest Method

69.~~5.4.1~~ **Interest revenue shall be calculated by using the effective interest method (see ~~Appendix A and~~ paragraphs 9 and AG156–AG162~~B5.4.1–B5.4.7~~). 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 amortised 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 amortised cost of the financial asset in subsequent reporting periods.**

70.~~5.4.2~~ An entity that, in a reporting period, calculates interest revenue by applying the effective interest method to the amortised cost of a financial asset in accordance with paragraph 69~~5.4.1~~(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 69~~5.4.1~~(b) were applied (such as an improvement in the borrower's credit rating).

Modification of Contractual Cash Flows

71.~~5.4.3~~ 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 recognise a modification gain or loss in ~~profit or loss~~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 139~~6.5.10~~. Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset.

Write-off

72.~~5.4.4~~ **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~~B3.2.16~~(r)).**

~~5.5~~ Impairment

Recognition of Expected Credit Losses

General Approach

73.~~5.5.1~~ **An entity shall recognise a loss allowance for expected credit losses on a financial asset that is measured in accordance with paragraphs 40 or 41 ~~4.1.2 or 4.1.2A~~, a lease receivable, ~~a contract asset~~ or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2~~2.1~~(g), 45~~4.2.1~~(c) or 45~~4.2.1~~(d).**

74.~~5.5.2~~ 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 other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~. However, the loss allowance shall be recognised in other comprehensive revenue and expense~~income~~ and shall not reduce the carrying amount of the financial asset in the statement of financial position.

75.~~5.5.3~~ **Subject to paragraphs 85–88~~5.5.13–5.5.16~~, 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.**

76.~~5.5.4~~ The objective of the impairment requirements is to recognise 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.

77.~~5.5.5~~ **Subject to paragraphs 85–88~~5.5.13–5.5.16~~, 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.**

78.~~5.5.6~~ 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.

79.~~5.5.7~~ 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 75~~5.5.3~~ 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.

80.~~5.5.8~~ An entity shall recognise in ~~profit or loss~~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 recognised in accordance with this Standard.

Determining Significant Increases in Credit Risk

81.~~5.5.9~~ 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.

82.~~5.5.10~~ 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 AG186–AG188~~B5.5.22–B5.5.24~~).

83.~~5.5.11~~ 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

84.~~5.5.12~~ If the contractual cash flows on a financial asset have been renegotiated or modified and the financial asset was not derecognised, an entity shall assess whether there has been a significant increase in the credit risk of the financial instrument in accordance with paragraph 75~~5.5.3~~ 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

85.~~5.5.13~~ **Despite paragraphs 75~~5.5.3~~ and 77~~5.5.5~~, at the reporting date, an entity shall only recognise the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance for purchased or originated credit-impaired financial assets.**

86.~~5.5.14~~ At each reporting date, an entity shall recognise in ~~profit or loss~~surplus or deficit the amount of the change in lifetime expected credit losses as an impairment gain or loss. An entity shall recognise 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 ~~Trade~~ Receivables~~, Contract Assets and Lease Receivables~~

87.~~5.5.15~~ **Despite paragraphs 75~~5.5.3~~ and 77~~5.5.5~~, an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for:**

(a) **~~Trade~~ Receivables ~~or contract assets~~ that result from exchange transactions that are within the scope of PBE IPSAS 9 and non-exchange transactions within the scope of PBE IPSAS 23.~~IFRS 15, and that:~~**

~~(i) **Do not contain a significant financing component in accordance with IFRS 15 (or when the entity applies the practical expedient in accordance with paragraph 63 of IFRS 15); or**~~

~~(ii) Contain a significant financing component in accordance with IFRS 15, 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 such trade receivables or contract assets but may be applied separately to trade receivables and contract assets.~~

(b) **Lease receivables that result from transactions that are within the scope of PBE IPSAS 13~~IFRS 16~~, 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.**

88.~~5.5.16~~ An entity may select its accounting policy for trade receivables~~,~~ and lease receivables ~~and contract assets~~ independently of each other.

89. The requirements for purchased or originated credit-impaired financial assets (see paragraphs 9 and 85 to 86) do not apply to short-term receivables.

Measurement of Expected Credit Losses

90.~~5.5.17~~ **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.**

91.~~5.5.18~~ 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.

92.~~5.5.19~~ 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.

93.~~5.5.20~~ 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.

~~5.6~~ Reclassification of Financial Assets

94.~~5.6.1~~ If an entity reclassifies financial assets in accordance with paragraph 54~~4.4.1~~, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses (including impairment gains or losses) or interest. Paragraphs 95–100~~5.6.2–5.6.7~~ set out the requirements for reclassifications.

95.~~5.6.2~~ If an entity reclassifies a financial asset out of the amortised cost measurement category and into the fair value through ~~profit or loss~~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 amortised cost of the financial asset and fair value is recognised in ~~profit or loss~~surplus or deficit.

96.~~5.6.3~~ If an entity reclassifies a financial asset out of the fair value through ~~profit or loss~~surplus or deficit measurement category and into the amortised cost measurement category, its fair value at the reclassification date becomes its new gross carrying amount. (See paragraph AG221~~B5.6.2~~ for guidance on determining an effective interest rate and a loss allowance at the reclassification date.)

97.~~5.6.4~~ If an entity reclassifies a financial asset out of the amortised cost measurement category and into the fair value through other comprehensive revenue and expense~~income~~ measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive revenue and expense~~income~~. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph AG220~~B5.6.1~~.)

98.~~5.6.5~~ If an entity reclassifies a financial asset out of the fair value through other comprehensive revenue and expense~~income~~ measurement category and into the amortised cost measurement category, the financial asset is reclassified at its fair value at the reclassification date. However, the cumulative gain or loss previously recognised in other comprehensive revenue and expense~~income~~ 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 amortised cost. This adjustment affects other comprehensive revenue and expense~~income~~ but does not affect ~~profit or loss~~surplus or deficit and therefore is not a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~ *Presentation of Financial Reports~~Statements~~*). The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph AG220~~B5.6.1~~.)

99.~~5.6.6~~ If an entity reclassifies a financial asset out of the fair value through ~~profit or loss~~surplus or deficit measurement category and into the fair value through other comprehensive revenue and expense~~income~~ measurement category, the financial asset continues to be measured at fair value. (See paragraph AG221~~B5.6.2~~ for guidance on determining an effective interest rate and a loss allowance at the reclassification date.)

100.~~5.6.7~~ If an entity reclassifies a financial asset out of the fair value through other comprehensive revenue and expense~~income~~ measurement category and into the fair value through ~~profit or loss~~surplus or deficit measurement category, the financial asset continues to be measured at fair value. The cumulative gain or loss previously recognised in other comprehensive revenue and expense~~income~~ is reclassified from net assets/equity to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~) at the reclassification date.

~~5.7~~ Gains and Losses

101.~~5.7.1~~ **A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in ~~profit or loss~~surplus or deficit unless:**

(a) **It is part of a hedging relationship (see paragraphs 137–143~~6.5.8–6.5.14~~ and, if applicable, paragraphs 99–105~~89–94~~ of PBE IPSAS 29~~IAS 39~~ 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 other comprehensive revenue and expense~~income~~ in accordance with paragraph 106~~5.7.5~~;**

(c) **It is a financial liability designated as at fair value through ~~profit or loss~~surplus or deficit and the entity is required to present the effects of changes in the liability's credit risk in other comprehensive revenue and expense~~income~~ in accordance with paragraph 108~~5.7.7~~; or**

(d) **It is a financial asset measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~ and the entity is required to recognise some changes in fair value in other comprehensive revenue and expense~~income~~ in accordance with paragraph 111~~5.7.10~~.**

102.~~5.7.1A~~ Dividends or similar distributions are recognised in ~~profit or loss~~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.

103.~~5.7.2~~ **A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 137–143~~6.5.8–6.5.14~~ and, if applicable, paragraphs 99–105~~89–94~~ of PBE IPSAS 29~~IAS 39~~ for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognised in ~~profit or loss~~surplus or deficit when the financial asset is derecognised, reclassified in accordance with paragraph 95~~5.6.2~~, through the amortisation process or in order to recognise impairment gains or losses. An entity shall apply paragraphs 95~~5.6.2~~ and 97~~5.6.4~~ if it reclassifies financial assets out of the amortised cost measurement category. A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 137–143~~6.5.8–6.5.14~~ and, if applicable, paragraphs 99–105~~89–94~~ of PBE IPSAS 29~~IAS 39~~ for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognised in ~~profit or loss~~surplus or deficit when the financial liability is derecognised and through the amortisation process. (See paragraph AG224~~B5.7.2~~ for guidance on foreign exchange gains or losses.)**

104.~~5.7.3~~ **A gain or loss on financial assets or financial liabilities that are hedged items in a hedging relationship shall be recognised in accordance with paragraphs 137–143~~6.5.8–6.5.14~~ and, if applicable, paragraphs 99–105~~89–94~~ of PBE IPSAS 29~~IAS 39~~ for the fair value hedge accounting for a portfolio hedge of interest rate risk.**

105.~~5.7.4~~ **If an entity recognises financial assets using settlement date accounting (see paragraphs 11, AG17 and AG20~~3.1.2, B3.1.3 and B3.1.6~~), 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 recognised for assets measured at amortised cost. For assets measured at fair value, however, the change in fair value shall be recognised in ~~profit or loss~~surplus or deficit or in other comprehensive revenue and expense~~income~~, as appropriate in accordance with paragraph 101~~5.7.1~~. The trade date shall be considered the date of initial recognition for the purposes of applying the impairment requirements.**

Investments in Equity Instruments

106.~~5.7.5~~ **At initial recognition, an entity may make an irrevocable election to present in other comprehensive ~~income~~ revenue and expense 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 recognised by an acquirer in a business combination to which**

PBE IFRS 3 applies.[8] **(See paragraph AG226~~B5.7.3~~ for guidance on foreign exchange gains or losses.)**

107.~~5.7.6~~ If an entity makes the election in paragraph 106~~5.7.5~~, it shall recognise in ~~profit or loss~~surplus or deficit dividends or similar distributions from that investment in accordance with paragraph 102~~5.7.1A~~.

Liabilities Designated as at Fair Value Through ~~profit or loss~~Surplus or Deficit

108.~~5.7.7~~ **An entity shall present a gain or loss on a financial liability that is designated as at fair value through ~~profit or loss~~surplus or deficit in accordance with paragraph 46~~4.2.2~~ or paragraph 51~~4.3.5~~ 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 other comprehensive revenue and expense~~income~~ (see paragraphs AG236–AG243~~B5.7.13–B5.7.20~~), and**

(b) **The remaining amount of change in the fair value of the liability shall be presented in ~~profit or loss~~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 ~~profit or loss~~surplus or deficit (in which case paragraph 109~~5.7.8~~ applies). Paragraphs AG228–AG230~~B5.7.5–B5.7.7~~ and AG233–AG235~~B5.7.10–B5.7.12~~ provide guidance on determining whether an accounting mismatch would be created or enlarged.

109.~~5.7.8~~ **If the requirements in paragraph 108~~5.7.7~~ would create or enlarge an accounting mismatch in ~~profit or loss~~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 ~~profit or loss~~surplus or deficit.**

110.~~5.7.9~~ Despite the requirements in paragraphs 108~~5.7.7~~ and 109~~5.7.8~~, an entity shall present in ~~profit or loss~~surplus or deficit all gains and losses on loan commitments and financial guarantee contracts that are designated as at fair value through ~~profit or loss~~surplus or deficit.

Assets Measured at Fair Value Through Other Comprehensive ~~Income~~Revenue and Expense

111.~~5.7.10~~**A gain or loss on a financial asset measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~ shall be recognised in other comprehensive revenue and expense~~income~~, except for impairment gains or losses (see paragraphs 73–93~~Section 5.5~~) and foreign exchange gains and losses (see paragraphs AG224–AG225~~B5.7.2–B5.7.2A~~), until the financial asset is derecognised or reclassified. When the financial asset is derecognised the cumulative gain or loss previously recognised in other comprehensive revenue and expense~~income~~ is reclassified from net assets/equity to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~). If the financial asset is reclassified out of the fair value through other comprehensive revenue and expense~~income~~ measurement category, the entity shall account for the cumulative gain or loss that was previously recognised in other comprehensive revenue and expense~~income~~ in accordance with paragraphs 98~~5.6.5~~ and 100~~5.6.7~~. Interest calculated using the effective interest method is recognised in ~~profit or loss~~surplus or deficit.**

112.~~5.7.11~~**As described in paragraph 111~~5.7.10~~, if a financial asset is measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~, the amounts that are recognised in ~~profit or loss~~surplus or deficit are the same as the amounts that would have been recognised in ~~profit or loss~~surplus or deficit if the financial asset had been measured at amortised cost.**

[8] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 106 would refer to "…contingent consideration recognised by an acquirer in a PBE combination to which PBE IPSAS 40 applies."

~~Chapter 6~~ Hedge Accounting

~~6.1~~ Objective and Scope of Hedge Accounting

113.~~6.1.1~~ 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 ~~profit or loss~~surplus or deficit (or other comprehensive revenue and expense~~income~~, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive revenue and expense~~income~~ in accordance with paragraph 106~~5.7.5~~). 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.

114.~~6.1.2~~ An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in accordance with paragraphs 116–128~~6.2.1–6.3.7~~ and AG244–AG274~~B6.2.1–B6.3.25~~. 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 130–143~~6.5.1–6.5.14~~ and AG294–AG321~~B6.5.1–B6.5.28~~. When the hedged item is a group of items, an entity shall comply with the additional requirements in paragraphs 146–151~~6.6.1–6.6.6~~ and AG333–AG348~~B6.6.1–B6.6.16~~.

115.~~6.1.3~~ 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 PBE IPSAS 29~~IAS 39~~ 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~~81A~~, 100~~89A~~ and AG157–AG175~~AG114–AG132~~ of PBE IPSAS 29~~IAS 39~~).

~~6.2~~ Hedging Instruments

Qualifying Instruments

116.~~6.2.1~~ **A derivative measured at fair value through ~~profit or loss~~surplus or deficit may be designated as a hedging instrument, except for some written options (see paragraph AG247~~B6.2.4~~).**

117.~~6.2.2~~ **A non-derivative financial asset or a non-derivative financial liability measured at fair value through ~~profit or loss~~surplus or deficit may be designated as a hedging instrument unless it is a financial liability designated as at fair value through ~~profit or loss~~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 other comprehensive ~~income~~revenue and expense in accordance with paragraph 108~~5.7.7~~. 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 other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~.**

118.~~6.2.3~~ **For hedge accounting purposes, only contracts with a party external to the reporting entity (i.e., external to the economic entity~~group~~ or individual entity that is being reported on) can be designated as hedging instruments.**

Designation of Hedging Instruments

119.~~6.2.4~~ 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 144~~6.5.15~~ and AG322~~B6.5.29~~–AG326~~B6.5.33~~);

(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 145~~6.5.16~~ and AG327–AG332~~B6.5.34–B6.5.39~~); and

(c) A proportion of the entire hedging instrument, such as 50 per cent 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.

120.~~6.2.5~~ 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.

121.~~6.2.6~~ 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 AG247~~B6.2.4~~). 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 AG247~~B6.2.4~~).

~~6.3~~ Hedged Items

Qualifying Items

122.~~6.3.1~~ **A hedged item can be a recognised asset or liability, an unrecognised 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 146–151~~6.6.1–6.6.6~~ and AG333–AG348~~B6.6.1–B6.6.16~~).**

A hedged item can also be a component of such an item or group of items (see paragraphs 128~~6.3.7~~ and AG256–AG274~~B6.3.7–B6.3.25~~).

123.~~6.3.2~~ **The hedged item must be reliably measurable.**

124.~~6.3.3~~ **If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.**

125.~~6.3.4~~ **An aggregated exposure that is a combination of an exposure that could qualify as a hedged item in accordance with paragraph 122~~6.3.1~~ and a derivative may be designated as a hedged item (see paragraphs AG252–AG253~~B6.3.3–B6.3.4~~). 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.**

126.~~6.3.5~~ **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~~group~~ only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the economic entity~~group~~, except for:**

(a) **The consolidated financial statements of an investment entity, as defined in PBE IPSAS 35~~IFRS 10~~, where transactions between an investment entity and its controlled entities~~subsidiaries~~ measured at fair value through ~~profit or loss~~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 PBE 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.**

127.~~6.3.6~~ However, as an exception to paragraph 126~~6.3.5~~, the foreign currency risk of a~~n~~ ~~intragroup~~ monetary item within an economic entity (for example, a payable/receivable between two controlled entities~~subsidiaries~~) 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 PBE IPSAS 4~~IAS 21~~ *The Effects of Changes in Foreign Exchange Rates*. In accordance with PBE IPSAS 4~~IAS 21~~, foreign exchange rate gains and losses on ~~intragroup~~ monetary items within an economic entity are not fully eliminated on consolidation when the ~~intragroup~~ monetary item is transacted between two ~~group~~ entities within the economic entity that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast ~~intragroup~~ 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 ~~profit or loss~~surplus or deficit.

Designation of Hedged Items

128.~~6.3.7~~ 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 AG257–AG264~~B6.3.8–B6.3.15~~). 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 AG265–AG269~~B6.3.16–B6.3.20~~).

~~6.4~~ Qualifying Criteria for Hedge Accounting

129.~~6.4.1~~ **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 AG278–AG280~~B6.4.4–B6.4.6~~);**

(ii) **The effect of credit risk does not dominate the value changes that result from that economic relationship (see paragraphs AG281–AG282~~B6.4.7–B6.4.8~~); 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 recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs AG283–AG285~~B6.4.9–B6.4.11~~).**

~~6.5~~ Accounting for Qualifying Hedging Relationships

130.~~6.5.1~~ **An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 129~~6.4.1~~ (which include the entity's decision to designate the hedging relationship).**

131.~~6.5.2~~ **There are three types of hedging relationships:**

(a) **Fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect ~~profit or loss~~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 recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect ~~profit or loss~~surplus or deficit.**

(c) **Hedge of a net investment in a foreign operation as defined in PBE IPSAS 4~~IAS 21~~.**

132.~~6.5.3~~ If the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~, the hedged exposure referred to in paragraph 131~~6.5.2~~(a) must be one that could affect other comprehensive ~~income~~revenue and expense. In that case, and only in that case, the recognised hedge ineffectiveness is presented in other comprehensive ~~income~~revenue and expense.

133.~~6.5.4~~ 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.

134.~~6.5.5~~ **If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio (see paragraph 129~~6.4.1~~(c)(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 AG300–AG314~~B6.5.7–B6.5.21~~).**

135.~~6.5.6~~ **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 organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, 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).

136.~~6.5.7~~ An entity shall apply:

(a) Paragraph 139~~6.5.10~~ 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 amortised cost; and

(b) Paragraph 141~~6.5.12~~ when it discontinues hedge accounting for cash flow hedges.

Fair Value Hedges

137.~~6.5.8~~ As long as a fair value hedge meets the qualifying criteria in paragraph 129~~6.4.1~~, the hedging relationship shall be accounted for as follows:

(a) **The gain or loss on the hedging instrument shall be recognised in ~~profit or loss~~surplus or deficit (or other comprehensive ~~income~~revenue and expense, if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~).**

(b) **The hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognised in ~~profit or loss~~surplus or deficit. If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive ~~income~~revenue and expense in accordance with paragraph 41~~4.1.2A~~, the hedging gain or loss on the hedged item shall be recognised in ~~profit or loss~~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 other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~, those amounts shall remain in other comprehensive ~~income~~revenue and expense. When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in ~~profit or loss~~surplus or deficit.**

138.~~6.5.9~~ 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 recognised in the statement of financial position.

139.~~6.5.10~~Any adjustment arising from paragraph 137~~6.5.8~~(b) shall be amortised to ~~profit or loss~~surplus or deficit if the hedged item is a financial instrument (or a component thereof) measured at amortised cost. Amortisation 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 amortisation is based on a recalculated effective interest rate at the date that amortisation 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 other comprehensive ~~income~~revenue and expense in accordance with paragraph 41~~4.1.2A~~, amortisation applies in the same manner but to the amount that represents the cumulative gain or loss previously recognised in accordance with paragraph 137~~6.5.8~~(b) instead of by adjusting the carrying amount.

Cash Flow Hedges

140.~~6.5.11~~As long as a cash flow hedge meets the qualifying criteria in paragraph 129~~6.4.1~~, the hedging relationship shall be accounted for as follows:

(a) **The separate component of net assets/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 recognised in other comprehensive ~~income~~revenue and expense.

(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 recognised in ~~profit or loss~~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 PBE IPSAS 1~~IAS 1~~) and hence it does not affect other comprehensive ~~income~~revenue and expense.**

(ii) **For cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~) in the same period or periods during which the hedged expected future cash flows affect ~~profit or loss~~surplus or deficit (for example, in the periods that interest revenue~~income~~ or interest expense is recognised 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 ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~).**

141.~~6.5.12~~When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 135~~6.5.6~~ and 136~~6.5.7~~(b)) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 140~~6.5.11~~(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 140~~6.5.11~~(d)(iii) applies. When the future cash flows occur, paragraph 140~~6.5.11~~(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 ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 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

142.~~6.5.13~~**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 PBE IPSAS 4~~IAS 21~~), 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 recognised in other comprehensive ~~income~~revenue and expense (see paragraph 140~~6.5.11~~); and**

(b) **The ineffective portion shall be recognised in ~~profit or loss~~surplus or deficit.**

143.~~6.5.14~~**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 ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~) in accordance with paragraphs 57–58~~48–49~~ of PBE IPSAS 4~~IAS 21~~ on the disposal or partial disposal of the foreign operation.**

Accounting for the Time Value of Options

144.~~6.5.15~~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 119~~6.2.4~~(a)), it shall account for the time value of the option as follows (see paragraphs AG322–AG326~~B6.5.29–B6.5.33~~):

(a) An entity shall distinguish the time value of options by the type of hedged item that the option hedges (see paragraph AG322~~B6.5.29~~):

(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 recognised in other comprehensive ~~income~~revenue and expense 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 PBE IPSAS 1~~IAS 1~~) and hence does not affect other comprehensive ~~income~~revenue and expense.

(ii) For hedging relationships other than those covered by (i), the amount shall be reclassified from the separate component of net assets/equity to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~) in the same period or periods during which the hedged expected future cash flows affect ~~profit or loss~~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 ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~).

(c) The change in fair value of the time value of an option that hedges a time-period related hedged item shall be recognised in other comprehensive ~~income~~revenue and expense 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 amortised on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect ~~profit or loss~~surplus or deficit (or other comprehensive ~~income~~revenue and expense, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~). Hence, in each reporting period, the amortisation amount shall be reclassified from the separate component of net assets/equity to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 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 amortisation) that has been accumulated in the separate component of net assets/equity shall be immediately reclassified into ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~).

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

145.~~6.5.16~~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 119~~6.2.4~~(b)), the entity may apply paragraph 144~~6.5.15~~ 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 AG327–AG332~~B6.5.34–B6.5.39~~.

~~6.6~~ Hedges of a Group of Items

Eligibility of a Group of Items as the Hedged Item

146.~~6.6.1~~ **A group of items (including a group of items that constitute a net position; see paragraphs AG333–AG340~~B6.6.1–B6.6.8~~) 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 ~~profit or loss~~surplus or deficit, as well as their nature and volume (see paragraphs AG339–AG340~~B6.6.7–B6.6.8~~).**

Designation of a Component of a Nominal Amount

147.~~6.6.2~~ 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.

148.~~6.6.3~~ 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 unrecognised firm commitment or a recognised 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 AG269~~B6.3.20~~).

Presentation

149.~~6.6.4~~ 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 ~~profit or loss and other~~ comprehensive ~~income~~revenue and expense, 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~~cost of sales~~) remains unaffected.

150.~~6.6.5~~ 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 recognised as an adjustment of the carrying amount of the respective individual items comprising the group in accordance with paragraph 137~~6.5.8~~(b).

Nil Net Positions

151.~~6.6.6~~ 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 recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

~~6.7~~ Option to Designate a Credit Exposure as Measured at Fair Value Through ~~profit or loss~~Surplus or Deficit

Eligibility of Credit Exposures for Designation at Fair Value Through ~~profit or loss~~Surplus or Deficit

152.~~6.7.1~~ **If an entity uses a credit derivative that is measured at fair value through ~~profit or loss~~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 ~~profit or loss~~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 unrecognised. The entity shall document the designation concurrently.

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

153.~~6.7.2~~ If a financial instrument is designated in accordance with paragraph 152~~6.7.1~~ as measured at fair value through ~~profit or loss~~surplus or deficit after its initial recognition, or was previously not recognised, the difference at the time of designation between the carrying amount, if any, and the fair value shall immediately be recognised in ~~profit or loss~~surplus or deficit. For financial assets measured at fair value through other comprehensive ~~income~~revenue and expense in accordance with paragraph 41~~4.1.2A~~, the cumulative gain or loss previously recognised in other comprehensive ~~income~~revenue and expense shall immediately be reclassified from net assets/equity to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~).

154.~~6.7.3~~ 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 ~~profit or loss~~surplus or deficit if:

(a) The qualifying criteria in paragraph 152~~6.7.1~~ 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 ~~profit or loss~~surplus or deficit (i.e., the entity's management~~business~~ model has not changed in the meantime so that a reclassification in accordance with paragraph 54~~4.4.1~~ was required).

155.~~6.7.4~~ 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 ~~profit or loss~~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 ~~profit or loss~~surplus or deficit shall be applied (including amortisation that results from the new carrying amount). For example, a financial asset that had originally been classified as measured at amortised 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 ~~profit or loss~~surplus or deficit.

~~Chapter 7~~ Effective Date and Transition

~~7.1~~ Effective Date

156.~~7.1.1~~ An entity shall apply this Standard for annual periods beginning on or after 1 January 2022~~2018~~. Earlier application is permitted. In the case of entities with insurance contracts within the scope of [proposed] PBE IFRS 17, early application is permitted only if PBE IFRS 17 is applied at the same time. 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~~s~~ 173 and 179~~7.1.2, 7.2.21 and 7.3.2~~). It shall also, at the same time, apply the amendments in Appendix ~~C~~D.

157 [Not used.]

~~7.1.2 Despite the requirements in paragraph 7.1.1, for annual periods beginning before 1 January 2018, an entity may elect to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 without applying the other requirements in this Standard. If an entity elects to apply only those paragraphs, it shall disclose that fact and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of IFRS 7 *Financial Instruments: Disclosures* (as amended by IFRS 9 (2010)). (See also paragraphs 7.2.2 and 7.2.15.)~~

~~7.1.3 *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, amended paragraphs 4.2.1 and 5.7.5 as a consequential amendment derived from the amendment to IFRS 3. An entity shall apply that amendment prospectively to business combinations to which the amendment to IFRS 3 applies.~~

~~7.1.4 IFRS 15, issued in May 2014, amended paragraphs 3.1.1, 4.2.1, 5.1.1, 5.2.1, 5.7.6, B3.2.13, B5.7.1, C5 and C42 and deleted paragraph C16 and its related heading. Paragraphs 5.1.3 and 5.7.1A, and a definition to Appendix A, were added. An entity shall apply those amendments when it applies IFRS 15.~~

~~7.1.5 IFRS 16, issued in January 2016, amended paragraphs 2.1, 5.5.15, B4.3.8, B5.5.34 and B5.5.46. An entity shall apply those amendments when it applies IFRS 16.~~

~~7.1.6 IFRS 17, issued in May 2017, amended paragraphs 2.1, B2.1, B2.4, B2.5 and B4.1.30, and added paragraph 3.3.5. An entity shall apply those amendments when it applies IFRS 17.~~

~~7.1.7 *Prepayment Features with Negative Compensation* (Amendments to IFRS 9), issued in October 2017, added paragraphs 7.2.29–7.2.34 and B4.1.12A and amended paragraphs B4.1.11(b) and B4.1.12(b). An entity shall apply these amendments for annual periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.~~

~~7.2~~ Transition

157.1. An entity that has previously applied PBE IFRS 9 *Financial Instruments* shall apply the transition provisions in paragraphs 157.3–157.8. An entity that has not previously applied PBE IFRS 9 shall apply the transition provisions in paragraphs 158–184.

157.2 For the purposes of the transition provisions, 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.

Entities Transitioning from PBE IFRS 9

157.3 When an entity that has previously applied PBE IFRS 9 first applies this Standard, it shall not change the classification or measurement of its existing financial assets and financial liabilities on the date of initial application, except as expressly permitted or required by this Standard or other PBE Standards. In such cases an entity shall also apply any other transition requirements in this Standard that are necessary.

Prepayment Features with Negative Compensation

157.4 When an entity that has previously applied PBE IFRS 9 first applies this Standard, on the date of initial application, with regard to designating a financial asset or financial liability as measured at fair value through surplus or deficit, an entity applies the requirements in paragraphs AG73–AG74.1 of this Standard (referred to as the revised requirements). An entity:

(a) Shall revoke its previous designation of a financial asset as measured at fair value through surplus or deficit if that designation was previously made in accordance with the condition in paragraph 44 but that condition is no longer satisfied as a result of the application of the revised requirements;

(b) May designate a financial asset as measured at fair value through surplus or deficit if that designation would not have previously satisfied the condition in paragraph 44 but that condition is now satisfied as a result of the application of the revised requirements;

(c) Shall revoke its previous designation of a financial liability as measured at fair value through surplus or deficit if that designation was previously made in accordance with the condition in paragraph 46(a) but that condition is no longer satisfied as a result of the application of the revised requirements; and

(d) May designate a financial liability as measured at fair value through surplus or deficit if that designation would not have previously satisfied the condition in paragraph 46(a) but that condition is now satisfied as a result of the application of the revised requirements.

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

157.5 An entity is not required to restate prior periods to reflect the application of the revised requirements. The entity may restate prior periods if, and only if, it is possible without the use of hindsight and the restated financial statements reflect all the requirements in this Standard. If an entity does not restate prior periods, the entity shall recognise 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 of these amendments in the opening accumulated surpluses (or other component of net assets/equity, as appropriate) of the annual reporting period that includes the date of initial application of the revised requirements in this Standard.

157.6 In the reporting period that includes the date of initial application of the revised requirements, the entity shall disclose the following information as at that date of initial application for each class of financial assets and financial liabilities that were affected by the revised requirements:

(a) The previous measurement category and carrying amount determined immediately before applying the revised requirements;

(b) The new measurement category and carrying amount determined after applying the revised requirements;

(c) The carrying 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; and

(d) The reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through surplus or deficit.

Hedge Accounting

157.7 When an entity that has previously applied the hedge accounting requirements of PBE IFRS 9 first applies this Standard it shall apply the requirements in paragraphs 113–155 of this Standard. When an entity that has previously applied the hedge accounting requirements of PBE IFRS 9 first applies this Standard it shall apply the requirements in paragraphs 113–155 of this Standard. On first time application of this Standard it shall apply hedge accounting to the existing hedging relationships to which it applied hedge accounting under PBE IFRS 9.

157.8 When an entity that has previously applied PBE IFRS 9 continued to apply the hedge accounting requirements of PBE IPSAS 29 it may continue to apply those requirements. Alternatively, an entity may elect, on adoption of this Standard, to apply the requirements in paragraphs 113–155 of this Standard in accordance with paragraphs 179–184 of this Standard.

Simplified Approach for Receivables – Impairment

157.9 When an entity that has previously applied PBE IFRS 9 first applies this Standard, on the date of initial application, with respect to the simplified approach for receivables, an entity applies the requirements in paragraph 87 retrospectively from the beginning of the earliest comparative period presented. However, the entity is not required to restate prior periods to reflect the application of paragraph 87.

Offsetting Financial Assets and Financial Liabilities

157.10 When an entity that has previously applied PBE IFRS 9 first applies this Standard it shall apply the requirements in paragraphs AG63A–AG63F of PBE IPSAS 28 (which include requirements related to offsetting financial assets and financial liabilities) retrospectively from the beginning of the earliest comparative period presented. Restatement is required. In addition, the entity shall provide the disclosures required by paragraphs 17A–17F and paragraphs AG42–AG55 of PBE IPSAS 30 in accordance with the transitional provisions in paragraph 53.7 of PBE IPSAS 30.

Extinguishing Financial Liabilities with Equity Instruments

157.11 When an entity that has previously applied PBE IFRS 9 first applies this Standard, on the date of initial application, an entity applies the requirements in Appendix~~–~~ C of this Standard with regard to extinguishing financial liabilities with equity instruments. An entity applies the requirements of Appendix C retrospectively from the beginning of the earliest comparative period presented. However, the entity is not required to restate prior periods to reflect the application of Appendix~~-~~ C.

Entities Transitioning from PBE IPSAS 29

158. An entity shall apply this Standard retrospectively, in accordance with PBE IPSAS 3~~IAS 8~~ *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 161–184~~7.2.4–7.2.26 and 7.2.28~~. This Standard shall not be applied to items that have already been derecognised at the date of initial application.

~~7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1, 7.2.3 7.2.28 and 7.3.2, 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. Depending on the entity's chosen approach to applying IFRS 9, the transition can involve one or more than one date of initial application for different requirements.~~

Transition for Classification and Measurement ~~(Chapters 4 and 5)~~

160.~~7.2.3~~ At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraphs 40~~4.1.2~~(a) or 41~~4.1.2A~~(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~~business~~ model in prior reporting periods.

161.~~7.2.4~~ If, at the date of initial application, it is impracticable (as defined in PBE IPSAS 3~~IAS 8~~) for an entity to assess a modified time value of money element in accordance with paragraphs AG68–AG70~~B4.1.9B–B4.1.9D~~ 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~~B4.1.9B–B4.1.9D~~. (See also paragraph 49~~42~~R of PBE IPSAS 30~~IFRS 7~~.)

162.~~7.2.5~~ If, at the date of initial application, it is impracticable (as defined in PBE IPSAS 3~~IAS 8~~) for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraph AG74~~B4.1.12~~(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~~B4.1.12~~. (See also paragraph 49~~42~~S of PBE IPSAS 30~~IFRS 7~~.)

163.~~7.2.6~~ If an entity measures a hybrid contract at fair value in accordance with paragraphs 41~~4.1.2A~~, 43~~4.1.4~~ or 44~~4.1.5~~ 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 173~~7.2.15~~).

164.~~7.2.7~~ If an entity has applied paragraph 163~~7.2.6~~ then at the date of initial application the entity shall recognise 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 ~~retained earnings~~ (or other component of net assets/equity, as appropriate) of the reporting period that includes the date of initial application.

165.~~7.2.8~~ At the date of initial application an entity may designate:

(a) A financial asset as measured at fair value through ~~profit or loss~~surplus or deficit in accordance with paragraph 44~~4.1.5~~; or

(b) An investment in an equity instrument as at fair value through other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~.

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.

166.~~7.2.9~~ At the date of initial application an entity:

(a) Shall revoke its previous designation of a financial asset as measured at fair value through ~~profit or loss~~surplus or deficit if that financial asset does not meet the condition in paragraph 44~~4.1.5~~.

(b) May revoke its previous designation of a financial asset as measured at fair value through ~~profit or loss~~surplus or deficit if that financial asset meets the condition in paragraph 44~~4.1.5~~.

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.

167.~~7.2.10~~ At the date of initial application, an entity:

(a) May designate a financial liability as measured at fair value through ~~profit or loss~~surplus or deficit in accordance with paragraph 46~~4.2.2~~(a).

(b) Shall revoke its previous designation of a financial liability as measured at fair value through ~~profit or loss~~surplus or deficit if such designation was made at initial recognition in accordance with the condition now in paragraph 46~~4.2.2~~(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 ~~profit or loss~~surplus or deficit if such designation was made at initial recognition in accordance with the condition now in paragraph 46~~4.2.2~~(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.

168.~~7.2.11~~ If it is impracticable (as defined in PBE IPSAS 3~~IAS 8~~) 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 amortised 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 amortised cost of that financial liability at the date of initial application of this Standard.

169.~~7.2.12~~If an entity previously accounted at cost (in accordance with PBE IPSAS 29~~IAS 39~~), 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 recognised in the opening accumulated surplus or deficit~~retained earnings~~ (or other component of net assets/equity, as appropriate) of the reporting period that includes the date of initial application.

170.~~7.2.13~~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 PBE IPSAS 29~~IAS 39~~, 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 recognised in the opening net assets/equity~~retained earnings~~ of the reporting period that includes the date of initial application.

171.~~7.2.14~~At the date of initial application, an entity shall determine whether the treatment in paragraph 108~~5.7.7~~ would create or enlarge an accounting mismatch in ~~profit or loss~~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.

172.~~7.2.14A~~ At the date of initial application, an entity is permitted to make the designation in paragraph 6~~2.5~~ 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 recognised in net assets/equity~~retained earnings~~ at the date of initial application.

173.~~7.2.15~~Despite the requirement in paragraph 158~~7.2.1~~, an entity that adopts the classification and measurement requirements of this Standard (which include the requirements related to amortised cost measurement for financial assets and impairment in paragraphs 69–72 and paragraphs 73–93~~Sections 5.4 and 5.5~~) shall provide the disclosures set out in paragraphs 49~~42~~L–49~~42~~O of PBE IPSAS 30~~IFRS 7~~ 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 recognise 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 ~~retained earnings~~ (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. ~~If an entity's chosen approach to applying IFRS 9 results in more than one date of initial application for different requirements, this paragraph applies at each date of initial application (see paragraph 7.2.2). This would be the case, for example, if an entity elects to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in accordance with paragraph 7.1.2 before applying the other requirements in this Standard.~~

174.~~7.2.16~~If an entity prepares interim financial reports in accordance with PBE IAS 34 *Interim Financial Reporting* 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 PBE IPSAS 3~~IAS 8~~).

Impairment ~~***(Section 5.5)***~~

175.~~7.2.17~~An entity shall apply the impairment requirements in paragraphs 73–93~~Section 5.5~~ retrospectively in accordance with PBE IPSAS 3~~IAS 8~~ subject to paragraphs 173~~7.2.15~~ and 176–178~~7.2.18–7.2.20~~.

176.~~7.2.18~~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 recognised (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 78~~5.5.6~~) and compare that to the credit risk at the date of initial application of this Standard.

177.~~7.2.19~~When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:

(a) The requirements in paragraphs 82~~5.5.10~~ and AG186–AG188~~B5.5.22–B5.5.24~~; and

(b) The rebuttable presumption in paragraph 83~~5.5.11~~ 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.

178.~~7.2.20~~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 recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial instrument is low credit risk at a reporting date, in which case paragraph 177~~7.2.19~~(a) applies).

Transition for Hedge Accounting ~~(Chapter 6)~~

179.~~7.2.21~~When an entity first applies this Standard, it may choose as its accounting policy to continue to apply the hedge accounting requirements of PBE IPSAS 29~~IAS 39~~ instead of the requirements in paragraphs 113–155~~Chapter 6~~ 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 PBE IPSAS 29~~IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* without the amendments that conform that Interpretation to the requirements in Chapter 6 of this Standard~~.

180.~~7.2.22~~Except as provided in paragraph 184~~7.2.26~~, an entity shall apply the hedge accounting requirements of this Standard prospectively.

181.~~7.2.23~~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.

182.~~7.2.24~~Hedging relationships that qualified for hedge accounting in accordance with PBE IPSAS 29~~IAS 39~~ that also qualify for hedge accounting in accordance with the criteria of this Standard (see paragraph 129~~6.4.1~~), after taking into account any rebalancing of the hedging relationship on transition (see paragraph 183~~7.2.25~~(b)), shall be regarded as continuing hedging relationships.

183~~7.2.25~~ 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 PBE IPSAS 29~~IAS 39~~; and

(b) Shall consider the hedge ratio in accordance with PBE IPSAS 29~~IAS 39~~ 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 recognised in ~~profit or loss~~surplus or deficit.

184.~~7.2.26~~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 144~~6.5.15~~ retrospectively if, in accordance with PBE IPSAS 29~~IAS 39~~, 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 145~~6.5.16~~ retrospectively if, in accordance with PBE IPSAS 29~~IAS 39~~, 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 145~~6.5.16~~) 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 135~~6.5.6~~ 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.

~~***Entities that have Applied IFRS 9 (2009), IFRS 9 (2010) or IFRS 9 (2013) Early***~~

~~7.2.27 An entity shall apply the transition requirements in paragraphs 7.2.1–7.2.26 at the relevant date of initial application. An entity shall apply each of the transition provisions in paragraphs 7.2.3–7.2.14A and 7.2.17–7.2.26 only once (i.e., if an entity chooses an approach of applying IFRS 9 that involves more than one date of initial application, it cannot apply any of those provisions again if they were already applied at an earlier date). (See paragraphs 7.2.2 and 7.3.2.)~~

~~7.2.28 An entity that applied IFRS 9 (2009), IFRS 9 (2010) or IFRS 9 (2013) and subsequently applies this Standard:~~

~~(a) Shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.1.5 but that condition is no longer satisfied as a result of the application of this Standard;~~

~~(b) May designate a financial asset as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.1.5 but that condition is now satisfied as a result of the application of this Standard;~~

~~(c) Shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.2.2(a) but that condition is no longer satisfied as a result of the application of this Standard; and~~

~~(d) May designate a financial liability as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.2.2(a) but that condition is now satisfied as a result of the application of this Standard.~~

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

~~***Transition for Prepayment Features with Negative Compensation***~~

~~7.2.29 An entity shall apply *Prepayment Features with Negative Compensation* (Amendments to IFRS 9) retrospectively in accordance with IAS 8, except as specified in paragraphs 7.2.30–7.2.34.~~

~~7.2.30 An entity that first applies these amendments at the same time it first applies this Standard shall apply paragraphs 7.2.1–7.2.28 instead of paragraphs 7.2.31–7.2.34.~~

~~7.2.31 An entity that first applies these amendments after it first applies this Standard shall apply paragraphs 7.2.32–7.2.34. The entity shall also apply the other transition requirements in this Standard necessary for applying these amendments. For that purpose, references to the date of initial application shall be read as referring to the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments).~~

~~7.2.32 With regard to designating a financial asset or financial liability as measured at fair value through profit or loss, an entity:~~

~~(a) Shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.1.5 but that condition is no longer satisfied as a result of the application of these amendments;~~

~~(b) May designate a financial asset as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.1.5 but that condition is now satisfied as a result of the application of these amendments;~~

~~(c) Shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.2.2(a) but that condition is no longer satisfied as a result of the application of these amendments; and~~

~~(d) May designate a financial liability as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.2.2(a) but that condition is now satisfied as a result of the application of these amendments.~~

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

~~7.2.33 An entity is not required to restate prior periods to reflect the application of these amendments. The entity may restate prior periods if, and only if, it is possible without the use of hindsight and the restated financial statements reflect all the requirements in this Standard. If an entity does not restate prior periods, the entity shall recognise 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 of these amendments in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.~~

~~7.2.34 In the reporting period that includes the date of initial application of these amendments, the entity shall disclose the following information as at that date of initial application for each class of financial assets and financial liabilities that were affected by these amendments:~~

~~(a) The previous measurement category and carrying amount determined immediately before applying these amendments;~~

~~(b) The new measurement category and carrying amount determined after applying these amendments;~~

~~(c) The carrying amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated; and~~

~~(d) The reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.~~

~~7.3~~ Withdrawal of ~~IFRIC 9,~~ PBE IFRS 9 ~~(2009), IFRS 9 (2010) and IFRS 9 (2013)~~

~~7.3.1 This Standard supersedes IFRIC 9 *Reassessment of Embedded Derivatives*. The requirements added to IFRS 9 in October 2010 incorporated the requirements previously set out in paragraphs 5 and 7 of IFRIC 9. As a consequential amendment, IFRS 1 *First-time Adoption of International Financial Reporting Standards* incorporated the requirements previously set out in paragraph 8 of IFRIC 9.~~

184.1~~7.3.2~~ This Standard supersedes PBE IFRS 9~~ (2009), IFRS 9 (2010) and IFRS 9 (2013)~~. *Effective Date of PBE IFRS 9*, issued in [Date], limited the early adoption of PBE IFRS 9 to annual periods beginning before [Date– proposed 1 January 2020]. ~~However, for annual periods beginning before 1 January 2018, an entity may elect to apply those earlier versions of IFRS 9 instead of applying this Standard if, and only if, the entity's relevant date of initial application is before 1 February 2015.~~

~~Appendix A~~
~~Defined terms~~

~~*This appendix is an integral part of the Standard.*~~

[Not used.]

Note: The definitions are located in paragraph 9.

Appendix ~~B~~A

Application Guidance

This Appendix is an integral part of PBE IPSAS 41~~the Standard~~.

Scope ~~(Chapter 2)~~

AG1.~~B2.1~~ 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 within the scope of [proposed] PBE IFRS 17 *Insurance Contracts*, they are within the scope of this Standard.

AG2.~~B2.2~~ 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 ~~IAS 26 *Accounting and Reporting by Retirement Benefit Plans*~~ and royalty agreements based on the volume of sales or service revenues that are accounted for under PBE IPSAS 9 *Revenue from Exchange Transactions* ~~IFRS 15 *Revenue from Contracts with Customers*~~.

AG3.~~B2.3~~ Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the management model ~~intention~~ 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 PBE IPSAS 36~~IAS 28~~ *Investments in Associates and Joint Ventures* to determine whether the equity method of accounting shall be applied to such an investment.

AG4.~~B2.4~~ This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2~~.1~~(e) excludes because they arise under contracts within the scope of [proposed] PBE IFRS 17. An entity does however apply this Standard to

(a) Financial guarantee contracts, except those where the issuer elects to treat such contracts as insurance contracts in accordance with PBE IPSAS 28 *Financial Instruments: Presentation*; and

(b) 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.~~B2.5~~ 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~~.1~~(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in [proposed] PBE IFRS 17 (see paragraph 7(e) of PBE IFRS 17) if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously ~~asserted explicitly that it regards such contracts as insurance contracts and has used~~ applied accounting that is applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, the issuer may elect to apply either this Standard or PBE IFRS 17 to such financial guarantee contracts. If this Standard applies, paragraph 57~~5.1.1~~ requires the issuer to recognise 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 ~~profit or loss~~surplus or deficit or unless paragraphs 26–34~~3.2.15–3.2.23~~ and AG32–AG38~~B3.2.12–B3.2.17~~ 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 73–93~~Section 5.5~~; and

(ii) The amount initially recognised less, when appropriate, the cumulative amortisation~~amount of income~~ recognised in accordance with the principles of PBE IPSAS 9~~IFRS 15~~ (see paragraph 45~~4.2.1~~(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 as defined in [proposed] PBE IFRS 17. 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 PBE IPSAS 9~~IFRS 15~~ in determining when it recognises the revenue from the guarantee and from the sale of goods.

~~B2.6 Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.~~

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 recognised simultaneously. Where the asset is a financial asset, it is recognised in accordance with PBE IPSAS 23 *Revenue from Non-Exchange Transactions*, and initially measured in accordance with PBE IPSAS 23 and this Standard. A liability that is initially recognised as a result of conditions imposed on the use of an asset is outside the scope of this Standard and is dealt with in PBE IPSAS 23. After initial recognition, if circumstances indicate that recognition of a liability in accordance with PBE IPSAS 23 is no longer appropriate, an entity considers whether a financial liability should be recognised in accordance with this Standard. Other liabilities that may arise from non-exchange revenue transactions are recognised and measured in accordance with this Standard if they meet the definition of a financial liability in PBE IPSAS 28.

Definitions

Derivatives

Note: Consistent with PBE IPSAS 29, the integral sections of PBE IPSAS 41 refers to an interbank offered rate rather than LIBOR. PBE IFRS 9 used the term LIBOR. Subsequent uses of this term have not been shaded.

AG7.~~BA.1~~ 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 the six-month interbank offered rate~~LIBOR~~ increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

AG8.~~BA.2~~ 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~~2.5~~ (see paragraphs 5–8~~2.4–2.7~~).

AG9.~~BA.3~~ 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.~~BA.4~~ 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 recognised as a derivative financial instrument. Instead, this Standard provides for special accounting for such regular way contracts (see paragraphs 11~~3.1.2~~ and AG17–20~~B3.1.3–B3.1.6~~).

AG11.~~BA.5~~ 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.~~BA.6~~ 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.~~BA.7~~ 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~~an intention~~ 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.~~BA.8~~ 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 ~~(Chapter 3)~~

Initial Recognition ~~(Section 3.1)~~

AG15.~~B3.1.1~~ As a consequence of the principle in paragraph 10~~–3.1.1~~, an entity recognises 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~~B3.2.14~~). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph AG36~~B3.2.15~~).

AG16.~~B3.1.2~~ The following are examples of applying the principle in paragraph 10~~3.1.1~~:

(a) Unconditional receivables and payables are recognised 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 recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise 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~~2.4–2.7~~, its net fair value is recognised as an asset or a liability on the commitment date (see paragraph AG92~~B4.1.30~~(c)). In addition, if a previously unrecognised 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 recognised as an asset or a liability after the inception of the hedge (see paragraphs 137~~6.5.8~~(b) and 138~~6.5.9~~).

(c) A forward contract that is within the scope of this Standard (see paragraph 2~~.1~~) is recognised 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 recognised as an asset or liability.

(d) Option contracts that are within the scope of this Standard (see paragraph 2~~.1~~) are recognised 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.~~B3.1.3~~ A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs AG19~~B3.1.5~~ and AG20~~B3.1.6~~. 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 ~~profit or loss~~surplus or deficit form a separate classification from assets designated as measured at fair value through ~~profit or loss~~surplus or deficit. In addition, investments in equity instruments accounted for using the option provided in paragraph 106~~5.7.5~~ form a separate classification.

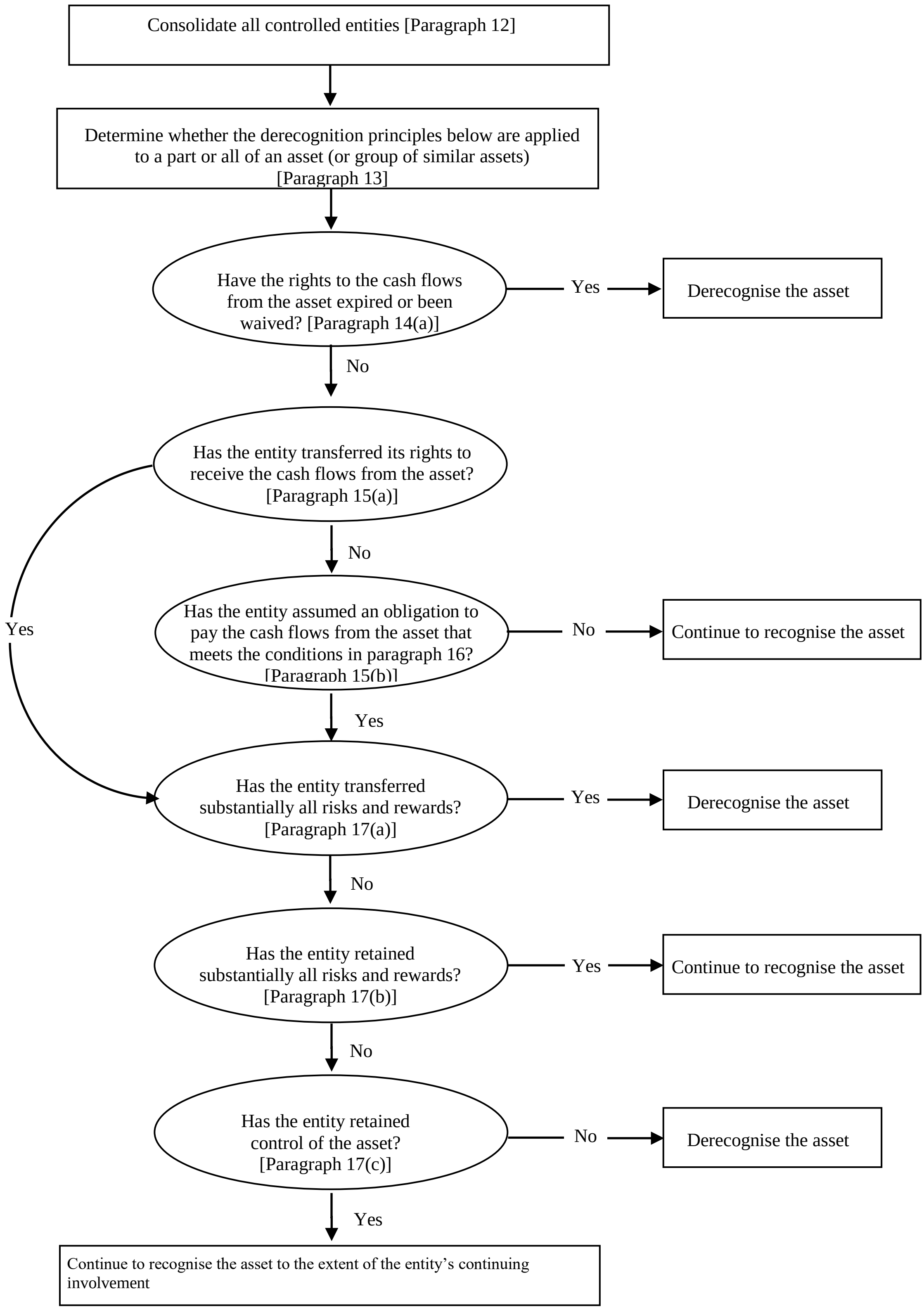
AG18.~~B3.1.4~~ A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

AG19.~~B3.1.5~~ 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.~~B3.1.6~~ 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 recognised for assets measured at amortised cost; it is recognised in ~~profit or loss~~surplus or deficit for assets classified as financial assets measured at fair value through ~~profit or loss~~surplus or deficit; and it is recognised in other comprehensive ~~income~~revenue and expense for financial assets measured at fair value through other comprehensive ~~income~~revenue and expense in accordance with paragraph 41~~4.1.2A~~ and for investments in equity instruments accounted for in accordance with paragraph 106~~5.7.5~~.

Derecognition of Financial Assets ~~(Section 3.2)~~

AG21.~~B3.2.1~~ The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



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~~3.2.4~~(b))

AG22.~~B3.2.2~~ The situation described in paragraph 15~~3.2.4~~(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~~3.2.5~~ and 17~~3.2.6~~ are met.

AG23.~~B3.2.3~~ In applying paragraph 16~~3.2.5~~, the entity could be, for example, the originator of the financial asset, or it could be an economic entity ~~group~~ that includes a controlled entity~~subsidiary~~ 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~~3.2.6~~)

AG24.~~B3.2.4~~ 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.~~B3.2.5~~ 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.~~B3.2.6~~ 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 recognise 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.~~B3.2.7~~ 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.~~B3.2.8~~ 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.~~B3.2.9~~ 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.~~B3.2.10~~ 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~~3.2.13~~, 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 derecognised and the part that continues to be recognised. 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 recognised at fair value.

AG31.~~B3.2.11~~ When measuring the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 24~~3.2.13~~, an entity applies the fair value measurement requirements in paragraphs 66–68 and AG144–AG155~~IFRS 13 *Fair Value Measurement* in addition to paragraph 3.2.14~~.

Transfers that do not Qualify for Derecognition

AG32.~~B3.2.12~~ The following is an application of the principle outlined in paragraph 26~~3.2.15~~. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Sale of Future Flows Arising from a Sovereign Right

AG33. In the public sector, securitisation schemes may involve a sale of future flows arising from a sovereign right, such as a right to taxation, that have not previously been recognised as assets. An entity recognises the revenue arising from such transactions in accordance with the relevant revenue standard (see PBE IPSAS 9 and PBE IPSAS 23). Such transactions may give rise to financial liabilities as defined in PBE 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 recognised when the entity becomes party to the contractual provisions of the instrument in accordance with paragraph 10 and classified in accordance with paragraphs 45 and 46. The financial liabilities shall be initially recognised in accordance with paragraph 57, and subsequently measured in accordance with paragraphs 62 and 63.

Continuing Involvement in Transferred Assets

AG34.~~B3.2.13~~ The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 27~~3.2.16~~.

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 derecognised 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 recognised in ~~profit or loss~~surplus or deficit on a time proportion basis (see PBE IPSAS 9) ~~when (or as) the obligation is satisfied (in accordance with the principles of IFRS 15)~~ and the carrying value of the asset is reduced by any loss allowance.

Assets Measured at Amortised 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 derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (i.e., the consideration received) adjusted for the amortisation 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 recognised in ~~profit or loss~~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 recognised in ~~profit or loss~~surplus or deficit.

Assets Measured at Fair Value

(c) If a call option right retained by an entity prevents a transferred asset from being derecognised 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 (CU80 – CU5) 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 derecognised 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 (CU100 + CU5) 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 derecognised 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 recognises an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) – CU5]. 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.~~B3.2.14~~ 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 recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising 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 recognised as a derivative asset.

AG36.~~B3.2.15~~ To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises 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 amortised cost if it meets the criteria in paragraph 40~~4.1.2~~.

Examples

AG37.~~B3.2.16~~ 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 derecognised 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 derecognised 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 derecognised 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 derecognises 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 derecognised.

(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 derecognised. 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 derecognised. 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 recognised to the extent of the transferor's continuing involvement (see paragraph AG29~~B3.2.9~~). 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 derecognised.

(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~~B3.2.9~~ 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 recognised 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) *Amortising 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 amortising 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 amortises 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 recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation 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.~~B3.2.17~~ 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 per cent and whose principal amount and amortised 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 per cent. The entity retains rights to CU1,000 of any collections of principal plus interest thereon at 10 per cent, plus the excess spread of 0.5 per cent 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 per cent 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 analyses 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% × CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90 per cent 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 per cent 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 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent 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~~3.2.14 of IFRS 9~~ as follows:

	Estimated fair value	*Percentage*	*Allocated carrying amount*
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 per cent 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 recognises the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises 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:

	Debit	*Credit*
Original asset	—	9,000
Asset recognised for subordination or the residual interest	1,000	—
Asset for the consideration received in the form of excess spread	40	—
~~Profit or loss~~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 recognises the consideration received for the credit enhancement (CU65) on a time proportion basis, accrues interest on the recognised asset using the effective interest method and recognises any impairment losses on the recognised 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 recognised 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 recognised liability by CU300. The net result is a charge to ~~profit or loss~~surplus or deficit for impairment losses of CU300.

Derecognition of Financial Liabilities ~~(Section 3.3)~~

AG39.~~B3.3.1~~ 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.~~B3.3.2~~ 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.~~B3.3.3~~ 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.~~B3.3.4~~ 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 derecognise the debt obligation unless the condition in paragraph AG39~~B3.3.1~~(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 recognises 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 PBE IPSAS 23.

AG44. Lenders will sometimes waive their right to collect debt owed by a public sector entity, for example, a central 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 PBE IPSAS 23.

AG45.~~B3.3.5~~ Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 12–34~~3.2.1–3.2.23~~ are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.

AG46.~~B3.3.6~~ For the purpose of paragraph 36~~3.3.2~~, 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 per cent 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 recognised 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 amortised over the remaining term of the modified liability.

AG47.~~B3.3.7~~ 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) Recognises a new financial liability based on the fair value of its obligation for the guarantee;~~,~~ and

(b) Recognises 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 ~~(Chapter 4)~~

Classification of Financial Assets ~~(Section 4.1)~~

The Entity's Management~~business~~ Model for ~~Managing~~ Financial Assets

AG48.~~B4.1.1~~ Paragraph 39~~4.1.1~~(a) requires an entity to classify financial assets on the basis of the entity's management~~business~~ model for ~~managing~~ the financial assets, unless paragraph 44~~4.1.5~~ applies. An entity assesses whether its financial assets meet the condition in paragraph 40~~4.1.2~~(a) or the condition in paragraph 41~~4.1.2A~~(a) on the basis of the management~~business~~ model as determined by the entity's key management personnel (as defined in PBE IPSAS 20~~IAS 24~~ *Related Party Disclosures*).

AG49.~~B4.1.2~~ An entity's management~~business~~ model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular ~~business~~ objective. The entity's management~~business~~ model does not depend on management's intentions 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 ~~business~~ management model for ~~managing~~ 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 realise fair value changes. Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into subportfolios 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.~~B4.1.2A~~ An entity's management~~business~~ model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's management~~business~~ 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~~business~~ model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the management~~business~~ 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 PBE IPSAS 3~~IAS 8~~ *Accounting Policies, Changes in Accounting Estimates and Errors*) nor does it change the classification of the remaining financial assets held in that management~~business~~ model (i.e., those assets that the entity recognised 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~~business~~ model assessment. However, when an entity assesses the management~~business~~ model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information.

AG51.~~B4.1.2B~~ An entity's management~~business~~ model for ~~managing~~ 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~~business~~ model. An entity will need to use judgement when it assesses its management~~business~~ model for ~~managing~~ 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~~business~~ model and the financial assets held within that management~~business~~ model are evaluated and reported to the entity's key management personnel;

(b) The risks that affect the performance of the management~~business~~ model (and the financial assets held within that management~~business~~ model) and, in particular, the way in which those risks are managed; and

(c) How management is~~managers of the business are~~ 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~~business~~ Model Whose Objective is to Hold Assets in Order to Collect Contractual Cash Flows

AG52.~~B4.1.2C~~ Financial assets that are held within a management~~business~~ model whose objective is to hold assets in order to collect contractual cash flows are managed to realise 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 realised 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~~business~~ 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 realised. 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.~~B4.1.3~~ Although the objective of an entity's management~~business~~ 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~~business~~ 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.~~B4.1.3A~~ The management~~business~~ 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~~business~~ 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 minimising potential credit losses due to credit deterioration are integral to such a management~~business~~ 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.~~B4.1.3B~~ 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~~business~~ 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~~business~~ 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~~business~~ 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.~~B4.1.4~~ The following are examples of when the objective of an entity's management~~business~~ 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~~business~~ model nor specify the relative importance of the factors.

Example	Analysis
Example 1 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. The entity performs credit risk management activities with the objective of minimising 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. 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.	Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (i.e., the cash amount that would be realised 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.
Example 2 An entity's management~~business~~ model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit-impaired. If payment on the loans is not made on a timely basis, the entity attempts to realise 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 realising cash flows by selling them. 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.	The objective of the entity's management~~business~~ model is to hold the financial assets in order to collect the contractual cash flows. 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). 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~~business~~ model.

Example	Analysis
Example 3 An entity has a management~~business~~ model with the objective of originating student loans ~~to customers~~ and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.	The consolidated economic entity~~group~~ originated the loans with the objective of holding them to collect the contractual cash flows. However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation 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.
Example 4 A local government entity that issues bonds ~~financial institution~~ holds financial assets to meet redemption ~~liquidity~~ needs in a 'stress case' scenario (e.g., a run on the government's issued securities~~bank's deposits~~). The entity does not anticipate selling these assets except in such scenarios. 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 realised. 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 realised 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.	The objective of the entity's management~~business~~ model is to hold the financial assets to collect contractual cash flows. 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~~liquidity~~ needs. Similarly, recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows. In contrast, if an entity holds financial assets to meet its everyday redemption~~liquidity~~ needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's management~~business~~ model is not to hold the financial assets to collect contractual cash flows. Similarly, if the entity is required by law or regulation~~its regulator~~ 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~~business~~ 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.

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

AG57.~~B4.1.4A~~ An entity may hold financial assets in a management~~business~~ model whose objective is achieved by both collecting contractual cash flows and selling financial assets. In this type of management~~business~~ 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~~business~~ model. There are various objectives that may be consistent with this type of management~~business~~ model. For example, the objective of the management~~business~~ 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.~~B4.1.4B~~ Compared to a management~~business~~ model whose objective is to hold financial assets to collect contractual cash flows, this management~~business~~ model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the management~~business~~ 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~~business~~ model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

AG59.~~B4.1.4C~~ The following are examples of when the objective of the entity's management~~business~~ 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~~business~~ model nor specify the relative importance of the factors.

Example	**Analysis**
Example 5 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. 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. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.	The objective of the management~~business~~ 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 maximise the return on the portfolio until the need arises for the invested cash. 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~~business~~ model is to hold financial assets to collect contractual cash flows.

Example	Analysis
Example 6 An entity~~financial institution~~ holds financial assets to meet its everyday liquidity needs. The entity seeks to minimise 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. 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.	The objective of the management~~business~~ model is to maximise 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~~business~~ model's objective.
Example 7 A social security fund ~~An insurer~~ holds financial assets in order to fund social security~~insurance contract~~ liabilities. The fund~~insurer~~ uses the proceeds from the contractual cash flows on the financial assets to settle social security ~~insurance contract~~ liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the fund~~insurer~~ 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.	The objective of the management~~business~~ model is to fund the social security ~~insurance contract~~ 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~~business~~ model's objective.

Other Management~~business~~ Models

AG60.~~B4.1.5~~ Financial assets are measured at fair value through ~~profit or loss~~surplus or deficit if they are not held within a management~~business~~ model whose objective is to hold assets to collect contractual cash flows or within a management~~business~~ model whose objective is achieved by both collecting contractual cash flows and selling financial assets (but see also paragraph 106~~5.7.5~~). One management~~business~~ model that results in measurement at fair value through ~~profit or loss~~surplus or deficit is one in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise 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~~business~~ 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~~business~~ model's objective; instead, it is incidental to it.

AG61.~~B4.1.6~~ A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 46~~4.2.2~~(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~~business~~ model's objective. Consequently, such portfolios of financial assets must be measured at fair value through ~~profit or loss~~surplus or deficit.

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

AG62.~~B4.1.7~~ Paragraph 39~~4.1.1~~(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~~business~~ model whose objective is to hold assets to collect contractual cash flows or within a management~~business~~ model whose objective is achieved by both collecting contractual cash flows and selling financial assets, unless paragraph 44~~4.1.5~~ applies. To do so, the condition in paragraphs 40~~4.1.2~~(b) and 41~~4.1.2A~~(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.~~B4.1.7A~~ 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~~B4.1.9A–B4.1.9E~~) 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, ~~or~~ 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.~~B4.1.7B~~ In accordance with paragraph 42~~4.1.3~~(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.~~B4.1.8~~ 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.~~B4.1.9~~ 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~~4.1.2~~(b) and 41~~4.1.2A~~(b) and cannot be subsequently measured at amortised cost or fair value through other comprehensive ~~income~~revenue and expense.

Consideration for the Time Value of Money

AG67.~~B4.1.9A~~ 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 judgement 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.~~B4.1.9B~~ 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.~~B4.1.9C~~ 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~~4.1.2~~(b) and 41~~4.1.2A~~(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.~~B4.1.9D~~ 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~~4.1.2~~(b) and 41~~4.1.2A~~(b) and therefore cannot be measured at amortised cost or fair value through other comprehensive ~~income~~revenue and expense.

AG71.~~B4.1.9E~~ 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~~B4.1.9A–B4.1.9D~~, 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~~4.1.2~~(b) and 41~~4.1.2A~~(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.~~B4.1.10~~ 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~~B4.1.18~~.)

Note: Paragraphs AG73(b), AG74(b) and AG74.1 reflect amendments equivalent to those set out in *Prepayment Features with Negative Compensation* (Amendments to IFRS 9) issued in October 2017. PBE IFRS 9 paragraphs B4.1.11(b) and B4.1.12(b) referred to 'reasonable additional compensation'.

AG73.~~B4.1.11~~ 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 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.~~B4.1.12~~ Despite paragraph AG72~~B4.1.10~~, a financial asset that would otherwise meet the condition in paragraphs 40~~4.1.2~~(b) and 41~~4.1.2A~~(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 amortised cost or fair value through other comprehensive ~~income~~revenue and expense (subject to meeting the condition in paragraph 40~~4.1.2~~(a) or the condition in paragraph 41~~4.1.2A~~(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 compensation for the early termination of the contract; and

(c) When the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

AG74.1~~B4.1.12A~~ For the purpose of applying paragraphs AG73~~B4.1.11~~(b) and AG74~~B4.1.12~~(b), irrespective of the event or circumstance that causes the early termination of the contract, a party may pay **or** receive reasonable compensation for that early termination. For example, a party may pay or receive reasonable compensation when it chooses to terminate the contract early (or otherwise causes the early termination to occur).

AG75.~~B4.1.13~~ 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
Instrument A 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.	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. However, if the interest payments were indexed to another variable such as the debtor's performance (e.g., the debtor's surplus or deficit~~net income~~) 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~~B4.1.7A~~).
Instrument B 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 the three-month interbank offered rate~~LIBOR~~ for a three-month term or the one-month interbank offered rate ~~LIBOR~~ for a one-month term.	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~~B4.1.7A~~). The fact that the interbank offered ~~LIBOR~~ interest rate is reset during the life of the instrument does not in itself disqualify the instrument. 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.

Instrument	**Analysis**
	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~~B4.1.9E~~ for guidance on regulated interest rates.) 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. 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).
Instrument C Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.	The contractual cash flows of both: (a) an instrument that has a fixed interest rate and (b) an instrument that has a variable interest rate 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~~B4.1.7A~~) 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.
Instrument D Instrument D is a full recourse loan and is secured by collateral.	The fact that a full recourse loan is collateralised 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.

Instrument	Analysis
Instrument E 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'.	The holder would analyse 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. 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.

AG76.~~B4.1.14~~ 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
Instrument F Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer.	The holder would analyse the convertible bond in its entirety. 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~~B4.1.7A~~); i.e., the return is linked to the value of the equity of the issuer.
Instrument G 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).	The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. The interest amounts are not consideration for the time value of money on the principal amount outstanding.

Instrument	Analysis
Instrument H 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. Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest.	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. If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding. 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. 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~~B4.1.12~~.)

AG77.~~B4.1.15~~ 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~~4.1.2~~(b), 41~~4.1.2A~~(b) and 42~~4.1.3~~ of this Standard.

AG78.~~B4.1.16~~ 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~~4.1.2~~(b) and 41~~4.1.2A~~(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.~~B4.1.17~~ 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~~4.1.2~~(b) and 41~~4.1.2A~~(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~~4.1.2~~(b) and 41~~4.1.2A~~(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

AG80.~~B4.1.18~~ 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.~~B4.1.19~~ 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 collateralised, 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.~~B4.1.20~~ In some types of transactions, an issuer may prioritise 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.~~B4.1.21~~ 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~~B4.1.23~~ and AG86~~B4.1.24~~; 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.~~B4.1.22~~ 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.~~B4.1.23~~ 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.~~B4.1.24~~ The underlying pool of instruments may also include instruments that:

(a) Reduce the cash flow variability of the instruments in paragraph AG85~~B4.1.23~~ and, when combined with the instruments in paragraph AG85~~B4.1.23~~, 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~~B4.1.23~~); or

(b) Align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph AG85~~B4.1.23~~ 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.~~B4.1.25~~ If any instrument in the pool does not meet the conditions in either paragraph AG85~~B4.1.23~~ or paragraph AG86~~B4.1.24~~, the condition in paragraph 83~~B4.1.21~~(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 judgement and perform sufficient analysis to determine whether the instruments in the pool meet the conditions in paragraphs AG85–AG86~~B4.1.23–B4.1.24~~. (See also paragraph AG80~~B4.1.18~~ for guidance on contractual cash flow characteristics that have only a de minimis effect.)

AG88.~~B4.1.26~~ If the holder cannot assess the conditions in paragraph AG83~~B4.1.21~~ at initial recognition, the tranche must be measured at fair value through ~~profit or loss~~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 A85–AG86~~B4.1.23–B4.1.24~~, the tranche does not meet the conditions in paragraph AG83~~B4.1.21~~ and must be measured at fair value through ~~profit or loss~~surplus or deficit. However, if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions in paragraphs AG85–AG86~~B4.1.23–B4.1.24~~, 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~~intention~~ of controlling the collateral.

Option to Designate a Financial Asset or Financial Liability as at Fair Value Through ~~profit or loss~~Surplus or Deficit ~~(Sections 4.1 and 4.2)~~

AG89.~~B4.1.27~~ Subject to the conditions in paragraphs 44~~4.1.5~~ and 46~~4.2.2~~, 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 ~~profit or loss~~surplus or deficit provided that doing so results in more relevant information.

AG90.~~B4.1.28~~ The decision of an entity to designate a financial asset or financial liability as at fair value through ~~profit or loss~~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~~14(b)~~ of PBE IPSAS 3~~IAS 8~~ requires the chosen policy to result in the financial statements providing faithfully representative ~~reliable~~ 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 ~~profit or loss~~surplus or deficit, paragraph 46~~4.2.2~~ 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~~4.2.2~~, 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.~~B4.1.29~~ Measurement of a financial asset or financial liability and classification of recognised 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 ~~profit or loss~~surplus or deficit, a financial asset would be classified as subsequently measured at fair value through ~~profit or loss~~surplus or deficit and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). 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 ~~profit or loss~~surplus or deficit.

AG92.~~B4.1.30~~ 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 ~~profit or loss~~surplus or deficit only if it meets the principle in paragraph 44~~4.1.5~~ or 46~~4.2.2~~(a):

(a) An entity has contracts within the scope of [proposed] PBE IFRS 17 (the measurement of which incorporates current information) and financial assets that it considers to be related and that would otherwise be measured at either fair value through other comprehensive ~~income~~revenue and expense or amortised 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 ~~profit or loss~~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 129~~6.4.1~~ 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 ~~profit or loss~~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 ~~profit or loss~~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 amortised cost and recognising a gain or loss each time a bond is repurchased.

AG93.~~B4.1.31~~ 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 ~~profit or loss~~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 ~~profit or loss~~surplus or deficit at its initial recognition and, at that time, any remaining transactions are expected to occur.

AG94.~~B4.1.32~~ 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 ~~profit or loss~~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 ~~profit or loss~~surplus or deficit. However, because designation as at fair value through ~~profit or loss~~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.~~B4.1.33~~ 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 ~~profit or loss~~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.~~B4.1.34~~ For example, an entity may use this condition to designate financial liabilities as at fair value through ~~profit or loss~~surplus or deficit if it meets the principle in paragraph 46~~4.2.2~~(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.~~B4.1.35~~ 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 ~~profit or loss~~surplus or deficit on the basis of this condition shall so designate all eligible financial liabilities that are managed and evaluated together.

AG98.~~B4.1.36~~ Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 46~~4.2.2~~(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~~4.2.2~~(b).

Embedded Derivatives ~~(Section 4.3)~~

AG99.~~B4.3.1~~ 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~~4.3.3~~ 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 ~~profit or loss~~surplus or deficit.

AG100.~~B4.3.2~~ 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.~~B4.3.3~~ 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.~~B4.3.4~~ 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 PBE IPSAS 28~~IAS 32 *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.~~B4.3.5~~ The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 49~~4.3.3~~(a)) in the following examples. In these examples, assuming the conditions in paragraph 49~~4.3.3~~(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 amortised 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 PBE IPSAS 28~~IAS 32~~.

(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.~~B4.3.6~~ 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 ~~profit or loss~~surplus or deficit, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 49~~4.3.3~~ because the host contract is a debt instrument under paragraph AG100~~B4.3.2~~ and the indexed principal payment is not closely related to a host debt instrument under paragraph AG103~~B4.3.5~~(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.~~B4.3.7~~ 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.~~B4.3.8~~ 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 recognised 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 PBE IPSAS 4~~IAS 21~~ *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in ~~profit or loss~~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.~~B4.3.9~~ As noted in paragraph AG99~~B4.3.1~~, 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~~4.3.3~~ 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 ~~profit or loss~~surplus or deficit. For that reason this Standard permits the entire hybrid contract to be designated as at fair value through ~~profit or loss~~surplus or deficit.

AG108.~~B4.3.10~~ Such designation may be used whether paragraph 49~~4.3.3~~ requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 51~~4.3.5~~ would not justify designating the hybrid contract as at fair value through ~~profit or loss~~surplus or deficit in the cases set out in paragraph 51~~4.3.5~~(a) and 51(b) because doing so would not reduce complexity or increase reliability.

Reassessment of Embedded Derivatives

AG109.~~B4.3.11~~ In accordance with paragraph 49~~4.3.3~~, 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.~~B4.3.12~~ Paragraph AG109~~B4.3.11~~ does not apply to embedded derivatives in contracts acquired in:

(a) A business combination (as defined in PBE IFRS 3 *Business Combinations*);

(b) A combination of entities or businesses under common control as described in paragraphs B1–B4 of PBE IFRS 3; or

(c) The formation of a joint venture as defined in PBE IPSAS 37 ~~IFRS 11~~ *Joint Arrangements*

or their possible reassessment at the date of acquisition.[9]

~~Reclassification of financial assets (Section 4.4)~~

Reclassification of Financial Assets

AG111.~~B4.4.1~~ Paragraph 54~~4.4.1~~ requires an entity to reclassify financial assets if the entity changes its management~~business~~ 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~~business~~ 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~~business~~ 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 to the long collection cycle of these loans. The entity enters into a long-term contract with a third-party collection service provider. The loan portfolios are no longer for sale, as they are held to collect the contractual cash flows with the aid of the collections service provider.

(b) A department of government decides to end its support for its national auto manufacturing industry by no longer providing favourable loans. That department no longer issues new loans and the department is actively marketing its loan portfolio for sale.

~~(a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.~~

~~(b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.~~

[9] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph AG110 would be revised.

AG112.~~B4.4.2~~ A change in the objective of the entity's management~~business~~ model must be effected before the reclassification date. For example, if a mortgage and housing corporation~~financial services firm~~ decides on ~~15~~ February 15 to shut down its retail mortgage business and hence must reclassify all affected financial assets on ~~1~~ April 1 (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~~business~~ model after ~~15~~ February 15.

AG113.~~B4.4.3~~ The following are not changes in ~~business~~ 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~~business~~ models.

Note: The order of material in the measurement section of PBE IFRS 9 differs from that in PBE IPSAS 41. The relevant headings and subheadings in PBE IFRS 9 and PBE IPSAS 41 are as follows.

PBE IFRS 9	**PBE IPSAS 41**
Measurement (Chapter 5)	**Measurement**
Initial Measurement (Section 5.1)	Non-Exchange Revenue Transactions
Non-Exchange Revenue Transactions	**Initial Measurement**
Initial Measurement of Financial Assets and Financial Liabilities	Initial Measurement of Financial Assets and Financial Liabilities (Paragraphs 57–59)
Concessionary Loans	Concessionary Loans
Valuing Financial Guarantees Issued Through a Non-Exchange Transaction	Equity Instruments Arising from Non-Exchange Transactions
Fair Value Measurement Considerations (Section 5.1A)	Valuing Financial Guarantees Issued Through a Non-Exchange Transaction
Active Market: Quoted Price	Subsequent Measurement
No Active Market: Valuation Technique	Investments in Equity Instruments and Contracts on Those Investments
Inputs to Valuation Techniques	Fair Value Measurement Considerations
Subsequent Measurement (Sections 5.2 and 5.3)	Active Market: Quoted Price
Investments in Equity Instruments and Contracts on Those Investments	No Active Market: Valuation Technique
…	Inputs to Valuation Techniques
	…

Measurement ~~(Chapter 5)~~

Non-Exchange Revenue Transactions

AG114. The initial recognition and measurement of assets and liabilities resulting from non-exchange revenue transactions is dealt with in PBE IPSAS 23. Assets resulting from non-exchange revenue transactions can arise out of both contractual and non-contractual arrangements (see PBE 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 recognised in accordance with PBE IPSAS 23;

(b) Initially measured:

(i) At fair value using the principles in PBE 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 ~~(Section 5.1)~~

Initial Measurement of Financial Assets and Financial Liabilities (Paragraphs 57–59)

AG115.~~B5.1.1~~ 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~~B5.1.2A and IFRS 13~~). However, if part of the consideration given or received is for something other than the financial instrument, ~~an entity shall measure~~ the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG149–AG154). 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~~income~~ unless it qualifies for recognition as some other type of asset.

AG116.~~B5.1.2~~ If an entity originates a loan that bears an off-market interest rate (e.g., 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, i.e., net of the fee it receives.

> Note: In PBE IFRS 9 the best evidence of the fair value of a financial instrument at initial recognition was discussed in paragraphs B5.1A.8 and B5.1A.9, which were based on PBE IPSAS 29 paragraph AG108, and reflected pre-IFRS 13 guidance.

AG117.~~B5.1.2A~~ The best evidence of 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 IFRS 13)~~. If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 58~~5.1.1A~~, the entity shall account for that instrument at that date as follows:

(a) At the measurement required by paragraph 57~~5.1.1~~ 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 recognise 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 57~~5.1.1~~, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise 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.

The requirements of this paragraph do not apply to concessionary loans or equity instruments arising from non-exchange transactions as outlined in paragraphs AG118 to AG130.

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 that commonly have below market terms 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 PBE IPSAS 41 (see paragraphs 12–34).

AG121. Concessionary loans also share many characteristics with originated credit-impaired loans. Whether a loan is classified as concessionary or originated credit-impaired determines whether the difference between the transaction price and the fair value of the loan is recognised as a concession or as a credit loss in the statement of comprehensive revenue and expense.

AG122. Whether a loan is concessionary or originated credit-impaired depends on its substance. An intention to incorporate a non-exchange component into the transaction, such as a transfer of resources, indicates the loan is concessionary. The non-exchange component is incorporated into the transaction by granting the loan at below market terms. By contrast, originated credit-impaired loans are loans where one or more events, that have a detrimental impact on the estimated future cash flows of the financial asset, have occurred.

AG123. 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 analyses the substance of the loan granted or received into its component parts, and accounts for those components using the principles in paragraphs AG124 and AG126 below.

AG124. An entity firstly assesses whether the substance of the concessionary loan is in fact a loan, a non-exchange transaction, a contribution from owners or a combination thereof, by applying the principles in PBE IPSAS 28 and paragraphs 42–58 of PBE 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 AG144–AG155. 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 paragraph AG115).

AG125. 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 PBE 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 PBE IPSAS 23 as well as paragraphs IE153 to IE161 accompanying this Standard.

Note: PBE IFRS 9 paragraph B5.1.2G contained requirements equivalent to paragraph AG126, but it did not contain the equivalent of paragraphs AG127–AG130.

AG126. After evaluating the substance of the concessionary loan and measuring the loan component 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 61–65.

AG127. In some circumstances a concessionary loan may be granted that is also originated credit-impaired. For example, a government may provide loans with concessionary terms on a recurring basis to a borrower that historically has not been able to repay in full. If the concessionary loan is credit-impaired, an entity measures the instrument at the fair value including the expected credit losses over the life of the instrument. An entity applies paragraph AG125(b) to account for the component parts and recognises the credit losses and concessionary element in its entirety as a concession.

Equity Instruments Arising from Non-Exchange Transactions

AG128. In the public sector, equity investment can be used as a way for an entity to provide financing or subsidised 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, subsidised housing, small business assistance...etc.)

AG129. At initial recognition of such transactions, an entity shall analyse the substance of the arrangement and assess whether the intention at the outset is the 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 PBE IPSAS 23. The entity providing the resources shall recognise the amount as an expense in surplus or deficit at initial recognition.

AG130. To the extent an equity instrument arises from the transaction, or component of the transaction, that is within the scope of this Standard, it is to be recognised initially at fair value in accordance with paragraph 57. The equity instrument is to be measured subsequently in accordance with paragraphs 61–63. If the instrument does not have an active market, the entity shall consider valuation techniques and inputs in paragraphs AG149–AG155) in determining its fair value.

Valuing Financial Guarantees Issued Through a Non-Exchange Transaction

AG131. Only contractual financial guarantees (or guarantees that are in substance, contractual) are within the scope of this Standard (See paragraphs AG3 and AG4 of PBE 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.

AG132. 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 recognised at fair value. Paragraphs 66–68 of this Standard provide commentary and guidance on determining fair value and this is complemented by Application Guidance in paragraphs AG144–AG155. Subsequent measurement for financial guarantee contracts is at the higher of the amount of the loss allowance determined in accordance with paragraphs 73–93 and the amount initially recognised less, when appropriate, cumulative amortisation in accordance with PBE IPSAS 9 *Revenue from Exchange Transactions*.

AG133. 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 recognise 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 73–93 and the amount initially recognised, less, when appropriate, cumulative amortisation recognised in accordance with PBE 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.

AG134. 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 fulfilment 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.

AG135. 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, Central 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 recognises the financial guarantee at that fair value in the statement of financial position and recognises an expense of an equivalent amount in the statement of comprehensive revenue and expense. 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.

AG136. 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 measure the financial guarantee contract at the amount of the loss allowance determined in accordance with paragraphs 73 to 93.

Subsequent Measurement ~~(Sections 5.2 and 5.3)~~

AG137.~~B5.2.1~~ If a financial instrument that was previously recognised as a financial asset is measured at fair value through ~~profit or loss~~surplus or deficit and its fair value decreases below zero, it is a financial liability measured in accordance with paragraph 45~~4.2.1~~. However, hybrid contracts with hosts that are assets within the scope of this Standard are always measured in accordance with paragraph 48~~4.3.2~~.

AG138.~~B5.2.2~~ 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 other comprehensive ~~income~~revenue and expense in accordance with either paragraph 106~~5.7.5~~ or 41~~4.1.2A~~. An entity acquires a financial asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises 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 recognises a loss of CU2 in other comprehensive ~~income~~revenue and expense. If the financial asset is measured at fair value through other comprehensive ~~income~~revenue and expense in accordance with paragraph 41~~4.1.2A~~, the transaction costs are amortised to ~~profit or loss~~surplus or deficit using the effective interest method.

AG139.~~B5.2.2A~~ The subsequent measurement of a financial asset or financial liability and the subsequent recognition of gains and losses described in paragraph AG117~~B5.1.2A~~ shall be consistent with the requirements of this Standard.

Investments in Equity Instruments and Contracts on Those Investments

AG140.~~B5.2.3~~ 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.

AG141.~~B5.2.4~~ 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 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 equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

AG142.~~B5.2.5~~ The list in paragraph AG141~~B5.2.4~~ 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.

AG143.~~B5.2.6~~ Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Note: PBE IFRS 9 paragraphs B5.1A.1 and B5.1A.2 addressed the same issues as paragraphs AG144 and AG145 below.

Fair Value Measurement Considerations

AG144. 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.

AG145. 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.'

Note: PBE IFRS 9 paragraphs B5.1A.3 to B5.1A.5 addressed the same issues as paragraphs AG146 to AG148 below.

Active Market: Quoted Price

AG146. 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.

AG147. 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.

AG148. 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.

Note: PBE IFRS 9 paragraphs B5.1A.6 to B5.1A.12 addressed the same issues as paragraphs AG149 to AG154. Paragraph B5.1A.8 also included guidance on the best evidence of the fair value of a financial instrument at initial recognition. This matter is addressed in PBE IPSAS 41 paragraph AG117. PBE IFRS 9 paragraph B5.1A.12 included the statement "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." This option is now located in paragraph 60 of PBE IPSAS 41.

No Active Market: Valuation Technique

AG149. 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.

AG150. 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.

AG151. 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.

AG152. 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.

AG153. 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.

AG154. 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.

Note: PBE IFRS 9 paragraph B5.1A.13 addressed the same issues as paragraph AG155 below.

Inputs to Valuation Techniques

AG155. 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 68).

(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.

Amortised Cost Measurement ~~(Section 5.4)~~

Effective Interest Method

Note: Paragraphs AG156 to AG158 are based on IFRS 9 paragraphs B5.4.1 to B5.4.3. PBE IFRS 9 did not include these paragraphs. See Appendix D: Amendments to PBE IPSAS 9 for details of the proposed amendments to PBE IPSAS 9 which contains similar guidance.

AG156.~~B5.4.1~~ 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 recognised in ~~profit or loss~~surplus or deficit. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

AG157.~~B5.4.2~~ 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~~4.2.1~~(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 recognised as revenue on expiry.

(c) Origination fees paid on issuing financial liabilities measured at amortised 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.

AG158.~~B5.4.3~~ Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with PBE IPSAS 9~~IFRS 15~~ 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~~4.2.1~~(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).

AG159.~~B5.4.4~~ When applying the effective interest method, an entity generally amortises 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 amortisation 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 amortised 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 amortised over the expected life of the financial instrument.

AG160.~~B5.4.5~~ 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 recognised 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.

AG161.~~B5.4.6~~ If an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 71~~5.4.3~~ and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortised 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 amortised 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 139~~6.5.10~~. The adjustment is recognised in ~~profit or loss~~surplus or deficit as revenue~~income~~ or expense.

AG162.~~B5.4.7~~ 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

AG163.~~B5.4.8~~ 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

AG164.~~B5.4.9~~ 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 per cent 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 per cent of the financial asset.

Impairment ~~**(Section 5.5)**~~

Collective and Individual Assessment Basis

AG165~~B5.5.1~~ In order to meet the objective of recognising 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 recognising 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.

AG166.~~B5.5.2~~ Lifetime expected credit losses are generally expected to be recognised 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.

AG167.~~B5.5.3~~ 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 student~~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~~customer~~ 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.

AG168.~~B5.5.4~~ 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 recognised 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 recognising lifetime expected credit losses when there has been a significant increase in credit risk since initial recognition on an individual instrument level.

AG169.~~B5.5.5~~ For the purpose of determining significant increases in credit risk and recognising 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).

AG170.~~B5.5.6~~ Paragraph 76~~5.5.4~~ requires that lifetime expected credit losses are recognised 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 recognise 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 Recognising Lifetime Expected Credit Losses

AG171.~~B5.5.7~~ The assessment of whether lifetime expected credit losses should be recognised 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.

AG172.~~B5.5.8~~ 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.

AG173.~~B5.5.9~~ 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.

AG174.~~B5.5.10~~ 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.

AG175.~~B5.5.11~~ 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.

AG176.~~B5.5.12~~ 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.

AG177.~~B5.5.13~~ 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 81~~5.5.9~~, 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.

AG178.~~B5.5.14~~ 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 recognised. 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

AG179.~~B5.5.15~~ 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 90~~5.5.17~~(c). An entity need not undertake an exhaustive search for information when determining whether credit risk has increased significantly since initial recognition.

AG180.~~B5.5.16~~ 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 75~~5.5.3~~ for the recognition of lifetime expected credit losses has been met.

AG181.~~B5.5.17~~ 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~~income~~ 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 amortised 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 behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural 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~~business~~ or organisational structure (such as the discontinuance of a segment of the entity~~business~~) 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 ~~shareholder~~ (or an individual's guarantors~~parents~~) if the entity's owners~~shareholder~~ (or guarantors~~parents~~) 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~~parent~~ 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 securitisations, 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 behaviour of the borrower, including changes in the payment status of borrowers in the economic entity~~group~~ (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 83~~5.5.11~~.

AG182.~~B5.5.18~~ 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

AG183.~~B5.5.19~~ The rebuttable presumption in paragraph 83~~5.5.11~~ is not an absolute indicator that lifetime expected credit losses should be recognised, but is presumed to be the latest point at which lifetime expected credit losses should be recognised even when using forward-looking information (including macroeconomic factors on a portfolio level).

AG184.~~B5.5.20~~ 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.

AG185.~~B5.5.21~~ 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

AG186.~~B5.5.22~~ The credit risk on a financial instrument is considered low for the purposes of paragraph 82~~5.5.10~~, 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.

AG187.~~B5.5.23~~ 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.

AG188.~~B5.5.24~~ Lifetime expected credit losses are not recognised 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 recognised in accordance with paragraph 75~~5.5.3~~.

Modifications

AG189.~~B5.5.25~~ 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.

AG190.~~B5.5.26~~ 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 75~~5.5.3~~ 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 recognised 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.

AG191.~~B5.5.27~~ If the contractual cash flows on a financial asset have been renegotiated or otherwise modified, but the financial asset is not derecognised, 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~~customer~~ would need to demonstrate consistently good payment behaviour 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

AG192.~~B5.5.28~~ 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.

AG193.~~B5.5.29~~ 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.

AG194.~~B5.5.30~~ 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.

AG195.~~B5.5.31~~ 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.

AG196.~~B5.5.32~~ 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.

AG197.~~B5.5.33~~ 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 recognised in ~~profit or loss~~surplus or deficit as an impairment gain or loss.

AG198.~~B5.5.34~~ 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 PBE IPSAS 13~~IFRS 16~~ *Leases*.

AG199.~~B5.5.35~~ An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 90~~5.5.17~~. An example of a practical expedient is the calculation of the expected credit losses on ~~trade~~ receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs AG215–AG216~~B5.5.51–B5.5.52~~) for ~~trade~~ 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 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent 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~~wholesale or retail~~).

Definition of Default

AG200.~~B5.5.36~~ Paragraph 81~~5.5.9~~ 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.

AG201.~~B5.5.37~~ 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

AG202.~~B5.5.38~~ In accordance with paragraph 92~~5.5.19~~, 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.

AG203.~~B5.5.39~~ However, in accordance with paragraph 93~~5.5.20~~, 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~~credit cards and overdraft facilities~~, 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.

AG204.~~B5.5.40~~ 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

AG205.~~B5.5.41~~ 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.

AG206.~~B5.5.42~~ Paragraph 90~~5.5.17~~(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 91~~5.5.18~~.

AG207.~~B5.5.43~~ 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

AG208.~~B5.5.44~~ 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 AG160~~B5.4.5~~.

AG209.~~B5.5.45~~ 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.

AG210.~~B5.5.46~~ 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 PBE IPSAS 13~~IFRS 16~~.

AG211.~~B5.5.47~~ 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 recognising the financial asset resulting from the loan commitment. This is because for the purpose of applying the impairment requirements, a financial asset that is recognised 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.

AG212.~~B5.5.48~~ 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

AG213.~~B5.5.49~~ 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.

AG214.~~B5.5.50~~ An entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument. The degree of judgement 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 judgement 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.

AG215.~~B5.5.51~~ 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).

AG216.~~B5.5.52~~ 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.

AG217.~~B5.5.53~~ 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.

AG218.~~B5.5.54~~ 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

AG219.~~B5.5.55~~ 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 recognised separately by the entity. The estimate of expected cash shortfalls on a collateralised 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 realisation 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 recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset in this or other Standards.

Reclassification of Financial Assets ~~(Section 5.6)~~

AG220.~~B5.6.1~~ If an entity reclassifies financial assets in accordance with paragraph 54~~4.4.1~~, paragraph 94~~5.6.1~~ requires that the reclassification is applied prospectively from the reclassification date. Both the amortised cost measurement category and the fair value through other comprehensive ~~income~~revenue and expense 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 amortised cost measurement category and the fair value through other comprehensive ~~income~~revenue and expense 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 other comprehensive ~~income~~revenue and expense measurement category and into the amortised cost measurement category, a loss allowance would be recognised 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 amortised cost measurement category and into the fair value through other comprehensive ~~income~~revenue and expense measurement category, the loss allowance would be derecognised (and thus would no longer be recognised as an adjustment to the gross carrying amount) but instead would be recognised as an accumulated impairment amount (of an equal amount) in other comprehensive ~~income~~revenue and expense and would be disclosed from the reclassification date.

AG221.~~B5.6.2~~ However, an entity is not required to separately recognise interest revenue or impairment gains or losses for a financial asset measured at fair value through ~~profit or loss~~surplus or deficit. Consequently, when an entity reclassifies a financial asset out of the fair value through ~~profit or loss~~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 73–93~~Section 5.5~~ to the financial asset from the reclassification date, the date of the reclassification is treated as the date of initial recognition.

Gains and Losses ~~(Section 5.7)~~

AG222.~~B5.7.1~~ Paragraph 106~~5.7.5~~ permits an entity to make an irrevocable election to present in other comprehensive ~~income~~revenue and expense 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 other comprehensive ~~income~~revenue and expense shall not be subsequently transferred to ~~profit or loss~~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 recognised in ~~profit or loss~~surplus or deficit in accordance with paragraph 107~~5.7.6~~ unless the dividend clearly represents a recovery of part of the cost of the investment.

AG223.~~B5.7.1A~~ Unless paragraph 44~~4.1.5~~ applies, paragraph 41~~4.1.2A~~ requires that a financial asset is measured at fair value through other comprehensive ~~income~~revenue and expense 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~~business~~ model whose objective is achieved by both collecting contractual cash flows and selling financial assets. This measurement category recognises information in ~~profit or loss~~surplus or deficit as if the financial asset is measured at amortised cost, while the financial asset is measured in the statement of financial position at fair value. Gains or losses, other than those that are recognised in ~~profit or loss~~surplus or deficit in accordance with paragraphs 111–112~~5.7.10–5.7.11~~, are recognised in other comprehensive ~~income~~revenue and expense. When these financial assets are derecognised, cumulative gains or losses previously recognised in other comprehensive ~~income~~revenue and expense are reclassified to ~~profit or loss~~surplus or deficit. This reflects the gain or loss that would have been recognised in ~~profit or loss~~surplus or deficit upon derecognition if the financial asset had been measured at amortised cost.

AG224.~~B5.7.2~~ An entity applies PBE IPSAS 4~~IAS 21~~ to financial assets and financial liabilities that are monetary items in accordance with PBE IPSAS 4~~IAS 21~~ and denominated in a foreign currency. PBE IPSAS 4~~IAS 21~~ requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in ~~profit or loss~~surplus or deficit. An exception is a monetary item that is designated as a hedging instrument in a cash flow hedge (see paragraph 140~~6.5.11~~), a hedge of a net investment (see paragraph 142~~6.5.13~~) or a fair value hedge of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~ (see paragraph 137~~6.5.8~~).

AG225.~~B5.7.2A~~ For the purpose of recognising foreign exchange gains and losses under PBE IPSAS 4~~IAS 21~~, a financial asset measured at fair value through other comprehensive ~~income~~revenue and expense in accordance with paragraph 41~~4.1.2A~~ is treated as a monetary item. Accordingly, such a financial asset is treated as an asset measured at amortised cost in the foreign currency. Exchange differences on the amortised cost are recognised in ~~profit or loss~~surplus or deficit and other changes in the carrying amount are recognised in accordance with paragraph 111~~5.7.10~~.

AG226.~~B5.7.3~~ Paragraph 106~~5.7.5~~ permits an entity to make an irrevocable election to present in other comprehensive ~~income~~revenue and expense 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 other comprehensive ~~income~~revenue and expense in accordance with paragraph 106~~5.7.5~~ includes any related foreign exchange component.

AG227.~~B5.7.4~~ 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 ~~profit or loss~~surplus or deficit.

Liabilities Designated as at Fair Value Through ~~Profit Or Loss~~Surplus or Deficit

AG228.~~B5.7.5~~ When an entity designates a financial liability as at fair value through ~~profit or loss~~surplus or deficit, it must determine whether presenting in other comprehensive ~~income~~revenue and expense the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in ~~profit or loss~~surplus or deficit. An accounting mismatch would be created or enlarged if presenting the effects of changes in the liability's credit risk in other comprehensive ~~income~~revenue and expense would result in a greater mismatch in ~~profit or loss~~surplus or deficit than if those amounts were presented in ~~profit or loss~~surplus or deficit.

AG229.~~B5.7.6~~ 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 ~~profit or loss~~surplus or deficit by a change in the fair value of another financial instrument measured at fair value through ~~profit or loss~~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.

AG230.~~B5.7.7~~ 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 other comprehensive ~~income~~revenue and expense the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in ~~profit or loss~~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 ~~profit or loss~~surplus or deficit and the characteristics of the other financial instruments. PBE IPSAS 30~~IFRS 7~~ *Financial Instruments: Disclosures* requires an entity to provide qualitative disclosures in the notes to the financial statements about its methodology for making that determination.

AG231.~~B5.7.8~~ 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 ~~profit or loss~~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 other comprehensive ~~income~~revenue and expense.

AG232.~~B5.7.9~~ Amounts presented in other comprehensive ~~income~~revenue and expense shall not be subsequently transferred to ~~profit or loss~~surplus or deficit. However, the entity may transfer the cumulative gain or loss within net assets/equity.

AG233.~~B5.7.10~~ The following example describes a situation in which an accounting mismatch would be created in ~~profit or loss~~surplus or deficit if the effects of changes in the credit risk of the liability were presented in other comprehensive ~~income~~revenue and expense. A Mortgage and Housing Corporation~~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 and Housing Corporation~~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 and Housing Corporation's~~mortgage bank's~~ liability decreases), the fair value of the Mortgage and Housing Corporation's~~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 and Housing Corporation~~mortgage bank~~. Consequently, the effects of changes in the credit risk of the liability (the bond) will be offset in ~~profit or loss~~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 other comprehensive ~~income~~revenue and expense there would be an accounting mismatch in ~~profit or loss~~surplus or deficit. Consequently, the Mortgage and Housing Corporation~~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 ~~profit or loss~~surplus or deficit.

AG234.~~B5.7.11~~ In the example in paragraph AG233~~B5.7.10~~, 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 and Housing Corporation~~mortgage bank~~). However, an accounting mismatch may also occur in the absence of a contractual linkage.

AG235.~~B5.7.12~~ For the purposes of applying the requirements in paragraphs 108~~5.7.7~~ and 109~~5.7.8~~, 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 ~~profit or loss~~surplus or deficit would arise only when the effects of changes in the liability's credit risk (as defined in PBE IPSAS 30~~IFRS 7~~) 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 109~~5.7.7~~ and 109~~5.7.8~~. 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 other comprehensive ~~income~~revenue and expense, 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 ~~profit or loss~~surplus or deficit. However, such a mismatch is caused by measurement imprecision, not the offsetting relationship described in paragraph AG229~~B5.7.6~~ and, therefore, does not affect the determination required by paragraphs 108~~5.7.7~~ and 109~~5.7.8~~.

The Meaning of 'Credit Risk' (paragraphs 108~~5.7.7~~ and 109~~5.7.8~~)

AG236.~~B5.7.13~~ PBE IPSAS 30~~IFRS 7~~ 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 108~~5.7.7~~(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 collateralised liability and a non-collateralised 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 collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero.

AG237.~~B5.7.14~~ For the purposes of applying the requirement in paragraph 108~~5.7.7~~(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).

AG238.~~B5.7.15~~ 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

AG239.~~B5.7.16~~ For the purposes of applying the requirement in paragraph 108~~5.7.7~~(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 AG240~~B5.7.17~~ and AG241~~B5.7.18~~); 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.

AG240.~~B5.7.17~~ 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.

AG241.~~B5.7.18~~ If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount in paragraph AG239~~B5.7.16~~(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 other comprehensive ~~income~~revenue and expense in accordance with paragraph 108~~5.7.7~~(a).

AG242.~~B5.7.19~~ The example in paragraph AG241~~B5.7.18~~ 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 AG239~~B5.7.16~~(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 other comprehensive ~~income~~revenue and expense in accordance with paragraph 108~~5.7.7~~(a).

AG243.~~B5.7.20~~ 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~~(Chapter 6)~~

Hedging Instruments~~ (Section 6.2)~~

Qualifying Instruments

AG244.~~B6.2.1~~ Derivatives that are embedded in hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments.

AG245.~~B6.2.2~~ An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

AG246.~~B6.2.3~~ For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with PBE IPSAS 4~~IAS 21~~.

Written Options

AG247.~~B6.2.4~~ This Standard does not restrict the circumstances in which a derivative that is measured at fair value through ~~profit or loss~~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

AG248.~~B6.2.5~~ 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 ~~profit or loss~~surplus or deficit as a hedging instrument, it may only designate the non-derivative financial instrument in its entirety or a proportion of it.

AG249.~~B6.2.6~~ 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 ~~(Section 6.3)~~

Qualifying Items

AG250.~~B6.3.1~~ A firm commitment to acquire an operation~~business~~ in a business 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.

AG251.~~B6.3.2~~ An equity method investment cannot be a hedged item in a fair value hedge. This is because the equity method recognises in ~~profit or loss~~surplus or deficit the investor's share of the investee's ~~profit or loss~~surplus or deficit, instead of changes in the investment's fair value. For a similar reason, an investment in a consolidated controlled entity~~subsidiary~~ cannot be a hedged item in a fair value hedge. This is because consolidation recognises in ~~profit or loss~~surplus or deficit the controlled entity's~~subsidiary's~~ ~~profit or loss~~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.

AG252.~~B6.3.3~~ Paragraph 125~~6.3.4~~ 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~~coffee~~ purchases in 15 months' time against price risk (based on US dollars) using a 15-month futures contract for oil~~coffee~~. The highly probable oil~~coffee~~ purchases and the futures contract for oil~~coffee~~ 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.

AG253.~~B6.3.4~~ 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 recognised 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.

AG254.~~B6.3.5~~ Paragraph 127~~6.3.6~~ states that in consolidated financial statements the foreign currency risk of a highly probable forecast ~~intragroup~~ 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 ~~profit or loss~~surplus or deficit. For this purpose an entity can be a controlling entity~~parent~~, controlled entity~~subsidiary~~, associate, joint arrangement or branch. If the foreign currency risk of a forecast ~~intragroup~~ transaction within the economic entity does not affect consolidated ~~profit or loss~~surplus or deficit, the ~~intragroup~~ 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~~group~~, unless there is a related external transaction. However, when the foreign currency risk of a forecast ~~intragroup~~ transaction within an economic entity will affect consolidated ~~profit or loss~~surplus or deficit, the ~~intragroup~~ 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 ~~group~~ if there is an onward sale of the inventory to a party external to the economic entity~~group~~. Similarly, a forecast ~~intragroup~~ sale of plant and equipment within the economic entity from the ~~group~~ entity that manufactured it to an ~~group~~ entity that will use the plant and equipment in its operations may affect consolidated ~~profit or loss~~surplus or deficit. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast ~~intragroup~~ transaction within the economic entity is denominated in a currency other than the functional currency of the purchasing entity.

AG255.~~B6.3.6~~ If a hedge of a forecast ~~intragroup~~ transaction within an economic entity qualifies for hedge accounting, any gain or loss is recognised in, and taken out of, other comprehensive ~~income~~revenue and expense in accordance with paragraph 140~~6.5.11~~. The relevant period or periods during which the foreign currency risk of the hedged transaction affects ~~profit or loss~~surplus or deficit is when it affects consolidated ~~profit or loss~~surplus or deficit.

Designation of Hedged Items

AG256.~~B6.3.7~~ 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

AG257.~~B6.3.8~~ 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.

AG258.~~B6.3.9~~ 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.

AG259.~~B6.3.10~~ 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 coffee 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 coffee price risk:

(i) Exchange-traded coffee futures contracts; and

(ii) Coffee supply contracts for Arabica coffee from Colombia delivered to a specific manufacturing site. These contracts price a tonne of coffee based on the exchange-traded coffee futures contract price plus a fixed price differential plus a variable logistics services charge using a pricing formula. The coffee supply contract is an executory contract in accordance with which Entity B takes actual delivery of coffee.

For deliveries that relate to the current harvest, entering into the coffee supply contracts allows Entity B to fix the price differential between the actual coffee quality purchased (Arabica coffee from Colombia) and the benchmark quality that is the underlying of the exchange-traded futures contract. However, for deliveries that relate to the next harvest, the coffee supply contracts are not yet available, so the price differential cannot be fixed. Entity B uses exchange-traded coffee futures contracts to hedge the benchmark quality component of its coffee 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: coffee price risk reflecting the benchmark quality, coffee price risk reflecting the difference (spread) between the price for the benchmark quality coffee and the particular Arabica coffee from Colombia that it actually receives, and the variable logistics costs. For deliveries related to the current harvest, after Entity B enters into a coffee supply contract, the coffee price risk reflecting the benchmark quality is a contractually specified risk component because the pricing formula includes an indexation to the exchange-traded coffee 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 coffee supply contracts (i.e., those deliveries are forecast transactions). Hence, the coffee 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 coffee 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 coffee 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 coffee price risk that reflects the benchmark quality) for coffee 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 crude oil futures contract, which is for Brent crude oil;
- 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 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 standardised 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~~LIBOR~~) 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.

AG260.~~B6.3.11~~ 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 recognised.

AG261.~~B6.3.12~~ 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 ~~profit or loss~~surplus or deficit.

AG262.~~B6.3.13~~ 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.

AG263.~~B6.3.14~~ 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.

AG264.~~B6.3.15~~ A contractually specified inflation risk component of the cash flows of a recognised 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

AG265.~~B6.3.16~~ 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.

AG266.~~B6.3.17~~ An example of a component that is a proportion is 50 per cent of the contractual cash flows of a loan.

AG267.~~B6.3.18~~ 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;[10]

(b) A part of a physical volume, for example, the bottom layer, measuring 5 million cubic metres, 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).

AG268.~~B6.3.19~~ 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 recognised in ~~profit or loss~~surplus or deficit no later than when the item is derecognised. 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 AG267~~B6.3.18~~(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.

AG269.~~B6.3.20~~ 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

AG270.~~B6.3.21~~ 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~~LIBOR~~ or a benchmark commodity price).

AG271.~~B6.3.22~~ For example, in the case of a financial liability whose effective interest rate is below a market related interest rate~~LIBOR~~, an entity cannot designate:

(a) A component of the liability equal to interest at the market rate~~LIBOR~~ (plus the principal amount in case of a fair value hedge); and

(b) A negative residual component.

AG272.~~B6.3.23~~ However, in the case of a fixed-rate financial liability whose effective interest rate is (for example) 100 basis points below the market rate~~LIBOR~~, an entity can designate as the hedged item

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

the change in the value of that entire liability (i.e., principal plus interest at the market rate~~LIBOR~~ minus 100 basis points) that is attributable to changes in the market rate~~LIBOR~~. 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 per cent at a time when the market rate~~LIBOR~~ is 4 per cent. It begins to hedge that asset some time later when the market rate~~LIBOR~~ has increased to 8 per cent 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 market rate ~~LIBOR~~ 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 per cent. Because the market rate ~~LIBOR~~ is less than this effective yield, the entity can designate the market rate ~~a LIBOR~~ component of 8 per cent 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).

AG273.~~B6.3.24~~ If a variable-rate financial liability bears interest of (for example) three-month interbank offered rate~~LIBOR~~ 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 ~~LIBOR~~ minus 20 basis points—including the floor) that is attributable to changes in the interbank offered rate~~LIBOR~~. Hence, as long as the three-month interbank offered rate ~~LIBOR~~ 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 the three-month interbank offered rate ~~LIBOR~~ with a zero or positive spread. However, if the three-month interbank offered rate ~~LIBOR~~ 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 the three-month interbank offered rate ~~LIBOR~~ with a zero or positive spread.

AG274.~~B6.3.25~~ 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 ~~(Section 6.4)~~

Hedge Effectiveness

AG275.~~B6.4.1~~ 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.

AG276.~~B6.4.2~~ When designating a hedging relationship and on an ongoing basis, an entity shall analyse 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 AG314~~B6.5.21~~ arising from rebalancing a hedging relationship) is the basis for the entity's assessment of meeting the hedge effectiveness requirements.

AG277.~~B6.4.3~~ 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 135~~6.5.6~~ 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

AG278.~~B6.4.4~~ 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).

AG279.~~B6.4.5~~ 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.

AG280.~~B6.4.6~~ The assessment of whether an economic relationship exists includes an analysis of the possible behaviour 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

AG281.~~B6.4.7~~ 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.

AG282.~~B6.4.8~~ An example of credit risk dominating a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralised 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

AG283.~~B6.4.9~~ 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 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from 85 per cent of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 85 per cent. 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.

AG284.~~B6.4.10~~ 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 recognised 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.

AG285.~~B6.4.11~~ 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 recognising 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~~coffee~~ purchases with standard oil~~coffee~~ futures contracts that have a contract size of 1,000 barrels~~37,500 lbs (pounds)~~. The entity could only use either seven~~five~~ or eight~~six~~ contracts (equivalent to 980~~85.0~~ tonnes and 1,120~~102.1~~ 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 oil~~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

AG286.~~B6.4.12~~ 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

AG287.~~B6.4.13~~ 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.

AG288.~~B6.4.14~~ 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 AG278–AG280~~B6.4.4–B6.4.6~~).

AG289.~~B6.4.15~~ 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.

AG290.~~B6.4.16~~ 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 AG278–AG280~~B6.4.4–B6.4.6~~). 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 AG283–AG285~~B6.4.9–B6.4.11~~). An entity can use the same or different methods for those two different purposes.

AG291.~~B6.4.17~~ 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.

AG292.~~B6.4.18~~ 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.

AG293.~~B6.4.19~~ 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 AG291~~B6.4.17~~).

Accounting for Qualifying Hedging Relationships ~~(Section 6.5)~~

AG294.~~B6.5.1~~ 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.

AG295.~~B6.5.2~~ 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 ~~profit or loss~~surplus or deficit. An example of a cash flow hedge is the use of a swap to change floating rate debt (whether measured at amortised 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 ~~profit or loss~~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 ~~profit or loss~~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 other comprehensive ~~income~~revenue and expense also cannot be the hedged item in a cash flow hedge.

AG296.~~B6.5.3~~ A hedge of a firm commitment (for example, a hedge of the change in fuel price relating to an unrecognised 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 133~~6.5.4~~, 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

AG297.~~B6.5.4~~ 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.

AG298.~~B6.5.5~~ 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).

AG299.~~B6.5.6~~ 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

AG300.~~B6.5.7~~ 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.

AG301.~~B6.5.8~~ Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs AG302–AG314~~B6.5.9–B6.5.21~~. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised immediately before adjusting the hedging relationship.

AG302.~~B6.5.9~~ 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.

AG303.~~B6.5.10~~ 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.

AG304.~~B6.5.11~~ 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 analyses 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 recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. Hence, this evaluation requires judgement.

AG305.~~B6.5.12~~ 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 recognising hedge ineffectiveness but does not require rebalancing.

AG306.~~B6.5.13~~ 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 recognised 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 recognised immediately before adjusting the hedging relationship in accordance with paragraph AG301~~B6.5.8~~.

AG307.~~B6.5.14~~ 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).

AG308.~~B6.5.15~~ 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 AG321~~B6.5.28~~).

AG309.~~B6.5.16~~ 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 ~~profit or loss~~surplus or deficit (unless it was designated as a hedging instrument in a different hedging relationship).

AG310.~~B6.5.17~~ 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.

AG311.~~B6.5.18~~ 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 AG309~~B6.5.16~~ for the consequences for the derivative volume (i.e., the 10 tonnes) that is no longer a part of the hedging relationship).

AG312.~~B6.5.19~~ 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).

AG313.~~B6.5.20~~ 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 135–136~~6.5.6–6.5.7~~ and AG315–AG321~~B6.5.22–B6.5.28~~).

AG314.~~B6.5.21~~ 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 AG276~~B6.4.2~~). The documentation of the hedging relationship shall be updated accordingly.

Discontinuation of Hedge Accounting

AG315.~~B6.5.22~~ Discontinuation of hedge accounting applies prospectively from the date on which the qualifying criteria are no longer met.

AG316.~~B6.5.23~~ 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).

AG317.~~B6.5.24~~ 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 per cent and 40 per cent 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 per cent to 40 per cent 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 per cent 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 recognised in ~~profit or loss~~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 recognised, 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.

AG318.~~B6.5.25~~ 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).

AG319.~~B6.5.26~~ 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.

AG320.~~B6.5.27~~ 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 AG313~~B6.5.20~~); 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 124~~6.3.3~~) and hence whether they are eligible as hedged items.

AG321.~~B6.5.28~~ 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

AG322.~~B6.5.29~~ 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 ~~profit or loss~~surplus or deficit. Hence, an entity shall assess the type of hedged item (see paragraph 144~~6.5.15~~(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 ~~profit or loss~~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 recognised in ~~profit or loss~~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 ~~profit or loss~~surplus or deficit (i.e., amortised 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.

AG323.~~B6.5.30~~ The characteristics of the hedged item, including how and when the hedged item affects ~~profit or loss~~surplus or deficit, also affect the period over which the time value of an option that hedges a time-period related hedged item is amortised, which is consistent with the period over which the option's intrinsic value can affect ~~profit or loss~~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 amortised to ~~profit or loss~~surplus or deficit over the same period over which any intrinsic value of the cap would affect ~~profit or loss~~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 amortised 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 amortised during years two and three.

AG324.~~B6.5.31~~ The accounting for the time value of options in accordance with paragraph 144~~6.5.15~~ 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 recognise any changes in time value in other comprehensive ~~income~~revenue and expense, 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 ~~profit or loss~~surplus or deficit (see paragraph 144~~6.5.15~~(b)) would be nil.

(b) A time-period related hedged item, the amortisation expense related to the time value is nil.

AG325.~~B6.5.32~~ The accounting for the time value of options in accordance with paragraph 144~~6.5.15~~ 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 144~~6.5.15~~). An entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.

AG326.~~B6.5.33~~ 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 net assets/equity in accordance with paragraph 144~~6.5.15~~ 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 net assets/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 ~~profit or loss~~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 net assets/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 recognised in ~~profit or loss~~surplus or deficit.

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

AG327.~~B6.5.34~~ 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 ~~profit or loss~~surplus or deficit. Hence, an entity shall assess the type of hedged item (see paragraphs 144(a)~~6.5.16~~ and 145~~6.5.15(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 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 ~~profit or loss~~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 recognised in ~~profit or loss~~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 ~~profit or loss~~surplus or deficit (i.e., amortised 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.

AG328.~~B6.5.35~~ The characteristics of the hedged item, including how and when the hedged item affects ~~profit or loss~~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 amortised, 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 amortised during the period that spans months seven to nine.

AG329.~~B6.5.36~~ The accounting for the forward element of a forward contract in accordance with paragraph 145~~6.5.16~~ 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 recognise any fair value changes attributable to the forward element in other comprehensive ~~income~~revenue and expense, 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 ~~profit or loss~~surplus or deficit (see paragraphs 144~~6.5.15~~(b) and 145~~6.5.16~~) would be nil.

(b) A time-period related hedged item, the amortisation amount related to the forward element is nil.

AG330.~~B6.5.37~~ The accounting for the forward element of forward contracts in accordance with paragraph 145~~6.5.16~~ 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 145~~6.5.16~~). 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.

AG331.~~B6.5.38~~ 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 net assets/equity in accordance with paragraph 145~~6.5.16~~ 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 net assets/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 ~~profit or loss~~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 net assets/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 recognised in ~~profit or loss~~surplus or deficit.

AG332.~~B6.5.39~~ 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 119~~6.2.4~~(b)), the application guidance in paragraphs AG327–AG331~~B6.5.34–B6.5.38~~ 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 ~~(Section 6.6)~~

Hedge of a Net Position

Eligibility for Hedge Accounting and Designation of a Net Position

AG333.~~B6.6.1~~ 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 PBE IPSAS 20~~IAS 24~~.

AG334.~~B6.6.2~~ 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.

AG335.~~B6.6.3~~ 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 recognised in different reporting periods in the future. The nil net position would be eligible for hedge accounting only if the conditions in paragraph 151~~6.6.6~~ are met.

AG336.~~B6.6.4~~ 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

AG337.~~B6.6.5~~ When an entity determines whether the hedge effectiveness requirements of paragraph 129~~6.4.1~~(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 129~~6.4.1~~(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.

AG338.~~B6.6.6~~ Similarly, if in the example in paragraph AG337~~B6.6.5~~ 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 129~~6.4.1~~(c) are met.

Cash Flow Hedges that Constitute a Net Position

AG339.~~B6.6.7~~ 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 ~~profit or loss~~surplus or deficit and also specifies their nature and volume.

AG340.~~B6.6.8~~ 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 ~~profit or loss~~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 ~~profit or loss~~surplus or deficit in the first reporting period and the first FC30 from sales of Product B that are expected to affect ~~profit or loss~~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 ~~profit or loss~~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 ~~profit or loss~~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 ~~profit or loss~~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 ~~profit or loss~~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 ~~profit or loss~~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.

AG341.~~B6.6.9~~ For a cash flow hedge of a net position, the amounts determined in accordance with paragraph 140~~6.5.11~~ 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 recognised only once the transactions that they relate to are recognised, such as when a forecast sale is recognised 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 recognised in the cash flow hedge reserve in accordance with paragraph 140~~6.5.11~~(a)–140~~6.5.11~~(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 recognises only amounts related to the forward exchange contract until the highly probable forecast sales transactions are recognised in the financial statements, at which time the gains or losses on those forecast transactions are recognised (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).

AG342.~~B6.6.10~~ 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 recognised only once the related forecast transactions are recognised in the financial statements.

Layers of Groups of Items Designated as the Hedged Item

AG343.~~B6.6.11~~ For the same reasons noted in paragraph AG268~~B6.3.19~~, 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.

AG344.~~B6.6.12~~ 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

AG345.~~B6.6.13~~ If items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of ~~profit or loss and other~~ comprehensive ~~income~~revenue and expense. The presentation of hedging gains or losses in that statement depends on the group of items.

AG346.~~B6.6.14~~ 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 ~~profit or loss and other~~ comprehensive ~~income~~revenue and expense 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.

AG347.~~B6.6.15~~ 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 ~~profit or loss and other~~ comprehensive ~~income~~revenue and expense. 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 ~~profit or loss~~surplus or deficit (when the net position affects ~~profit or loss~~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 PBE IPSAS 4~~IAS 21~~. The related hedging gain or loss is presented in a separate line item, so that ~~profit or loss~~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 ~~profit or loss~~surplus or deficit in a later period, the hedging gain or loss previously recognised in the cash flow hedge reserve on the sales is reclassified to ~~profit or loss~~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 PBE IPSAS 4~~IAS 21~~.

AG348.~~B6.6.16~~ 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 ~~profit or loss~~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 ~~profit or loss and other~~ comprehensive ~~income~~revenue and expense. This is to avoid the grossing up of a single instrument's net gains or losses into offsetting gross amounts and recognising 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 ~~(Chapter 7)~~

Transition ~~(Section 7.2)~~

Financial Assets Held for Trading

AG349.~~B7.2.1~~ At the date of initial application of this Standard, an entity must determine whether the objective of the entity's management~~business~~ model for managing any of its financial assets meets the condition in paragraph 40~~4.1.2~~(a) or the condition in paragraph 41~~4.1.2A~~(a) or if a financial asset is eligible for the election in paragraph 106~~5.7.5~~. 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

AG350.~~B7.2.2~~ 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 178~~7.2.20~~ applies.

AG351.~~B7.2.3~~ In order to determine the loss allowance on financial instruments initially recognised (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 AG165~~B5.5.1~~–AG170~~B5.5.6~~.

AG352.~~B7.2.4~~ 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.

~~Definitions (Appendix A)~~

Definitions: See paragraphs AG7 to AG14.

~~Derivatives~~

~~BA.1 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 LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.~~

~~BA.2 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 2.5 (see paragraphs 2.4–2.7).~~

~~BA.3 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.~~

~~BA.4 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 recognised as a derivative financial instrument. Instead, this Standard provides for special accounting for such regular way contracts (see paragraphs 3.1.2 and B3.1.3–B3.1.6).~~

~~BA.5 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~~

~~BA.6 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.~~

~~BA.7 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 an intention 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.~~

~~BA.8 The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.~~

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

This Appendix is an integral part of PBE IPSAS 41.

Note: The text in this Appendix is marked-up from IFRIC 16. PBE IFRS 9 included Appendix C – Hedges of a net investment in a foreign operation

Introduction

B1.~~1~~ Many reporting entities have investments in foreign operations (as defined in PBE IPSAS 4~~IAS 21~~ *The Effects of Changes in Foreign Exchange Rates* paragraph 10~~8~~). Such foreign operations may be controlled entities~~subsidiaries~~, associates, joint ventures or branches. PBE IPSAS 4~~IAS 21~~ 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 recognise foreign exchange differences in other comprehensive revenue and expense~~income~~ until it disposes of the foreign operation.

B2.~~2~~ 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.~~[11]~~ This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint ventures are accounted for using the equity method and financial statements that include a branch or joint operations as defined in PBE IPSAS 37 *Joint Arrangements.* 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.~~3~~ PBE IPSAS 41~~IFRS 9~~ *Financial Instruments* 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 recognised in other comprehensive revenue and expense~~income~~ and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.

~~4 An entity with many foreign operations may be exposed to a number of foreign currency risks. This Interpretation provides guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation.~~

~~5 IFRS 9 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 Interpretation provides guidance on where, within a group, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting.~~

~~6 IAS 21 and IFRS 9 require cumulative amounts recognised in other comprehensive income 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 reclassified from equity to profit or loss as a reclassification adjustment when the parent disposes of the foreign operation. This Interpretation provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.~~

~~Scope~~

B4.~~7~~ This Appendix ~~Interpretation~~ 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 PBE IPSAS 41~~IFRS 9~~. It should not be applied by analogy to other types of hedge accounting. ~~For convenience~~ This Appendix ~~Interpretation~~ refers to such an entity as a controlling ~~parent~~ entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial

~~[11] This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint ventures are accounted for using the equity method and financial statements that include a branch or a joint operation as defined in IFRS 11 *Joint Arrangements.*~~

statements. All references to a controlling ~~parent~~ 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.

~~8 This Interpretation applies only to hedges of net investments in foreign operations; it should not be applied by analogy to other types of hedge accounting.~~

~~Issues~~

B5.~~9~~ ~~Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. The issues addressed in this Interpretation are~~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~~the nature of the hedged risk and the amount of the hedged item for which a hedging relationship may be designated~~:

(i) Whether the controlling~~parent~~ entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the controlling~~parent~~ 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~~parent~~ entity's consolidated financial statements and the functional currency of the foreign operation; and

(ii) If the controlling~~parent~~ 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 ~~parent~~ 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~~parent~~ entity (i.e., whether the fact that the net investment in the foreign operation is held through an intermediate controlling entity~~parent~~ affects the economic risk to the ultimate controlling entity~~parent~~).

(b) Where in an economic entity~~group~~ the hedging instrument can be held. It specifically addresses:

(i) PBE IPSAS 41 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~~group~~, regardless of its functional currency, can hold the hedging instrument.~~;~~

~~(ii) Whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.~~

(c) What amounts should be reclassified from net assets/equity to surplus or deficit~~profit or loss~~ as reclassification adjustments on disposal of the foreign operation:

(i) When a foreign operation that was hedged is disposed of, what amounts from the controlling~~parent~~ entity's foreign currency translation reserve in respect of the hedging instrument and ~~in respect~~ of that foreign operation should be reclassified from net assets/equity to surplus or deficit~~profit or loss~~ in the controlling~~parent~~ entity's consolidated financial statements; and

(ii) Whether the method of consolidation affects the determination of the amounts to be reclassified from net assets/equity to surplus or deficit~~profit or loss~~.

~~Consensus~~

Application of PBE IPSAS 41 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.~~10~~ Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the controlling~~parent~~ entity's functional currency.

B7.~~11~~ 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~~parent~~ 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~~parent~~ depends on whether any lower level controlling entity~~parent~~ 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 ~~parent~~entity's consolidated financial statements.

B8.~~12~~ 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~~parent~~ entity (the immediate, intermediate or ultimate controlling~~parent~~ entity) of that foreign operation. The fact that the net investment is held through an intermediate controlling entity~~parent~~ does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate controlling~~parent~~ entity.

B9.~~13~~ 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~~parent~~ entity within the economic entity~~group~~ (e.g.~~for example~~, both a direct and an indirect controlling~~parent~~ entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate controlling entity~~parent~~. A hedging relationship designated by one controlling~~parent~~ entity in its consolidated financial statements need not be maintained by another higher level controlling~~parent~~ entity. However, if it is not maintained by the higher level controlling~~parent~~ entity, the hedge accounting applied by the lower level controlling entity~~parent~~ must be reversed before the higher level controlling entity's~~parent's~~ hedge accounting is recognised.

Where the Hedging Instrument can be Held

B10.~~14~~ 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~~group~~, as long as the designation, documentation and effectiveness requirements of PBE IPSAS 41~~IFRS 9~~ paragraph 129~~6.4.1~~ that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the economic entity~~group~~ should be clearly documented because of the possibility of different designations at different levels of the economic entity~~group~~.

B11.~~15~~ 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 ~~parent~~ 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 recognised in surplus or deficit~~profit or loss~~, in other comprehensive revenue and expense~~income~~, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognised in surplus or deficit~~profit or loss~~ or in other comprehensive revenue and expense~~income~~. As part of the application of hedge accounting, the total effective portion of the change is included in other comprehensive revenue and expense~~income~~. 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.~~16~~ When a foreign operation that was hedged is disposed of, the amount reclassified to surplus or deficit~~profit or loss~~ as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the controlling entity~~parent~~ in respect of the hedging instrument is the amount that PBE IPSAS 41~~IFRS 9~~ paragraph 143~~6.5.14~~ 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.~~17~~ The amount reclassified to surplus or deficit~~profit or loss~~ from the foreign currency translation reserve in the consolidated financial statements of a controlling entity~~parent~~ in respect of the net investment in that foreign operation in accordance with PBE IPSAS 4~~IAS 21~~ paragraph 57~~48~~ is the amount included in that controlling entity's~~parent's~~ foreign currency translation reserve in respect of that foreign operation. In the ultimate controlling entity's~~parent's~~ consolidated financial statements, the aggregate net amount recognised 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~~parent~~ uses the direct or the step-by-step method of consolidation,~~[12]~~ 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 the reclassification to surplus or deficit~~profit or loss~~ of an amount different 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 PBE IPSAS 4~~IAS 21~~. However, it is an accounting policy choice that should be followed consistently for all net investments.

~~Transition~~

~~19 IAS 8 specifies how an entity applies a change in accounting policy resulting from the initial application of an Interpretation. An entity is not required to comply with those requirements when first applying the Interpretation. If an entity had designated a hedging instrument as a hedge of a net investment but the hedge does not meet the conditions for hedge accounting in this Interpretation, the entity shall apply IAS 39 to discontinue that hedge accounting prospectively.~~

~~Appendix~~
~~Application guidance~~

~~*This appendix is an integral part of the Interpretation.*~~

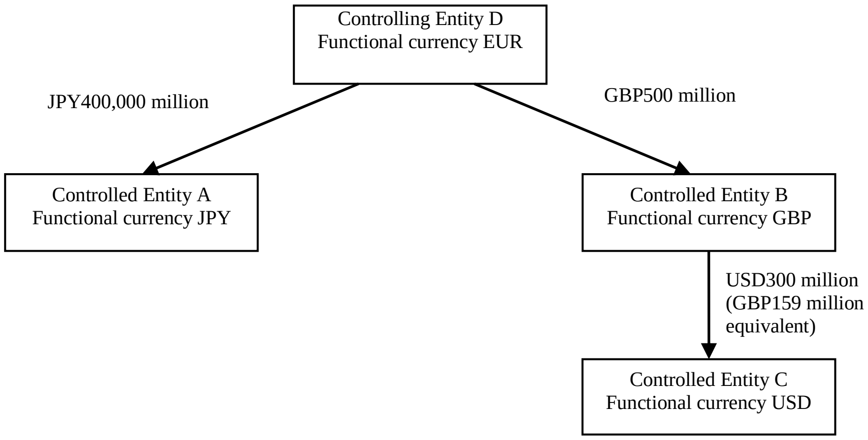
Example

B16.~~AG1~~ Th~~is~~e following example~~appendix~~ illustrates the application of the preceding paragraphs~~Interpretation~~ using the entity~~corporate~~ structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with PBE IPSAS 41~~IFRS 9~~, although this testing is not discussed~~ in this Appendix~~. Controlling Entity D~~Parent~~, being the ultimate controlling~~parent~~ entity, presents its consolidated financial statements in its functional currency of euro (EUR). Each of the controlled entities~~subsidiaries~~ i.e., Controlled Entity A, Controlled Entity B and Controlled Entity C, is wholly owned. Controlling Entity D's~~Parent's~~ £500 million net investment in ~~Subsidiary~~ Controlled Entity B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Controlled Entity~~Subsidiary~~ B's US$300 million net investment in Controlled Entity~~Subsidiary~~ C (functional currency US dollars (USD)). In other words, Controlled Entity ~~Subsidiary~~ B's net assets other than its investment in Controlled Entity~~Subsidiary~~ C are £341 million.

~~[12] 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 parent. 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 parent(s) and then translated into the functional currency of the ultimate parent (or the presentation currency if different).~~

Nature of Hedged Risk for which a Hedging Relationship may be Designated (paragraphs B6–B9 ~~10–13~~)

B17.~~AG2~~ Controlling Entity D~~Parent~~ can hedge its net investment in each of Controlled Entities~~Subsidiaries~~ 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, Controlling Entity D~~Parent~~ can hedge the USD/GBP foreign exchange risk between the functional currencies of Controlled Entity~~Subsidiary~~ B and Controlled Entity ~~Subsidiary~~ C. In its consolidated financial statements, Controlled Entity ~~Subsidiary~~ B can hedge its net investment in Controlled Entity ~~Subsidiary~~ 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~~Parent~~ could designate the forward foreign exchange risk.



Amount of Hedged Item for which a Hedging Relationship may be Designated (paragraphs B6–B9 ~~10–13~~)

B18.~~AG3~~ ~~Parent~~ Controlling Entity D wishes to hedge the foreign exchange risk from its net investment in ~~Subsidiary~~ Controlled Entity C. Assume that Controlled Entity~~Subsidiary~~ A has an external borrowing of US$300 million. The net assets of Controlled Entity ~~Subsidiary~~ A at the start of the reporting period are ¥400,000 million including the proceeds of the external borrowing of US$300 million.

B19.~~AG4~~ The hedged item can be an amount of net assets equal to or less than the carrying amount of ~~Parent~~Controlling Entity D's net investment in Controlled Entity~~Subsidiary~~ C (US$300 million) in its consolidated financial statements. In its consolidated financial statements ~~Parent~~Controlling Entity D can designate the US$300 million external borrowing in Controlled Entity~~Subsidiary~~ 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~~Subsidiary~~ C. In this case, both the EUR/USD foreign exchange difference on the US$300 million external borrowing in Controlled Entity~~Subsidiary~~ A and the EUR/USD foreign exchange difference on the US$300 million net investment in Controlled Entity~~Subsidiary~~ C are included in the foreign currency translation reserve in ~~Parent~~Controlling Entity D's consolidated financial statements after the application of hedge accounting.

B20.~~AG5~~ In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Controlled Entity~~Subsidiary~~ A would be recognised in ~~Parent~~Controlling Entity D's consolidated financial statements as follows:

- USD/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit~~profit or loss,~~; and
- JPY/EUR spot foreign exchange rate change in other comprehensive revenue and expense~~income~~.

Instead of the designation in paragraph B19~~AG4~~, in its consolidated financial statements ~~Parent~~Controlling Entity D can designate the US$300 million external borrowing in Controlled Entity ~~Subsidiary~~ A as a hedge of the GBP/USD spot foreign exchange risk between Controlled Entity~~Subsidiary~~ C and Controlled Entity~~Subsidiary~~ B. In this case, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Controlled Entity~~Subsidiary~~ A would instead be recognised in ~~Parent~~Controlling 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~~Subsidiary~~ C,
- GBP/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit~~profit or loss,~~; and
- JPY/EUR spot foreign exchange rate change in other comprehensive ~~income~~revenue and expense.

B21.~~AG6~~ ~~Parent~~Controlling Entity D cannot designate the US$300 million external borrowing in Controlled Entity~~Subsidiary~~ 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~~Subsidiary~~ B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the economic entity~~group~~ comprising Controlled Entity~~Subsidiary~~ B and Controlled Entity~~Subsidiary~~ C.

Where in an Economic Entity ~~group~~ can the Hedging Instrument be Held (paragraphs B10~~14~~ and B11~~15~~)?

B22.~~AG7~~ As noted in paragraph B20~~AG5~~, the total change in value in respect of foreign exchange risk of the US$300 million external borrowing in Controlled Entity ~~Subsidiary~~ A would be recorded in both surplus or deficit~~profit or loss~~ (USD/JPY spot risk) and other comprehensive revenue and expense~~income~~ (EUR/JPY spot risk) in ~~Parent~~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~~AG4~~ because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of ~~Parent~~Controlling Entity D against the US dollar functional currency of Controlled Entity~~Subsidiary~~ 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 Reclassified to Surplus or Deficit~~profit or loss~~ on Disposal of a Foreign Operation (paragraphs B12 and B13~~16 and 17~~)

B23.~~AG8~~ When ~~Subsidiary~~Controlled Entity C is disposed of, the amounts reclassified to surplus or deficit~~profit or loss~~ in ~~Parent~~Controlling Entity D's consolidated financial statements from its foreign currency translation reserve (FCTR) are:

(a) In respect of the US$300 million external borrowing of ~~Subsidiary~~Controlled Entity A, the amount that PBE IPSAS 41~~IFRS 9~~ requires to be identified, i.e., the total change in value in respect of foreign exchange risk that was recognised in other comprehensive revenue and expense~~income~~ as the effective portion of the hedge; and

(b) In respect of the US$300 million net investment in ~~Subsidiary~~Controlled Entity C, the amount determined by the entity's consolidation method. If ~~Parent~~Controlling Entity D uses the direct method, its FCTR in respect of ~~Subsidiary~~Controlled Entity C will be determined directly by the EUR/USD foreign exchange rate. If ~~Parent~~Controlling Entity D uses the step-by-step method, its FCTR in respect of ~~Subsidiary~~Controlled Entity C will be determined by the FCTR recognised by ~~Subsidiary~~Controlled Entity B reflecting the GBP/USD foreign exchange rate, translated to ~~Parent~~Controlling Entity D's functional currency using the EUR/GBP foreign exchange rate. ~~Parent~~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 reclassified when it disposes of ~~Subsidiary~~Controlled Entity C to be the amount that it would have recognised if it had always used the direct method, depending on its accounting policy.

Hedging More than One Foreign Operation (paragraphs B7~~11~~, B9~~13~~ and B11~~15~~)

B24.~~AG9~~ The following examples illustrate that in the consolidated financial statements of ~~Parent~~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~~Subsidiaries~~ 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 ~~Parent~~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 ~~Parent~~Controlling Entity D's consolidated surplus or deficit~~profit or loss~~. Of course, it would be possible for ~~Parent~~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.

~~Parent~~Entity D Holds Both USD and GBP Hedging Instruments

B25.~~AG10~~ ~~Parent~~Controlling Entity D may wish to hedge the foreign exchange risk in relation to its net investment in ~~Subsidiary~~Controlled Entity B as well as that in relation to ~~Subsidiary~~Controlled Entity C. Assume that ~~Parent~~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 ~~Subsidiary~~Controlled Entity B and ~~Subsidiary~~Controlled Entity C. The designations ~~Parent~~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 ~~Subsidiary~~Controlled Entity C with the risk being the spot foreign exchange exposure (EUR/USD) between ~~Parent~~Controlling Entity D and ~~Subsidiary~~Controlled Entity C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in ~~Subsidiary~~Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between ~~Parent~~Controlling Entity D and ~~Subsidiary~~Controlled Entity B.

(b) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in ~~Subsidiary~~Controlled Entity C with the risk being the spot foreign exchange exposure (GBP/USD) between ~~Subsidiary~~Controlled Entity B and ~~Subsidiary~~Controlled Entity C and up to £500 million hedging instrument designated as a hedge of £500 million of the net investment in ~~Subsidiary~~Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between ~~Parent~~Controlling Entity D and ~~Subsidiary~~Controlled Entity B.

B26.~~AG11~~ The EUR/USD risk from ~~Parent~~Controlling Entity D's net investment in ~~Subsidiary~~Controlled Entity C is a different risk from the EUR/GBP risk from ~~Parent~~Controlling Entity D's net investment in ~~Subsidiary~~Controlled Entity B. However, in the case described in paragraph B25~~AG10~~(a), by its designation of the USD hedging instrument it holds, ~~Parent~~Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in ~~Subsidiary~~Controlled Entity C. If ~~Parent~~Controlling Entity D also designated a GBP instrument it holds as a hedge of its £500 million net investment in ~~Subsidiary~~Controlled Entity B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in ~~Subsidiary~~Controlled Entity C, would be hedged twice for GBP/EUR risk in ~~Parent~~Controlling Entity D's consolidated financial statements.

B27.~~AG12~~ In the case described in paragraph B25~~AG10~~(b), if ~~Parent~~Controlling Entity D designates the hedged risk as the spot foreign exchange exposure (GBP/USD) between ~~Subsidiary~~Controlled Entity B and ~~Subsidiary~~Controlled Entity C, only the GBP/USD part of the change in the value of its US$300 million hedging instrument is included in ~~Parent~~Controlling Entity D's foreign currency translation reserve relating to ~~Subsidiary~~Controlled Entity C. The remainder of the change (equivalent to the GBP/EUR change on £159 million) is included in ~~Parent~~Controlling Entity D's consolidated surplus or deficit~~profit or loss~~, as in paragraph B20~~AG5~~. Because the designation of the USD/GBP risk between Controlled Entities~~Subsidiaries~~ B and C does not include the GBP/EUR risk, ~~Parent~~Controlling Entity D is also able to designate up to £500 million of its net investment in ~~Subsidiary~~Controlled Entity B with the risk being the spot foreign exchange exposure (GBP/EUR) between ~~Parent~~Controlling Entity D and ~~Subsidiary~~Controlled Entity B.

~~Subsidiary~~Entity B Holds the USD Hedging Instrument

B28.~~AG13~~ Assume that ~~Subsidiary~~Controlled Entity B holds US$300 million of external debt the proceeds of which were transferred to ~~Parent~~Controlling Entity D by an inter-entity~~company~~ loan denominated in pounds sterling. Because both its assets and liabilities increased by £159 million, ~~Subsidiary~~Controlled Entity B's net assets are unchanged. ~~Subsidiary~~Controlled Entity B could designate the external debt as a hedge of the GBP/USD risk of its net investment in ~~Subsidiary~~Controlled Entity C in its consolidated financial statements. ~~Parent~~Controlling Entity D could maintain ~~Subsidiary~~Controlled Entity B's designation of that hedging instrument as a hedge of its US$300 million net investment in ~~Subsidiary~~Controlled Entity C for the GBP/USD risk (see paragraph B9~~13~~) and ~~Parent~~Controlling Entity D could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in ~~Subsidiary~~Controlled Entity B. The first hedge, designated by ~~Subsidiary~~Controlled Entity B, would be assessed by reference to ~~Subsidiary~~Controlled Entity B's functional currency (pounds sterling) and the second hedge, designated by ~~Parent~~Controlling Entity D, would be assessed by reference to ~~Parent~~Controlling Entity D's functional currency (euro). In this case, only the GBP/USD risk from ~~Parent~~Controlling Entity D's net investment in ~~Subsidiary~~Controlled Entity C has been hedged in ~~Parent~~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 ~~Parent~~Controlling Entity D's

£500 million net investment in ~~Subsidiary~~Controlled Entity B may be hedged in the consolidated financial statements of ~~Parent~~Controlling Entity D.

B29.~~AG14~~ However, the accounting for ~~Parent~~Controlling Entity D's £159 million loan payable to ~~Subsidiary~~Controlled Entity B must also be considered. If ~~Parent~~Controlling Entity D's loan payable is not considered part of its net investment in ~~Subsidiary~~Controlled Entity B because it does not satisfy the conditions in PBE 1PSAS 4~~IAS 21~~ paragraph 18~~15~~, the GBP/EUR foreign exchange difference arising on translating it would be included in ~~Parent~~Controlling Entity D's consolidated surplus or deficit~~profit or loss~~. If the £159 million loan payable to ~~Subsidiary~~Controlled Entity B is considered part of ~~Parent~~Controlling Entity D's net investment, that net investment would be only £341 million and the amount ~~Parent~~Controlling Entity D could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.

B30~~AG15~~ If ~~Parent~~Controlling Entity D reversed the hedging relationship designated by ~~Subsidiary~~Controlled Entity B, ~~Parent~~Controlling Entity D could designate the US$300 million external borrowing held by ~~Subsidiary~~Controlled Entity B as a hedge of its US$300 million net investment in ~~Subsidiary~~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 ~~Subsidiary~~Controlled Entity B. In this case the effectiveness of both hedges would be computed by reference to ~~Parent~~Controlling Entity D's functional currency (euro). Consequently, both the USD/GBP change in value of the external borrowing held by ~~Subsidiary~~Controlled Entity B and the GBP/EUR change in value of ~~Parent~~Controlling Entity D's loan payable to ~~Subsidiary~~Controlled Entity B (equivalent to USD/EUR in total) would be included in the foreign currency translation reserve in ~~Parent~~Controlling Entity D's consolidated financial statements. Because ~~Parent~~Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in ~~Subsidiary~~Controlled Entity C, it can hedge only up to £341 million for the EUR/GBP risk of its net investment in ~~Subsidiary~~Controlled Entity B.

Note: The non-integral example that accompanies IFRIC 16 is incorporated the illustrative examples that accompany PBE IPSAS 41 – see paragraphs IE148 to IE152.

Appendix C: Extinguishing Financial Liabilities with Equity Instruments

This Appendix is an integral part of PBE IPSAS 41.

Note: The text in this Appendix is marked-up from IFRIC 19.PBE IFRS 9 did not include an equivalent appendix.

Introduction

C1.~~1~~ 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'. ~~The IFRIC has received requests for guidance on the accounting for such transactions.~~

Scope

C2.~~2~~ This Appendix~~Interpretation~~ 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.~~3~~ An entity shall not apply this Appendix~~Interpretation~~ 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.~~4~~ This Appendix~~Interpretation~~ 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~~3.3.3~~ of PBE IPSAS 41 *Financial Instruments*~~IFRS 9~~?

(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.~~5~~ 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~~3.3.3~~ of PBE IPSAS 41~~IFRS 9~~. 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~~3.3.1~~ of PBE IPSAS 41~~IFRS 9~~.

C6.~~6~~ When equity instruments issued to a creditor to extinguish all or part of a financial liability are recognised initially, an entity shall measure them at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured.

C7.~~7~~ 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 68~~47~~ of PBE IPSAS 41~~IFRS 13~~ is not applied.

C8.~~8~~ 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.~~9~~ The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognised in surplus or deficit~~profit or loss~~, in accordance with paragraph 37~~3.3.3~~ of PBE IPSAS 41~~IFRS 9~~. The equity instruments issued shall be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished.

C10.~~10~~ 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~~3.3.2~~ of PBE IPSAS 41~~IFRS 9~~.

C11.~~11~~ An entity shall disclose a gain or loss recognised in accordance with paragraphs C9 and C10 as a separate line item in surplus or deficit~~profit or loss~~ or in the notes.

Appendix D

Amendments to Other Standards

ED NZASB 2018-5 PBE IPSAS 41 proposes to amend the following standards:

- PBE IPSAS 1 *Presentation of Financial Reports*
- PBE IPSAS 4 *The Effects of Changes in Foreign Exchange Rates*
- PBE IPSAS 5 *Borrowing Costs*
- PBE IPSAS 9 *Revenue from Exchange Transactions*
- PBE IPSAS 12 *Inventories*
- PBE IPSAS 13 *Leases*
- PBE IPSAS 14 *Events After the Reporting Date*
- PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*
- PBE IPSAS 21 *Impairment of Non-Cash-Generating Assets*
- PBE IPSAS 23 *Revenue from Non-Exchange Transactions*
- PBE IPSAS 26 *Impairment of Cash-Generating Assets*
- PBE IPSAS 28 *Financial Instruments: Presentation*
- PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*
- PBE IPSAS 30 *Financial Instruments: Disclosures*
- PBE IPSAS 32 *Service Concession Arrangements: Grantor*
- PBE IPSAS 34 *Separate Financial Statements*
- PBE IPSAS 35 *Consolidated Financial Statements*
- PBE IPSAS 36 *Investments in Associates and Joint Ventures*
- PBE IPSAS 37 *Joint Arrangements*
- PBE IPSAS 38 *Disclosure of Interests in Other Entities*
- PBE IFRS 3 *Business Combinations*
- Forthcoming PBE IPSAS 40 *PBE Combinations*
- PBE IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
- PBE IAS 12 *Income Taxes*
- PBE IAS 34 *Interim Financial Reporting*
- PBE FRS 45 *Service Concession Arrangements: Operator*
- PBE FRS 47 *First-time Adoption of PBE Standards by Entities Other Than Those Previously Applying NZ IFRS*
- XRB A1 *Application of the Accounting Standards Framework*
- PBE SFR–A (NFP) *Public Benefit Entity Simple Format Reporting–Accrual (Not-For-Profit)*
- PBE SFR–A (PS) *Public Benefit Entity Simple Format Reporting–Accrual (Public Sector)*

Appendix D

Amendments to Other Standards

The amendments in this Appendix reflect the text of the relevant standards, including amendments set out in:

(a) PBE FRS 48 *Service Performance Reporting*, issued November 2017 and effective from 1 January 2021;

(b) *2018 Omnibus Amendments to PBE Standards,* issued October 2018. The relevant amendments reflected in this Appendix are effective from 1 January 2019; and

(c) ED 2018-7 PBE IFRS 17 *Insurance Contracts* which is expected to be finalised and issued at the same time as PBE IPSAS 41.

The amendments do not reflect the proposals in ED 2018-4 PBE IPSAS 40 *PBE Combinations*, issued in September 2018 and open for comment until 31 January 2019. However, this Appendix identifies the amendments that would be required to PBE IPSAS 40, if PBE IPSAS 40 were to be issued before PBE IPSAS 41.

Except where otherwise stated, an entity shall apply the amendments in this Appendix when it applies PBE IPSAS 41 issued in [date].

PBE IPSAS 1 *Presentation of Financial Reports*

In paragraph 7, the definition of 'other comprehensive revenue and expense' and paragraphs 79, 82, 99.1, 103.5, 103.7, 103.8 and 154.7 are amended.
A reference to paragraphs 125A–125C of IPSAS 41 (which are not used in this Standard) is added.
Paragraph 154.12 is added. New text is underlined and deleted text is struck through.

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

...

<u>**Other comprehensive revenue and expense**</u> **comprises items of revenue and expense (including reclassification adjustments) that are not recognised in surplus or deficit as required or permitted by other PBE Standards.**

The components of other comprehensive revenue and expense include:

(a) ...

(d) Gains and losses <u>from investments in equity instruments designated at fair value through other comprehensive revenue and expense in accordance with paragraph 106 of PBE IPSAS 41 *Financial Instruments*</u> ~~on remeasuring available-for-sale financial assets (see PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*)~~; and

<u>(e) Gains and losses on financial assets measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41;</u>

(~~e~~<u>f</u>) The effective portion of gains and losses on hedging instruments in a cash flow hedge ~~(see PBE IPSAS 29)~~ <u>and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive revenue and expense in accordance with paragraph 106 of PBE IPSAS 41 (see paragraphs 113–155 of PBE IPSAS 41)</u>;

<u>(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 108 of PBE IPSAS 41);</u>

<u>(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 113–155 of PBE IPSAS 41);</u> ~~and~~

<u>(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</u>

financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (see paragraphs 113–155 of PBE IPSAS 41)~~.~~; and

…

79. Current assets include assets (such as taxes receivable, user charges receivable, fines and regulatory fees receivable, members' fees receivable, contract grants receivable, prepayments, inventories and accrued investment revenue) that are either realised, consumed or sold, as part of the normal operating cycle even when they are not expected to be realised 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~~ PBE IPSAS 41 ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~) and the current portion of non-current financial assets.

…

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~~ PBE IPSAS 41 ~~PBE 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.

…

99.1 The surplus or deficit section of the statement of comprehensive revenue and expense 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) Insurance revenue (see [proposed] PBE IFRS 17);

(aa) Gains and losses arising from the derecognition of financial assets measured at amortised cost;

(ab) Insurance service expenses from contracts issued within the scope of PBE IFRS 17;

(ac) Revenue or expenses from reinsurance contracts issued within the scope of PBE IFRS 17 (see PBE IFRS 17);

(b) Finance costs;

(ba) Impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with paragraphs 73–93 of PBE IPSAS 41;

(bb) Insurance finance revenue or expenses from contracts issued within the scope of PBE IFRS 17 (see PBE IFRS 17);

(bc) Finance revenue or expenses from reinsurance contracts held (see PBE IFRS 17);

(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 amortised 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 amortised cost of the financial asset and its fair value at the reclassification date (as defined in PBE IPSAS 41);

(cb) If a financial asset is reclassified out of the fair value through other comprehensive revenue and expense measurement category so that it is measured at fair value through surplus or deficit, any cumulative gain or loss previously recognised in other comprehensive revenue and expense that is reclassified to surplus or deficit;

…

103.5 Other PBE Standards specify whether and when amounts previously recognised in other comprehensive revenue and expense 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 other comprehensive revenue and expense in the period that the adjustment is reclassified to surplus or deficit. ~~For example, gains realised on the disposal of available-for-sale financial assets are included in surplus or deficit of the current period.~~ These amounts may have been recognised in other comprehensive revenue and expense as unrealised gains in the current or previous periods. Those unrealised gains must be deducted from other comprehensive revenue and expense in the period in which the realised gains are reclassified to surplus or deficit to avoid including them in total comprehensive revenue and expense twice.

…

103.7 Reclassification adjustments arise, for example, on disposal of a foreign operation (see PBE IPSAS 4)~~, on derecognition of available-for-sale financial assets (see PBE IPSAS 29)~~ and when some ~~a~~ hedged forecast cash flows ~~transaction~~ affect~~s~~ surplus or deficit (see ~~paragraph 111 of PBE IPSAS 29~~ paragraph 140(d) of PBE IPSAS 41 in relation to cash flow hedges).

103.8 Reclassification adjustments do not arise on changes in revaluation surplus recognised in accordance with PBE IPSAS 17 or PBE IPSAS 31 or on remeasurements of defined benefit plans recognised in accordance with PBE IPSAS 39. These components are recognised in other comprehensive revenue and expense and are not reclassified to surplus or deficit in subsequent periods. Changes in revaluation surplus may be transferred to accumulated comprehensive revenue and expense in subsequent periods as the asset is used or when it is derecognised (see PBE IPSAS 17 and PBE IPSAS 31). In accordance with PBE IPSAS 41, 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.

…

125A–125C [Not used]

…

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

(a) Whether assets are investment properties;

(b) Whether agreements for the provision of goods and/or services that involve the use of dedicated assets are leases;

(c) Whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; ~~and~~

(d) 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;

(e) 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.

…

154.7 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 7, 79, 82, 99.1, 103.5, 103.7 and 103.8. An entity shall apply those amendments when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

154.12 **PBE IPSAS 41, issued in [date], amended paragraphs 7, 79, 82, 99.1, 103.5, 103.7, 103.8, 138 and 154.7. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IPSAS 4 *The Effects of Changes in Foreign Exchange Rates*

Paragraphs 3, 4, 5, 31, 58, 61 and 72.3 are amended. Paragraph 72.6 is added. New text is underlined and deleted text is struck through.

3. **An entity that prepares and presents financial statements 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 PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~;**

   ...

4. PBE IPSAS 41 ~~PBE 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 PBE IPSAS 41 ~~PBE 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. PBE IPSAS 41 ~~PBE IPSAS 29~~ applies to hedge accounting.

   …

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 PBE IPSAS 41~~PBE IPSAS 29~~.

   …

58. An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of contributed capital, or abandonment of all or part of that entity. ~~The payment of a dividend or similar distribution is part of a disposal only when it constitutes a return of the investment, for example when the dividend or similar distribution is paid out of pre-acquisition surplus.~~ A writedown of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the entity holding the interest, does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised in surplus or deficit at the time of a writedown.

   …

61. **The entity shall disclose:**

   (a) **The amount of exchange differences recognised in surplus or deficit, except for those arising on financial instruments measured at fair value through surplus or deficit in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~; and**

   …

72.3 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 3, 4, 5, 31, 58 and 61. An entity shall apply those amendments when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

72.6 **PBE IPSAS 41, issued in [date], amended paragraphs 3, 4, 5, 31, 61 and 72.3. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IPSAS 5 *Borrowing Costs*

Note: This ED proposes to amend PBE IPSAS 5. IPSAS 41, issued August 2018, did not amend IPSAS 5 – the IPSASB is expected to consider equivalent amendments in a future improvements project.

Paragraphs 6 and 43.3 are amended. Paragraph 43.5 is added. New text is underlined and deleted text is struck through.

6. Borrowing costs may include:

   (a) ~~Interest on bank overdrafts and short-term and long-term borrowings~~ Interest expense calculated using the effective interest method as described in PBE IPSAS 41 *Financial Instruments*;

(b)–(c) [Deleted by IPSASB]

~~(b) Amortisation of discounts or premiums relating to borrowings;~~

~~(c) Amortisation of ancillary costs incurred in connection with the arrangement of borrowings;~~

(d) Finance charges in respect of finance leases and service concession arrangements; and

(e) Exchange differences arising from foreign currency borrowings, to the extent that they are regarded as an adjustment to interest costs.

...

43.3 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 6. An entity shall apply that amendment when it applies PBE IFRS 9.*[*]**

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

43.5 **PBE IPSAS 41, issued in [date], amended paragraphs 6 and 43.3. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IPSAS 9 *Revenue from Exchange Transactions*

Note: The amendments to PBE IPSAS 9 propose to delete requirements relating to dividends and interest because the proposed PBE IPSAS 41 includes requirements for the recognition of dividends and interest.

Paragraphs 1, 9, 10, 16, 33, 39 and 42.4 are amended. Paragraph 42.5 is added. Paragraphs 34–36 are deleted. New text is underlined and deleted text is struck through.

Scope

1. **An entity that prepares and presents financial statements shall apply this Standard in accounting for revenue arising from the following exchange transactions and events:**

(a) **The rendering of services;**

(b) **The sale of goods; and**

(c) **The use by others of entity assets yielding ~~interest,~~ royalties~~, and dividends or similar distributions~~.**

…

9. The use by others of entity assets gives rise to revenue in the form of:

(a) Interest – charges for the use of cash or cash equivalents, or amounts due to the entity;

(b) Royalties – charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights, and computer software; and

(c) Dividends or similar distributions – distributions of surpluses to holders of equity investments in proportion to their holdings of a particular class of capital.

Interest and dividends or similar distributions are accounted for in accordance with PBE IPSAS 41 *Financial Instruments*.

10. This Standard does not deal with revenues arising from:

(a) …

(d) Insurance contracts within the scope of ~~PBE IFRS 4~~ [proposed] PBE IFRS 17 *Insurance Contracts*. However, an entity may choose to apply this Standard to insurance contracts that have as their primary purpose the provision of services for a fixed fee in accordance with paragraph 8 of PBE IFRS 17;

(e) Interest, dividends or similar distributions, or c~~C~~hanges in the fair value of financial assets and financial liabilities or their disposal (see PBE IPSAS 41 *Financial Instruments* ~~guidance on the~~

~~recognition and measurement of financial instruments can be found in PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~);

…

16. In most cases, the consideration is in the form of cash or cash equivalents, and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest-free credit to the purchaser or accept a note receivable bearing a below-market interest rate from the purchaser as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:

    (a) The prevailing rate for a similar instrument of an issuer with a similar credit rating; or

    (b) A rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

    The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with PBE IPSAS 41~~paragraphs 33 and 34~~.

…

~~Interest,~~ Royalties~~, and Dividends or Similar Distributions~~

33. **Revenue arising from the use by others of entity assets yielding ~~interest,~~ royalties~~, and dividends or similar distributions~~ shall be recognised as they are earned in accordance with the substance of the relevant agreement. ~~using the accounting treatments set out in paragraph 34 when:~~**

    ~~(a)~~ **~~It is probable that the economic benefits or service potential associated with the transaction will flow to the entity; and~~**

    ~~(b)~~ **~~The amount of the revenue can be measured reliably.~~**

34–36 [Deleted by NZASB]

~~34.~~ **~~Revenue shall be recognised using the following accounting treatments:~~**

   ~~(a)~~ **~~Interest shall be recognised on a time proportion basis that takes into account the effective yield on the asset;~~**

   ~~(b)~~ **~~Royalties shall be recognised as they are earned in accordance with the substance of the relevant agreement; and~~**

   ~~(c)~~ **~~Dividends or similar distributions shall be recognised when the shareholder's or the entity's right to receive payment is established.~~**

~~35. The effective yield on an asset is the rate of interest required to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of the asset. Interest revenue includes the amount of amortisation of any discount, premium, or other difference between the initial carrying amount of a debt security and its amount at maturity.~~

~~36. When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognised as revenue. When dividends or similar distributions on equity securities are declared from pre-acquisition net surplus, those dividends or similar distributions are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends or similar distributions are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.~~

…

Disclosure

39. **An entity shall disclose:**

    (a) **The accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services;**

(b) **The amount of each significant category of revenue recognised during the period, including revenue arising from:**

(i) **The rendering of services;**

(ii) **The sale of goods;**

(iii) [Deleted by NZASB] ~~**Interest;**~~

(iv) **Royalties;**

(v) [Deleted by NZASB] ~~**Dividends or similar distributions;**~~

(vi) **Members' fees or subscriptions (exchange component); and**

(c) **The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.**

…

42.4 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 10. An entity shall apply that amendment when it applies PBE IFRS 9.** *

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

42.5 **PBE IPSAS 41, issued in [date], amended paragraphs 1, 9, 10, 16, 33, 39 and 42.4 and deleted paragraphs 34-36. An entity shall apply those amendments when it applies PBE IPSAS 41.**

In the non-integral implementation guidance that accompanies PBE IPSAS 9, paragraphs IG1, IG12 and a heading above paragraph IG29 are amended. New text is underlined and deleted text is struck through.

Implementation Guidance

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

IG1. Entities derive revenues from exchange or non-exchange transactions. This Standard deals only with revenue arising from exchange transactions including the following~~. Revenue from exchange transactions is derived from~~:

(a) Sale of goods or provision of services to third parties or members of the organisation;

(b) Sale of goods or provision of services to government agencies;

(c) The use by others of entity assets yielding ~~interest,~~ royalties~~, and dividends or similar distributions~~; and

(d) Subscriptions or levies on members of the organisation (excluding any donation element).

…

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 interest rate (see PBE IPSAS 41) ~~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) [Deleted by NZASB] ~~**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 recognised in surplus or deficit, the fees are recognised as revenue when the instrument is initially recognised.~~

~~(i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under PBE IPSAS 29* Financial Instruments: Recognition and Measurement *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 PBE IPSAS 29), are deferred and recognised 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 PBE 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 PBE 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 PBE IPSAS 29), is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of PBE IPSAS 29 are accounted for as derivatives and measured at fair value.~~

~~(iii) *Origination fees received on issuing financial liabilities measured at amortised 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 PBE IPSAS 29) incurred, in the initial carrying amount of the financial liability and recognised 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) …

(ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of PBE IPSAS 41* ~~*PBE IPSAS 29*~~

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of PBE IPSAS 41 ~~PBE IPSAS 29~~, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of PBE IPSAS 41 ~~PBE IPSAS 29~~ are accounted for as derivatives and measured at fair value.

(iii) *Investment management fees*

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

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in PBE IPSAS 41 ~~PBE 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 …

…

~~Interest,~~ Royalties~~, and Dividends or Similar Distributions~~

Licence Fees and Royalties

IG29. …

…

Comparison with IPSAS 9

PBE IPSAS 9 *Revenue from Exchange Transactions* is drawn from IPSAS 9 *Revenue from Exchange Transactions.* ~~There are no significant differences between PBE IPSAS 9 and IPSAS 9.~~ The scope of the two standards differ. Revenue from interest and dividends or similar distributions are outside the scope of PBE IPSAS 9 but within the scope of IPSAS 9.

PBE IPSAS 12 *Inventories*

Paragraphs 2 and 52.5 are amended. Paragraph 52.7 is added. New text is underlined and deleted text is struck through.

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

   (a) …

   (b) **Financial instruments (see PBE IPSAS 28 *Financial Instruments: Presentation* and PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~); and**

…

52.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 2. An entity shall apply that amendment when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

52.7 **PBE IPSAS 41, issued in [date], amended paragraphs 2 and 52.5. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IPSAS 13 *Leases*

Paragraph 86.3 is renumbered and amended. Paragraph 86.5 is added. New text is underlined.

86.~~3~~4 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph B7. An entity shall apply that amendment when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

86.5 **PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraphs 86.3 and B7. An entity shall apply those amendments when it applies PBE IPSAS 41.**

…

In Appendix B, paragraph B7 is amended.

B7. Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under ~~this Standard,~~ PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, PBE IPSAS 41~~29~~ *Financial Instruments~~: Recognition and Measurement~~* or [proposed] PBE IFRS 17~~4~~ *Insurance Contracts*, depending on the terms.

PBE IPSAS 14 *Events After the Reporting Date*

Paragraphs 11 and 33.2 are amended. Paragraph 33.4 is added. New text is underlined and deleted text is struck through.

11. The following are examples of adjusting events after the reporting date that require an entity to adjust the amounts recognised in its financial statements, or to recognise items that were not previously recognised:

    (a) ...

    (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 recognised 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 receivable account~~;

…

33.2 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 11. An entity shall apply that amendment when it applies PBE IFRS 9.*~~.~~**

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

33.4 **PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraphs 11 and 33.2. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*

Paragraphs 4 and 112.5 are amended. Paragraph 112.8 is added. New text is underlined and deleted text is struck through.

4. This Standard does not apply to financial instruments (including guarantees) that are within the scope of PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~.

…

112.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 4. An entity shall apply that amendment when it applies PBE IFRS 9.*~~.~~**

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

112.8 **PBE IPSAS 41, issued in [date], amended paragraphs 4 and 112.5. An entity shall apply those amendments when it applies PBE IPSAS 41.**

In the non-integral implementation guidance that accompanies PBE IPSAS 19, paragraph IG14 is deleted. New text is underlined and deleted text is struck through.

A Single Guarantee

IG14. [Deleted by IPSASB] ~~During 2004–05, 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 2005–06, the financial condition of the operator deteriorates and, at December 31 2005, the operator files for protection from its creditors.~~

~~This contract meets the definition of a financial guarantee contract in PBE IPSAS 29, except those where the issuer elects to treat such contracts as insurance contracts in accordance with PBE IFRS 4 *Insurance*~~

~~*Contracts*. The following is an example of an accounting policy that complies with the requirements in PBE IPSAS 29 for financial guarantee contracts within the scope of PBE IPSAS 29.~~

~~**Analysis**~~

~~(a) At June 30 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 – No outflow of benefits is probable at June 30 2005.~~

~~**Conclusion**~~

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

~~**Analysis**~~

~~(b) At June 30 2006~~

~~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 June 30 2006, 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 recognised less, when appropriate, cumulative amortisation in accordance with PBE IPSAS 9 *Revenue from Exchange Transactions*.~~

PBE IPSAS 21 *Impairment of Non-Cash-Generating Assets*

Paragraphs 2, 9, 13 and 83.4 are amended. Paragraph 83.8 is added. New text is underlined and deleted text is struck through.

2. **An entity that prepares and presents financial statements shall apply this Standard in accounting for impairment of non-cash-generating assets, except:**

   (a) …

   (c) **Financial assets that are included in the scope of PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~;**

   …

9. This Standard does not apply to financial assets that are included in the scope of PBE IPSAS 28 *Financial Instruments: Presentation*. Impairment of these assets is dealt with in PBE IPSAS 41~~PBE IPSAS 29~~.

   …

13. Investments in:

   (a) Controlled entities, as defined in PBE IPSAS 35 *Consolidated Financial Statements*;

   (b) Associates, as defined in PBE IPSAS 36 *Investments in Associates and Joint Ventures*; and

   (c) Joint arrangements, as defined in PBE IPSAS 37 *Joint Arrangements*;

   are financial assets that are excluded from the scope of PBE IPSAS 41~~29~~. Where such investments are classified as cash-generating assets, they are dealt with under PBE IPSAS 26. Where these assets are non-cash-generating assets, they are dealt with under this Standard.

   …

83.4 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 2, 9 and 13. An entity shall apply those amendments when it applies PBE IFRS 9.~~*~~**

~~* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.~~

…

83.8 **PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraphs 2, 9, 13 and 83.4. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IPSAS 23 *Revenue from Non-Exchange Transactions*

Paragraphs 43, 105A and 125.4 are amended. Paragraph 125.6 is added. New text is underlined and deleted text is struck through.

43. Consistent with PBE IPSAS 12 *Inventories*, PBE IPSAS 16 *Investment Property*, ~~and~~ PBE IPSAS 17~~,~~ and PBE IPSAS 41 *Financial Instruments* assets acquired through non-exchange transactions are measured at their fair value as at the date of acquisition.

…

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 PBE IPSAS 41 ~~PBE 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 PBE IPSAS 41~~PBE IPSAS 29~~) is non-exchange revenue that should be accounted for in accordance with this Standard.

…

125.4 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 105A and A54. An entity shall apply those amendments when it applies PBE IFRS 9.~~*~~**

~~* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.~~

…

125.6 **PBE IPSAS 41, issued in [date], amended paragraphs 43, 105A, 125.4 and A54, renumbered paragraph A54.1 and added paragraphs A55 to A59. An entity shall apply those amendments when it applies PBE IPSAS 41.**

In the non-integral implementation guidance that accompanies PBE IPSAS 23, paragraph A54 is amended and paragraph A54.1 is renumbered (as A59.1). Paragraphs A55 to A59 are added. New text is underlined and deleted text is struck through.

A54. 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:

…

Analysis

…

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 PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29~~.

…

(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 PBE IPSAS 41~~29~~).

…

A55. An individual donates shares in listed Entity X to 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.

A56. 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

A57. As Entity A received the shares as a donation, it uses PBE IPSAS 23 to initially recognise 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 PBE IPSAS 23 and PBE IPSAS 41.

A58. PBE IPSAS 23 prescribes that assets acquired as part of a non-exchange revenue transaction are initially measured at fair value, while PBE IPSAS 41 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 other comprehensive revenue and expense, the transaction costs of CU10,000 are added to the value of the shares of CU1,000,000 on initial measurement.

A59. The subsequent measurement and derecognition of the shares is addressed in PBE IPSAS 41. The entity measures investments in shares at fair value through other comprehensive revenue and expense which means that the shares are measured at a fair value with any subsequent changes in fair value recognised in other comprehensive revenue and expense. Dividends are however recognised 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	CU1,010,000	
	Cr	Non-exchange revenue		CU1,000,000
	Cr	Bank (Transfer costs paid)		CU10,000
2.	Subsequent measurement at December 31, 20X8			
Dr		Other comprehensive revenue and expense (fair value adjustment of investment)	CU110,000	
	Cr	Investment in Entity X		CU110,000
3.	Subsequent measurement at December 31, 20X9			
Dr		Impairment loss (other comprehensive revenue and expense)	CU700,000	
	Cr	Investment in Entity X		CU700,000

…

A59.1~~A54.1~~ For the year ended December 31, 20X2, Entity B prepares and presents financial statements in accordance with PBE Standards. It makes the following disclosures in its financial statements:

…

PBE IPSAS 26 *Impairment of Cash-Generating Assets*

Paragraphs 2, 9, and 12 are amended. Paragraph 127.4 is renumbered and amended. Paragraph 127.9 is added. New text is underlined and deleted text is struck through.

2. **An entity that prepares and presents financial statements shall apply this Standard in accounting for the impairment of cash-generating assets, except for:**

(a) …

(c) **Financial assets that are within the scope of PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~;**

…

9. This Standard does not apply to any financial assets that are included in the scope of PBE IPSAS 28 *Financial Instruments: Presentation*. Impairment of these assets is dealt with in PBE IPSAS 41 ~~PBE IPSAS 29~~.

…

12. Investments in:

(a) …

(b) …

(c) …

are financial assets that are excluded from the scope of PBE IPSAS 41 ~~PBE IPSAS 29~~. Where such investments …

…

127.4~~5~~ **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 2, 9 and 12. An entity shall apply those amendments when it applies PBE IFRS 9.*~~.~~**

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

127.9 **PBE IPSAS 41, issued in [date], amended paragraphs 2, 9, 12 and 127.4. An entity shall apply those amendments when it applies PBE ISAS 41.**

PBE IPSAS 28 *Financial Instruments: Presentation*

Note:

The amendments to PBE IPSAS 30 (see paragraph 3(c)) have been aligned with the amendments to PBE IPSAS 30 set out in [proposed] PBE IFRS 17. The amendments also reflect a number of narrow scope amendments issued by the IASB including:

(a) *Classification of Rights Issues* (Amendments to IAS 32) (October 2009): see paragraphs 9 (definition of a financial liability) and 14(b)(ii).

(b) *Offsetting Financial Assets and Financial Liabilities* (Amendments to IAS 32) (December 2011): see paragraphs AG63A–AG63F.

Paragraphs 2, 3, 4, 9, 10, 14, 28, 36, 47, 48 and 62.4 are amended. Paragraphs 38.1 and 62.6 are added. New text is underlined and deleted text is struck through.

2. The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in PBE IFRS 9 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~ and for disclosing information about them in PBE IPSAS 30 *Financial Instruments: Disclosures*.

Scope (see also paragraphs AG3–AG9)

3. **An entity that prepares and presents financial statements 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 PBE IPSAS 34 *Separate Financial Statements*, PBE IPSAS 35 *Consolidated Financial Statements*, PBE IPSAS 36 *Investments in Associates and Joint Ventures.** However, in some cases, PBE IPSAS 34, 35 or 36 require or permit an entity to account for an interest in a controlled entity, associate, or joint venture using PBE IPSAS 41 ~~PBE 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.

~~* An entity that applies this Standard before it applies PBE IPSASs 34–37 shall read references to PBE IPSASs 34–37 as references to PBE IPSASs 6–8.~~

(b) ...

(c) **~~Obligations arising from~~ Insurance contracts as defined in [proposed] PBE IFRS 17 *Insurance Contracts* and investment contracts with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to:**

(i) **Derivatives that are embedded in ~~insurance~~ contracts within the scope of PBE IFRS 17 if PBE IPSAS 41 ~~PBE IPSAS 29~~ requires the entity to account for them separately; ~~and~~**

(ii) **Investment components that are separated from contracts within the scope of PBE IFRS 17, if PBE IFRS 17 requires such separation. ~~Financial guarantee contracts, if the issuer applies PBE IPSAS 29 in recognising and measuring the contracts, but shall apply PBE IFRS 4 *Insurance Contracts* if the issuer elects to apply that standard in recognising and measuring them.~~**

Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies PBE IPSAS 41 in recognising and measuring the contracts, but shall apply PBE IFRS 17 if the issuer elects, in accordance with paragraph 7(e) of PBE IFRS 17, to apply PBE IFRS 17 in recognising 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) [Deleted by NZASB] **~~Financial instruments that are within the scope of PBE IFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15–32 and AG25–AG35 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 PBE IPSAS 29).~~**

(e) ...

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 PBE IPSAS 41.**

…

Definitions (see also paragraphs AG10–AG48)

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

…

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 unfavourable to the entity; or**

(b) **A contract that will or may be settled in the entity's own equity instruments and is:**

(i) **A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or**

(ii) **A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number**

of an 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 PBE IPSAS 41 or paragraph 10 of PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and are used in this Standard with the meaning specified in that Standard.

- Amortised cost of a financial asset or financial liability;
- ~~Available-for-sale financial assets~~;
- ~~Derecognising~~ Derecognition;
- Derivative;
- Effective interest method;
- ~~Financial asset or financial liability at fair value through surplus or deficit;~~
- Financial guarantee contract;
- Financial liability at fair value through surplus or deficit;
- Firm commitment;
- Forecast transaction;
- Hedge effectiveness;
- Hedged item;
- Hedging instrument;
- ~~Held-to maturity investments~~ Held for trading;
- ~~Loans and receivables;~~
- 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 unfavourable 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 an 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 paragraphs 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 recognised initially at the present value of the redemption amount, and ~~under PBE 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 PBE IPSAS 41 ~~PBE 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. PBE IPSAS 41 ~~PBE 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 recognising the components of the instrument separately.

…

Treasury Shares (see also paragraph AG61)

…

38.1 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's treasury shares. Despite paragraph 38, an entity may elect not to deduct from equity a treasury share that is included in such a fund or is an underlying item when, and only when, an entity reacquires its own equity instrument for such purposes. Instead, the entity may elect to continue to account for that treasury share as equity and to account for the reacquired instrument as if the instrument were a financial asset and measure it at fair value through surplus or deficit in accordance with PBE IPSAS 41. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See [proposed] PBE IFRS 17 for terms used in this paragraph that are defined in that Standard.)

…

Offsetting a Financial Asset and a Financial Liability (see also paragraphs AG63A–AG63F 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) …

(b) …

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 PBE IPSAS 41 ~~PBE 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 PBE IPSAS 30 for recognised financial instruments that are within the scope of paragraph 17A of PBE IPSAS 30.

…

62.4 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 2, 3, 4, 10, 28, 36, 47, AG2, AG55, B19 and B21. An entity shall apply those amendments when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

62.6 **PBE IPSAS 41, issued in [date], amended paragraphs 2, 3, 4, 9, 10, 14, 28, 36, 47, 48, 62.4, AG2, AG55, B19 and B21, added paragraphs 38.1 and AG63A–AG63F (and the related headings) and deleted paragraph AG63. An entity shall apply those amendments when it applies PBE IPSAS 41.**

In Appendix A, paragraphs AG2 and AG55 are amended. Paragraphs AG63A–AG63F (and the related headings) are added. Paragraph AG63 is deleted. New text is underlined and deleted text is struck through.

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 PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29~~.

…

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. PBE IPSAS 41 deals with the classification and measurement of financial assets that are compound financial instruments from the holder's perspective. ~~PBE IPSAS 29 deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain the features of both debt and equity instruments.~~

Offsetting a Financial Asset and a Financial Liability (paragraphs 47–55)

AG63. [Deleted by IPSASB] ~~To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognised amounts. An entity may have a conditional right to set off recognised 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 Recognised 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 business;

(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 Realise 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 realise the asset and settle the liability simultaneously. Although the entity may have a right to settle net, it may still realise 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 collateralised 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 honoured if called upon.

In Appendix B, paragraphs B19 and B21 are amended. New text is underlined and deleted text is struck through.

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 68 of PBE IPSAS 41 *Financial Instruments* ~~52 of PBE 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.

…

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 68 of PBE IPSAS 41 ~~52 of PBE 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 recognise a gain or loss on the transfer.

In the NZASB's Basis for Conclusions on PBE IPSAS 28, paragraph BC3 is amended. New text is underlined and deleted text is struck through.

BC3 The NZASB noted that both NZ IFRSs and IPSASs permit, in limited circumstances, an entity to elect to account for financial guarantee contracts as insurance contracts. The NZASB also noted that the circumstances in which this is permitted differ slightly between the two suites of standards. The NZASB considered that entities transitioning from NZ IFRS to PBE Standards should be required to continue their existing treatment in respect of financial guarantee contracts in existence at the time of transition. Apart from this modification, the NZASB considered that PBE IPSAS 28 and PBE IPSAS 29[1] should apply to financial guarantee contracts subsequently entered into by entities that have transitioned from NZ IFRS and to the financial guarantee contracts of all other entities.

[1] PBE IFRS 9 *Financial Instruments* was issued in January 2017. PBE IFRS 9 was superseded by PBE IPSAS 41 *Financial Instruments* issued in [Date]. Both PBE IFRS 9 and PBE IPSAS 41 carried forward this aspect of the scope of PBE IPSAS 29.

In the non-integral implementation guidance that accompanies PBE IPSAS 28, paragraphs IE1 and IE5 are amended. New text is underlined and deleted text is struck through.

IE1. The following examples illustrate the application of paragraphs 13–32 and PBE IPSAS 41 *Financial Instruments* ~~PBE 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 …

February 1, 20X2

Dr …

Cr …

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 PBE IPSAS 41, paragraph AG1151 ~~PBE IPSAS 29, paragraph AG82~~).

…

PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*

Paragraphs 2, 9, 10, 80, 98, 99, 101, 102, 107, 109, 112, 113 and 126.5 are amended, paragraph 126.8 is added and paragraphs 1, 3–6, 11–79 and 88 (and some related headings) are deleted. New text is underlined and deleted text is struck through.

~~Objective~~

1. [Deleted by IPSASB] ~~The objective of this Standard is to establish principles for recognising 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 PBE IPSAS 28 *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in PBE IPSAS 30 *Financial Instruments: Disclosures.*~~

Scope

2. **This Standard shall be applied by all entities to all ~~types of~~ financial instruments within the scope of PBE IPSAS 41 *Financial Instruments* if, and to the extent that~~, except~~:**

   (a) **PBE IPSAS 41 permits the hedge accounting requirements of this Standard to be applied; and**

   (b) **The financial instrument is part of a hedging relationship that qualifies for hedge accounting in accordance with this Standard.**

   ~~(a) **Those interests in controlled entities, associates and joint ventures that are accounted for in accordance with PBE IPSAS 34 *Separate Financial Statements*, PBE IPSAS 35 *Consolidated Financial Statements* or PBE IPSAS 36 *Investments in Associates and Joint Ventures*. However, in some cases, PBE IPSAS 34, PBE IPSAS 35 or PBE 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 in 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 PBE IPSAS 28.**~~

   ~~(b) **Rights and obligations under leases to which PBE IPSAS 13 *Leases* applies. However:**~~

      ~~(i) **Lease receivables recognised 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 recognised 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)–(k) [Deleted by IPSASB]

   ~~(c) **Employers' rights and obligations under employee benefit plans, to which PBE IPSAS 39 *Employee Benefits* applies.**~~

   ~~(d) **Financial instruments issued by the entity that meet the definition of an equity instrument in PBE 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 PBE 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 PBE IFRS 4 *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 PBE IFRS 4 *Insurance Contracts* if the issuer elects to apply that standard in recognising 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 acquiree that will result in an entity 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 PBE 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 recognises as a provision in accordance with PBE IPSAS 19, or for which, in an earlier period, it recognised a provision in accordance with PBE IPSAS 19.**~~

~~(j) **The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions, to which PBE IPSAS 23 *Revenue from Non-Exchange Transactions* applies.**~~

~~(k) **Rights and obligations under service concession arrangements to which PBE IPSAS 32 *Service Concession Arrangements: Grantor* applies. However, financial liabilities recognised 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).**~~

3–6 [Deleted by IPSASB]

…

9. The terms defined in PBE IPSAS 9, PBE IPSAS 28 and PBE IPSAS 41 are used in this Standard with the meanings specified in paragraph 11 of PBE IPSAS 9, paragraph 9 of PBE IPSAS 28 and paragraph 9 of PBE IPSA 41. PBE IPSAS 9, PBE IPSAS 28 and PBE IPSAS 41 define~~s~~ the following terms:

- Amortised cost of a financial asset or financial liability;
- Derecognition;
- Derivative;
- Effective interest method;
- Effective interest rate;
- Equity instrument;
- Fair value;
- Financial asset;
- Financial instrument;
- Financial liability; ~~and~~
- Firm commitment; and
- 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~~ **…**

~~Definitions of four categories of financial instruments~~ **…**
[Note: The deleted definitions are: definitions of a financial asset or financial liability at fair value through surplus or deficit, held-to-maturity investments, loans and receivables, available-for-sale financial assets]

~~Definition of a financial guarantee contract~~ **…**

~~Definitions relating to recognition and measurement~~ **…**

[Note: The deleted definitions are: the amortised cost of a financial asset or financial liability, the effective interest method, derecognition, a regular way purchase or sale, transaction costs]

…

~~Embedded Derivatives~~

11–79. [Deleted by IPSASB]

Hedging

80. **If an entity applies PBE IPSAS 41 and has not chosen as its accounting policy to continue to apply the hedge accounting requirements of this Standard (see paragraph 179 of PBE IPSAS 41), it shall apply the hedge accounting requirements in paragraphs 113–155 of PBE IPSAS 41. 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 115 of PBE IPSAS 41, apply the hedge accounting requirements in this Standard instead of those in PBE IPSAS 41. 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.~~**

…

88. [Deleted by IPSASB] ~~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) ...

    (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 48 and 49 and Appendix A paragraphs AG113 and AG114 for guidance on determining fair value)~~.**

    (e) ...

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) ...

    (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 recognised 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 ~~an available-for-sale financial asset~~ a financial asset measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41.

…

101. If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in ~~paragraph 64~~ paragraph 101 of PBE IPSAS 41.

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 organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, 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) ...

(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 recognised in accordance with paragraph ~~64~~101 of PBE IPSAS 41.

…

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 recognised in other comprehensive revenue and expense 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 recognised as an expense). However, if an entity expects that all or a portion of a loss recognised in other comprehensive revenue and expense 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 recognised in other comprehensive revenue and expense in accordance with paragraph 106, and includes them in the initial cost or other carrying amount of the asset or liability.**

…

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 has been recognised in other comprehensive revenue and expense from the period when the hedge was effective (see paragraph 106(a)) shall remain separately in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109 or 111 applies. 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 organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, 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) …

Hedges of a Net Investment

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 PBE 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 recognised in other comprehensive revenue and expense (see PBE IPSAS 1); and**

(b) **The ineffective portion shall be recognised in surplus or deficit.**

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in other comprehensive revenue and expense shall be reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see PBE IPSAS 1) in accordance with paragraphs 56–57 of PBE IPSAS 4 on disposal or partial disposal of the foreign operation.

…

126.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 2, 9, 10, 80, 98–101, 107, AG128, AG157, AG161, deleted paragraphs 1, 3–6, 11–79, 88, AG1–AG126 and AG129. An entity shall apply those amendments when it applies PBE IFRS 9.**[*]

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

126.8 **PBE IPSAS 41, issued in [date], amended paragraphs 2, 9, 10, 80, 98–101, 107, 109, 112, 113, 126.5, AG128, AG134, AG157, AG161, added AG156A and deleted paragraphs 1, 3–6, 11–79, 88, 126.8, AG1–AG126 and AG129. An entity shall apply those amendments when it applies PBE IPSAS 41.**

Paragraphs AG128, AG134, AG157 and AG161 are amended. Paragraph AG156A is added. Paragraphs AG1–AG126 and AG129 (and some related headings) are deleted. New text is underlined and deleted text is struck through.

AG1–AG126. [Deleted by IPSASB]

…

AG128. A financial asset measured ~~held-to-maturity investment carried~~ at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG129. [Deleted by IPSASB]

…

AG134. If a hedge of a forecast transaction within the economic entity qualifies for hedge accounting, any gain or loss that is recognised in other comprehensive revenue and expense in accordance with paragraph 106(a) shall be reclassified from net assets/equity 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.

…

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) ...

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) ...

(b) Items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because PBE IPSAS 41 *Financial Instruments* ~~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.

Appendix B *Reassessment of Embedded Derivatives* is deleted.

Appendix B
Reassessment of Embedded Derivatives

B1–B7. [Deleted by IPSASB]

Appendix C *Hedges of a Net Investment in a Foreign Operation* is deleted.
In the non-integral implementation guidance that accompanies PBE IPSAS 29, sections A–G are deleted.

Implementation Guidance

Sections A–G [Deleted by IPSASB]

In the non-integral illustrative examples that accompany PBE IPSAS 29, paragraphs IE32–IE50 are deleted.

Illustrative Examples

IE32–IE50. [Deleted by IPSASB]

PBE IPSAS 30 *Financial Instruments: Disclosures*

Note:

The amendments to PBE IPSAS 30 have been aligned with the amendments to PBE IPSAS 30 set out in [proposed] PBE IFRS 17. The amendments also reflect a number of narrow scope amendments issued by the IASB including:

(a) *Disclosures–Transfers of Financial Assets* (Amendments to IFRS 7) (October 2010) and the subsequent amendments to those requirements: see paragraph 17 (deleted) and paragraphs 49A-49H and AG31 to AG41.

(b) *Disclosures–Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7) (December 2011): see paragraphs 17A–17F and AG42–AG55.

Paragraphs 2–5, 8, 11, RDR 11.1 12–13, 13A, 14, 17, 18, 24, RDR 24.1, 34, 35, 37 and 43 are amended.
Paragraphs 5A, 14A–14B, 15A–15C, 17A–17F, 20A, 24A, 25A–25D, 26A–26C, 27A–27F, 28A–28F, 28G, 37A, 42A–42E, 42F–42G, 42M–42N, 49A–49S, 53.7 and several headings are added.
Paragraphs RDR 11.2, 15–16, 20, 26, 27, RDR 27.1, 28, 36, 44 and 53.5 (and the heading preceding paragraph 17) are deleted.
New text is underlined and deleted text is struck through.

2. The principles in this Standard complement the principles for recognising, measuring, and presenting financial assets and financial liabilities in PBE IPSAS 28 *Financial Instruments: Presentation* and PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~.

Scope

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 PBE IPSAS 34 *Separate Financial Statements,* PBE IPSAS 35 *Consolidated Financial Statements*, PBE IPSAS 36 *Investments in Associates and Joint Ventures.* However, in some cases, PBE IPSAS 34, 35 or 36 require or permits an entity to account for an interest in a controlled entity, associate, or joint venture using ~~PBE IPSAS 29~~ PBE IPSAS 41; 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 PBE IPSAS 28.**

   (b) …

   (c) **~~Rights and obligations arising under~~ Insurance contracts as defined in [proposed] PBE IFRS 17 *Insurance Contracts* and investment contracts with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to:**

      (i) **Derivatives that are embedded in insurance contracts within the scope of PBE IFRS 17 if ~~PBE IPSAS 29~~ PBE IPSAS 41 requires the entity to account for them separately; and**

      (ii) **Investment components that are separated from contracts within the scope of PBE IFRS 17, if PBE IFRS 17 requires such separation; ~~An issuer of financial guarantee contracts if the issuer applies PBE IPSAS 29 in recognising and measuring the contracts, but shall apply PBE IFRS 4 *Insurance Contracts* if the issuer elects to apply that standard in recognising and measuring them.~~**

   Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies PBE IPSAS 41 in recognising and measuring the contracts, but shall apply [proposed] PBE IFRS 17 if the issuer elects, in accordance with paragraph 7(e) of PBE IFRS 17, to apply PBE IFRS 17 in recognising 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 that this Standard applies to ~~for~~ contracts within the scope of PBE IPSAS 41 ~~4–6 of PBE IPSAS 29, to which that Standard applies~~.**

   (e) …

4. This Standard applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of ~~PBE IPSAS 29~~ PBE IPSAS 41. Unrecognised financial instruments include some financial instruments that, although outside the scope of ~~PBE IPSAS 29~~ PBE IPSAS 41, 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 ~~PBE IPSAS 29~~ PBE IPSAS 41 (see paragraphs 6–8 of PBE IPSAS 41).

5A. The credit risk disclosure requirements in paragraphs 42A–42N apply to those rights for receivables that result from exchange transactions that are within the scope of PBE IPSAS 9 and non-exchange transactions within the scope of PBE IPSAS 23 which give rise to financial instruments for the purpose of recognising impairment gains or losses in accordance with paragraph 3 of PBE IPSAS 41. Any reference to financial assets or financial instruments in these paragraphs shall include those rights unless otherwise specified.

…

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

   …

   Credit risk rating grades is the rating of credit risk based on the risk of a default occurring on the financial instrument.

…

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

...

Statement of Financial Position

Categories of Financial Assets and Financial Liabilities

11. The carrying amounts of each of the following categories, as defined in ~~PBE IPSAS 29~~ PBE IPSAS 41, shall be disclosed either in the statement of financial position or in the notes:

*(a) Financial assets measured at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition~~,~~ or subsequently in accordance with paragraph 152 of PBE IPSAS 41; (ii) those measured as such in accordance with the election in paragraph 38.1 of PBE IPSAS 41; (iii) those measured as such in accordance with the election in paragraph 38.1 of PBE IPSAS 28; and (iv) those mandatorily measured at fair value through surplus or deficit in accordance with PBE IPSAS 41~~ and (ii) those classified as held for trading in accordance with PBE IPSAS 29~~;

(b)–(d)~~Held-to-maturity investments;~~ [Deleted by IPSASB]

~~(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 152 of PBE IPSAS 41and (ii) those that meet the definition of held for trading in PBE IPSAS 41 ~~classified as held for trading in~~ ~~accordance with~~ ~~PBE IPSAS 29~~; ~~and~~

(f) Financial assets ~~liabilities~~ measured at amortised cost;~~.~~

(g) Financial liabilities measured at amortised cost; and

(h) Financial assets measured at fair value through other comprehensive revenue and expense; showing separately (i) financial assets that are measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41; and (ii) investments in equity instruments designated as such upon initial recognition in accordance with paragraph 106 of PBE IPSAS 41.

RDR 11.1 A Tier 2 entity shall disclose, either in the statement of financial position or in the notes, the carrying amounts of (i) financial assets measured at fair value through surplus or deficit and (ii) financial liabilities measured at fair value through surplus or deficit. ~~is not required to make the separate disclosure required by paragraph 11(a).~~

~~RDR 11.2 A Tier 2 entity is not required to make the separate disclosure required by paragraph 11(e).~~

Financial Assets or Financial Liabilities at Fair Value through Surplus or Deficit

*12. If the entity has designated as measured at fair value through surplus or deficit a financial asset (or group of financial assets) that would otherwise be measured at fair value through other comprehensive revenue and expense or amortised 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(b)).

(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) …

(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 ~~loan or receivable~~ financial asset 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 PBE IPSAS 41~~10 of PBE IPSAS 29,~~ and is required to present the effects of changes in that liability's credit risk in other comprehensive revenue and expense (see paragraph 108 of PBE IPSAS 41), 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 AG236–AG243 of PBE IPSAS 41 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 derecognised during the period, the amount (if any) presented in other comprehensive revenue and expense that was realised 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 PBE IPSAS 41and 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 108 and 109 of PBE IPSAS 41), 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 AG236–AG243 of PBE IPSAS 41for 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 ~~T~~the methods used to comply with the requirements in paragraphs 12(c), ~~and~~ 13(a) and 13A(a) and paragraph 108(a) of PBE IPSAS 41, 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 108(a) of PBE IPSAS 41 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 other comprehensive revenue and expense would create or enlarge an accounting mismatch in surplus or deficit (see paragraphs 108 and 109 of PBE IPSAS 41). If an entity is required to present the effects of changes in a liability's credit risk in surplus or deficit (see paragraph 109 of PBE IPSAS 41), the disclosure must include a detailed description of the economic relationship described in paragraph AG229 of PBE IPSAS 41.

Investments in Equity Instruments Designated at Fair Value through Other Comprehensive Revenue and Expense

*14A If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive revenue and expense, as permitted by paragraph 106 of PBE IPSAS 41, it shall disclose:

(a) Which investments in equity instruments have been designated to be measured at fair value through other comprehensive revenue and expense.

(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 recognised during the period, showing separately those related to investments derecognised 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 derecognised investments in equity instruments measured at fair value through other comprehensive revenue and expense 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 [Deleted by IPSASB]

~~15. If the entity has reclassified a financial asset (in accordance with paragraphs 60–63 of PBE IPSAS 29) as one measured:~~

~~(a) At cost or amortised cost, rather than at fair value; or~~

~~(b) At fair value, rather than at cost or amortised 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 PBE IPSAS 41. For each such event, an entity shall disclose:

(a) The date of reclassification.

(b) A detailed explanation of the change in business 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 amortised cost or fair value through other comprehensive revenue and expense in accordance with paragraph 54 of PBE IPSAS 41:

(a) The effective interest rate determined on the date of reclassification; and

(b) The interest revenue recognised.

15C. If, since its last annual reporting date, an entity has reclassified financial assets out of the fair value through other comprehensive revenue and expense category so that they are measured at amortised cost or out of the fair value through surplus or deficit category so that they are measured at amortised cost or fair value through other comprehensive revenue and expense 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 recognised in surplus or deficit or other comprehensive revenue or expense during the reporting period if the financial assets had not been reclassified.

16. [Deleted by IPSASB] ~~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 PBE IPSAS 29 or out of the available-for-sale category in accordance with paragraph 58 of PBE 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 PBE 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 recognised in surplus or deficit or in other comprehensive revenue and expense 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 recognised in surplus or deficit or in other comprehensive revenue and expense if the financial asset had not been reclassified, and the gain, loss, revenue, and expense recognised 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. [Deleted by IPSASB] ~~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 PBE 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 recognise all of the assets, the carrying amounts of the assets, and of the associated liabilities; and~~

~~(d) When the entity continues to recognise 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 recognise, 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 recognised financial instruments that are set off in accordance with paragraph 47 of PBE IPSAS 28. These disclosures also apply to recognised 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 PBE IPSAS 28.

*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 recognised financial assets and recognised 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 recognised financial assets and recognised financial liabilities that are within the scope of paragraph 17A:

(a) The gross amounts of those recognised financial assets and recognised financial liabilities;

(b) The amounts that are set off in accordance with the criteria in paragraph 47 of PBE 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 recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 47 of PBE 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 recognised financial assets and recognised 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 39(a) of PBE IPSAS 29~~ paragraph 34(a) of PBE IPSAS 41; and

(b) The terms and conditions relating to its pledge.

…

Allowance Account for Credit Losses

20. [Deleted by IPSASB] ~~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 other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41is 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 Comprehensive Revenue and Expense

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 comprehensive revenue and expense or in the notes:

(a) Net gains or net losses on:

*(i) Financial assets or financial liabilities measured 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 152 of PBE IPSAS 41, and those on financial assets or financial liabilities that are ~~classified as held for trading in accordance with PBE IPSAS 29~~ mandatorily measured at fair value through surplus or deficit in accordance with PBE IPSAS 41 (e.g., financial liabilities that meet the definition of held for trading in PBE IPSAS 41). For financial liabilities designated as at fair value through surplus or deficit, an entity shall show separately the amount of gain or loss recognised in other comprehensive revenue and expense and the amount recognised in surplus or deficit;

(ii)–(iv) [Deleted by IPSASB] ~~Available for sale financial assets, showing separately the amount of gain or loss recognised in other comprehensive revenue and expense during the period and the amount reclassified from net assets/equity to surplus or deficit for the period;~~

~~(iii) Held-to-maturity investments;~~

~~(iv) Loans and receivables; and~~

(v) Financial liabilities measured at amortised cost;

(vi) Financial assets measured at amortised cost;

(vii) Investments in equity instruments designated at fair value through other comprehensive revenue and expense in accordance with paragraph 106 of PBE IPSAS 41and

(viii) Financial assets measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41, showing separately the amount of gain or loss recognised in other comprehensive revenue and expense during the period and the amount reclassified upon derecognition from accumulated other comprehensive revenue and expense to surplus or deficit for the period.

(b) Total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41 (showing these amounts separately); or financial liabilities that are not measured 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)–(e) [Deleted by IPSASB]

~~*(d) Interest revenue on impaired financial assets accrued in accordance with paragraph AG126 of PBE IPSAS 29; and~~

~~(e) The amount of any impairment loss for each class of financial asset.~~

RDR 24.1 A Tier 2 entity ~~is not required to make the separate disclosure required by paragraph 24(a)(i)~~ shall disclose, either in the statement of comprehensive revenue and expense or in the notes, net gains or losses on financial assets or financial liabilities measured at fair value through surplus or deficit. For financial liabilities designated as at fair value through surplus or deficit, an entity shall show separately the amount of gain or loss recognised in other comprehensive revenue and expense and the amount recognised in surplus or deficit.

*24A. An entity shall disclose an analysis of the gain or loss recognised in the statement of comprehensive revenue and expense arising from the derecognition of financial assets measured at amortised cost, showing separately gains and losses arising from derecognition of those financial assets. This disclosure shall include the reasons for derecognising 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 comprehensive revenue and expense 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.

The Risk Management Strategy

26. [Deleted by IPSASB] ~~An entity shall disclose the following separately for each type of hedge described in PBE 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.~~

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 128 of PBE IPSAS 41) 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. [Deleted by IPSASB] ~~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 recognised in other comprehensive revenue and expense during the period;~~

~~(d) The amount that was reclassified from net assets/equity to surplus or deficit for the period, showing the amount included in each line item in the statement of comprehensive revenue and expense; 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.~~

RDR 27.1 [Deleted by NZASB] ~~A Tier 2 entity is required to show only the total amount of cash flow hedges reclassified from net assets/equity and included in surplus or deficit for the period in accordance with paragraph 27(d).~~

*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 AG317(b) of PBE IPSAS 41) 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. [Deleted by IPSASB] ~~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 recognised in surplus or deficit that arises from cash flow hedges; and~~

~~(c) The ineffectiveness recognised 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 recognising hedge ineffectiveness for the period; and

*(d) The nominal amounts (including quantities such as tonnes or cubic metres) of the hedging instruments.

RDR 28A.1. A Tier 2 entity is not required to make the disclosures required by paragraph 28A in a tabular format.

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 recognised 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 recognised 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 recognising 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 139 of PBE IPSAS 41.

(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 recognising hedge ineffectiveness for the period (i.e., for cash flow hedges the change in value used to determine the recognised hedge ineffectiveness in accordance with paragraph 140(c) of PBE IPSAS 41);

*(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 140 and 142(a) of PBE IPSAS 41; 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.

RDR 28B.1. A Tier 2 entity is not required to make the disclosures required by paragraph 28B in a tabular format.

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—recognised in surplus or deficit (or other comprehensive revenue and expense for hedges of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive revenue and expense in accordance with paragraph 106 of PBE IPSAS 41); and *(ii) The line item in the statement of comprehensive revenue and expense that includes the recognised 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 recognised in other comprehensive revenue and expense;

(ii) Hedge ineffectiveness recognised in surplus or deficit;

*(iii) The line item in the statement of comprehensive revenue and expense that includes the recognised 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 PBE 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 comprehensive revenue and expense that includes the reclassification adjustment (see PBE IPSAS 1); and

(vi) For hedges of net positions, the hedging gains or losses recognised in a separate line item in the statement of comprehensive revenue and expense (see paragraph 149 of PBE IPSAS 41).

RDR 28C.1. A Tier 2 entity is not required to make the disclosures required by paragraph 28C in a tabular format.

RDR 28C.2. A Tier 2 entity is required to disclose only the amount reclassified from the cash flow hedge reserve or the foreign currency translation reserve into surplus or deficit as a reclassification adjustment in accordance with paragraph 28C(b)(iv).

*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 other comprehensive revenue and expense in accordance with PBE 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 140(d)(i) and (d)(iii) of PBE IPSAS 41;

(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 144 of PBE IPSAS 41; 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 145 of PBE IPSAS 41.

*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 152

of PBE IPSAS 41, 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 recognised 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 152 of PBE IPSAS 41; 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 155 of PBE IPSAS 41and the related nominal or principal amount (except for providing comparative information in accordance with PBE 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 paragraph~~s~~ AG149–AG154 of PBE IPSAS 41~~AG106–AG112 of PBE 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 AG151 of PBE IPSAS 41 ~~AG108 of PBE 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 recognising 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 AG117(b) of PBE IPSAS 41~~AG109 of PBE IPSAS 29~~); and

~~*~~(b) The aggregate difference yet to be recognised 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~~;~~.

(b) [Deleted by IPSASB] ~~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 PBE IPSAS 29 because its fair value cannot be measured reliably; and~~

(c) [Deleted by NZASB] ~~For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.~~

36. [Deleted by NZASB] ~~In the cases described in paragraph 35(b) and (c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:~~

~~(a) …~~

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 amortised cost in accordance with paragraph 40 of PBE IPSAS 41, an entity shall disclose:

…

37A. For concessionary loans measured at fair value in accordance with paragraph 41 or 43 of PBE IPSAS 41 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, including the nature of the concession; and

(d) Valuation assumptions.

…

Nature and Extent 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 PBE 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 PBE 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 PBE IPSAS 41are applied. However:

(a) For receivables that result from exchange transactions that are within the scope of PBE IPSAS 9 and non-exchange transactions within the scope of PBE IPSAS 23 and lease receivables, paragraph 42J(a) applies to those receivables or lease receivables on which lifetime expected credit losses are recognised in accordance with paragraph 87 of PBE IPSAS 41, 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 82 of PBE IPSAS 41, including the classes of financial instruments to which it applies; and

(ii) The presumption in paragraph 83 of PBE IPSAS 41, 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 84 of PBE IPSAS 41for 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 77 of PBE IPSAS 41; 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 75 of PBE IPSAS 41.

*42G. An entity shall explain the inputs, assumptions and estimation techniques used to apply the requirements in paragraphs 73–93 of PBE IPSAS 41. 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 has 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 PBE IPSAS 9 or non-exchange transactions that are within the scope of PBE IPSAS 23 or lease receivables for which the loss allowances are measured in accordance with paragraph 87 of PBE IPSAS 41.

(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 recognised 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 PBE IPSAS 41;

(c) Changes because of financial instruments that were derecognised (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 amortised cost before the modification and the net modification gain or loss recognised 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 PBE 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 recognised 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 PBE IPSAS 9 or non-exchange transactions that are within the scope of PBE IPSAS 23 or lease receivables for which the loss allowances are measured in accordance with paragraph 87 of PBE IPSAS 41.

(c) That are purchased or originated credit-impaired financial assets.

*42N. For receivables that result from exchange transactions that are within the scope of PBE IPSAS 9 or non-exchange transactions that are within the scope of PBE IPSAS 23 or lease receivables to which an entity applies paragraph 87 of PBE IPSAS 41, the information provided in accordance with paragraph 42M may be based on a provision matrix (see paragraph AG199 of PBE IPSAS 41).

*43. For all financial instruments within the scope of this Standard, but to which the impairment requirements in PBE IPSAS 41are not applied, 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 PBE 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~~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) [Deleted by IPSASB]~~Information about the credit quality of financial assets that are neither past due nor impaired; and~~

(d) [Deleted by IPSASB]~~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. [Deleted by IPSASB]~~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 derecognised 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 derecognised in their entirety and the associated liabilities; and

*(b) To evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised 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 PBE IPSAS 41 are met.

Transferred Financial Assets that are Not Derecognised 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 derecognised 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 recognise all of the transferred assets, the carrying amounts of the transferred assets and the associated liabilities.

*(f) When the entity continues to recognise the assets to the extent of its continuing involvement (see paragraphs 17(c)(ii) and 27 of PBE IPSAS 41), the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

RDR 42D.1 When a Tier 2 entity continues to recognise the assets to the extent of its continuing involvement (see paragraphs 17(c)(ii) and 27 of PBE IPSAS 41), the entity is required to disclose the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities in accordance with paragraph 49D(f).

Transferred Financial Assets that are Derecognised in Their Entirety

49E. To meet the objectives set out in paragraph 49B(b), when an entity derecognises transferred financial assets in their entirety (see paragraph 17(a) and 17(c)(i) of PBE IPSAS 41) 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 recognised in the entity's statement of financial position and represent the entity's continuing involvement in the derecognised financial assets, and the line items in which the carrying amount of those assets and liabilities are recognised.

*(b) The fair value of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets.

(c) The amount that best represents the entity's maximum exposure to loss from its continuing involvement in the derecognised 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 derecognised 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 derecognised 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 derecognised 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 recognised at the date of transfer of the assets.

(b) Revenue and expenses recognised, both in the reporting period and cumulatively, from the entity's continuing involvement in the derecognised 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) recognised 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 comprehensive revenue and expense 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 PBE IPSAS 41

Entities Transitioning from PBE IFRS 9

49H.1 Except as expressly permitted by PBE IPSAS 41, an entity that has previously applied PBE IFRS 9 shall not change the classification or measurement of its existing financial assets and financial liabilities on the date of initial application of PBE IPSAS 41. On the date of initial application of PBE IPSAS 41 such an entity is not required to comply with paragraphs 49I to 49S.

49H.2 An entity that has previously applied PBE IFRS 9 need not provide the disclosures required by paragraphs 49A–49H and AG31–AG41 for periods that begin before the initial application date of PBE IPSAS 41.

Entities Transitioning from PBE IPSAS 29

49I. In the reporting period that includes the date of initial application of PBE IPSAS 41, an 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 PBE IPSAS 29;

(b) The new measurement category and carrying amount determined in accordance with PBE IPSAS 41;

(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 PBE IPSAS 41 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 PBE IPSAS 41, an entity shall disclose qualitative information to enable users to understand:

(a) How it applied the classification requirements in PBE IPSAS 41 to those financial assets whose classification has changed as a result of applying PBE IPSAS 41.

(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 PBE IPSAS 41 (i.e., when the entity transitions from PBE IPSAS 29 to PBE IPSAS 41 for financial assets), it shall present the disclosures set out in paragraphs 49L–49O of this Standard as required by paragraph 173 of PBE IPSAS 41.

49L. When required by paragraph 49K, an entity shall disclose the changes in the classifications of financial assets and financial liabilities as at the date of initial application of PBE IPSAS 41, showing separately:

(a) The changes in the carrying amounts on the basis of their measurement categories in accordance with PBE IPSAS 29 (i.e., not resulting from a change in measurement attribute on transition to PBE IPSAS 41); and

(b) The changes in the carrying amounts arising from a change in measurement attribute on transition to PBE IPSAS 41.

The disclosures in this paragraph need not be made after the annual reporting period in which the entity initially applies the classification and measurement requirements for financial assets in PBE IPSAS 41.

49M. When required by paragraph 49K, an entity shall disclose the following for financial assets and financial liabilities that have been reclassified so that they are measured at amortised 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 other comprehensive revenue and expense, as a result of the transition to PBE IPSAS 41:

(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 recognised in surplus or deficit or other comprehensive revenue and expense 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 annual reporting period in which the entity initially applies the classification and measurement requirements for financial assets in PBE IPSAS 41.

49N. When required by paragraph 49K, 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 PBE IPSAS 41:

(a) The effective interest rate determined on the date of initial application; and

(b) The interest revenue or expense recognised.

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 168 of PBE IPSAS 41), 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 annual reporting period in which the entity initially applies the classification and measurement requirements for financial assets in PBE IPSAS 41.

49O. When an entity presents the disclosures set out in paragraphs 49K–49N, those disclosures, and the disclosures in paragraph 29 of this Standard, must permit reconciliation between:

(a) The measurement categories presented in accordance with PBE IPSAS 29 and PBE IPSAS 41; and

(b) The class of financial instrument

as at the date of initial application.

49P. On the date of initial application of paragraphs 73–93 of PBE IPSAS 41, an entity is required to disclose information that would permit the reconciliation of the ending impairment allowances in accordance with PBE IPSAS 29 and the provisions in accordance with PBE IPSAS 19 to the opening loss allowances determined in accordance with PBE IPSAS 41. For financial assets, this disclosure shall be provided by the related financial assets' measurement categories in accordance with PBE IPSAS 29 and PBE IPSAS 41, 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 PBE IPSAS 41, 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 amortised cost measurement of financial assets and impairment in paragraphs 69–72 and 73–93 of PBE IPSAS 41) of:

(a) PBE IPSAS 41 for prior periods; and

(b) PBE IPSAS 29 for the current period.

49R. In accordance with paragraph 161 of PBE IPSAS 41, if it is impracticable (as defined in PBE IPSAS 3) at the date of initial application of PBE IPSAS 41 for an entity to assess a modified time value of money element in accordance with paragraphs AG68–AG70 of PBE IPSAS 41 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 PBE IPSAS 41.

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 PBE IPSAS 41 until those financial assets are derecognised.

49S. In accordance with paragraph 162 of PBE IPSAS 41, if it is impracticable (as defined in PBE 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 PBE IPSAS 41 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 PBE IPSAS 41. 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 PBE IPSAS 41 until those financial assets are derecognised.

…

53.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 2–5, 8, 11, RDR 11.1, 12–14, 17, 18, 24, RDR 24.1, 34–37, and 43, deleted paragraphs 15–16, 20, 26, 27, RDR27.1, 28, 44 and one heading and added paragraphs 14A–14B, 16A–16D, 20A, 24A, 25A–25D, 26A–26C, 27A–27F, 28A–28F, 28G, 42A–42E, 42F–42G, 42M–42N, 49I–49S and several headings. An entity shall apply those amendments when it applies PBE IFRS 9. Those amendments need not be applied to comparative information provided for periods before the date of initial application of PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

53.7 **PBE IPSAS 41, issued in [date], amended paragraphs 2–5, 8, 11, RDR 11.1, 12–13, 13A, 14, 17, 18, 24, RDR 24.1, 34, 35, 37, 43 and 53.5, deleted paragraphs RDR 11.2, 15–16, 20, 26, 27, RDR27.1, 28, 36, 44 and 53.5 and one heading and added paragraphs 5A, 14A–14B, 15A–15C, 17A–17F, 20A, 24A, 25A–25D, 26A–26C, 27A–27F, 28A–28F, 28G, 42A–42E, 42F–42G, 42M–42N, 49A–49S and several headings. An entity shall apply those amendments when it applies PBE IPSAS 41. If an entity has previously applied PBE IFRS 9 those amendments need not be applied to comparative information provided for periods before the date of initial application of PBE IFRS 9 and shall apply the specific transitional provisions in paragraphs 49H.1 and 49H.2 of this Standard. If an entity has not previously applied PBE IFRS 9 those amendments need not be applied to comparative information provided for periods before the date of initial application of PBE IPSAS 41.**

In the Application Guidance, paragraphs AG1, AG5, AG9, AG10, AG22 and AG27 are amended, the heading above paragraph AG4 and paragraph AG4 are deleted and the headings above paragraph AG8A and paragraphs AG8A–AG8J are added. New text is underlined and deleted text is struck through.

Application Guidance

This Appendix is an integral part of PBE 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 ~~PBE IPSAS 29~~ PBE IPSAS 41 *Financial Instruments* (which determine how financial instruments are measured and where changes in fair value are recognised).

…

~~Significance of Financial Instruments for Financial Position and Financial Performance~~

~~Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs 13 and 14)~~

~~*~~AG4. [Deleted by IPSASB]~~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~~s~~ 46 ~~10, 13, or 14~~ of ~~PBE IPSAS 29~~ PBE IPSAS 41 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 PBE 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 PBE 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) ~~The criteria for designating financial assets as available for sale.~~ 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 PBE IPSAS 41 for such designation.

(c) Whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph ~~40 of PBE IPSAS 29~~ 11 of PBE IPSAS 41).

(d) [Deleted by IPSASB]~~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)–(g) [Deleted by IPSASB]~~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 recognised in accordance with PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, disclosure of the circumstances that result in a provision being recognised.

Paragraph 137 of PBE IPSAS 1 also requires entities to disclose, in the summary of ~~along with its~~ significant accounting policies or other notes, the judgements, 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 recognised 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 81 of PBE IPSAS 41, the determination of whether lifetime expected credit losses should be recognised 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 PBE IPSAS 41 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)(ii) 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 75 of PBE IPSAS 41. 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 PBE IPSAS 41. 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 recognised 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 recognised 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 recognised 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 PBE 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 82 of PBE IPSAS 41, 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 recognised. 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. Paragraphs ~~43(a)~~ 42K(a) and 43(a) require~~s~~ 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 PBE IPSAS 28; and

(b) Any ~~impairment losses~~ loss allowance recognised in accordance with ~~PBE IPSAS 29~~ PBE IPSAS 41.

*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.

…

*AG24. Interest rate risk arises on interest-bearing financial instruments recognised in the statement of financial position (e.g., ~~loans and receivables and~~ debt instruments acquired or issued) and on some financial instruments not recognised 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 ~~classified as~~ measured at fair value through surplus or deficit ~~and impairments of available-for-sale financial assets~~) is disclosed separately from the sensitivity of other comprehensive revenue and expense ~~net assets/equity~~ (that arises, for example, from ~~instruments classified as available for sale~~ investments in equity instruments whose changes in fair value are presented in other comprehensive revenue and expense).

…

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 economic entity) in a financial asset transferred by its controlled 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 economic entity).

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 Derecognised 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 recognise 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 derecognised 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, securitisations 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 derecognised financial assets or other amounts payable to the transferee in respect of the derecognised 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 judgement 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 derecognised 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 derecognised 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 recognised asset (i.e., the interest in the asset derecognised and the interest retained by the entity) were different from the fair value of the previously recognised 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 recognised financial instruments that are set off in accordance with paragraph 47 of PBE IPSAS 28. 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 PBE IPSAS 28.

*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 Recognised Financial Assets and Recognised 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 amortised cost, while a derivative will be measured at fair value). An entity shall include instruments at their recognised amounts and describe any resulting measurement differences in the related disclosures.

Disclosure of the Gross Amounts of Recognised Financial Assets and Recognised Financial Liabilities within the Scope of Paragraph 17A (paragraph 17C(a))

*AG45. The amounts required by paragraph 17C(a) relate to recognised financial instruments that are set off in accordance with paragraph 47 of PBE IPSAS 28. The amounts required by paragraph 17C(a) also relate to recognised 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 recognised as a result of collateral agreements that do not meet the offsetting criteria in paragraph 47 of PBE IPSAS 28. 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 PBE IPSAS 28 (paragraph 17C(b))

*AG46. Paragraph 17C(b) requires that entities disclose the amounts set off in accordance with paragraph 47 of PBE IPSAS 28 when determining the net amounts presented in the statement of financial position. The amounts of both the recognised financial assets and the recognised 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 recognised derivative asset and a recognised derivative liability that meet the offsetting criteria in paragraph 47 of PBE IPSAS 28. 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 PBE IPSAS 28, 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 recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 47 of PBE IPSAS 28 (for example, current rights of set-off that do not meet the criterion in paragraph 47(b) of PBE 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 recognised 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-collateralisation 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 PBE IPSAS 28, 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.

Paragraphs IG3 and IG4 and the related heading are deleted.

The heading above paragraph IG7 which begins "*Significance of Financial Instruments*..." is footnoted. The heading immediately above paragraph IG7 and paragraphs IG7–IG11 are deleted.

Paragraph IG13 is amended.
Paragraphs IG13A to IG13C and the related heading are added.

The illustrative disclosures following paragraphs IG14 and IG15 are amended. The text of paragraphs IG14 and IG15 is shown for ease of reading:

Paragraph IG16 and the illustrative disclosure following paragraph IG16 are amended.

Headings and paragraphs IG22A–IG22D are added and headings and paragraphs IG25–IG31 are deleted:

Paragraphs IG41–IG44 and their related headings are added. Paragraph IG45 and its related heading is added.

New text is underlined and deleted text is struck through.

~~*Materiality*~~

IG3–IG4 [Deleted by IPSASB]

…

Significance of Financial Instruments for Financial Position and Financial Performance (paragraphs 10–36, AG4 and AG5)[1]

~~*Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs 13(a)(i) and AG4)*~~

IG7–IG11 [Deleted by IPSASB]

1 PBE IPSAS 41 *Financial Instruments* deleted paragraph AG4 of PBE IPSAS 30.

…

Total Interest Expense (paragraph 24(b))

IG13. Total interest expense disclosed in accordance with paragraph 24(b) is a component of the finance costs, which paragraph 99.1(b) ~~102(b)~~ of PBE IPSAS 1 requires to be presented separately in the statement of comprehensive revenue and expense ~~financial performance~~. The line item for finance costs may also include amounts associated with non-financial liabilities.

Note: This Appendix adds a new hedge accounting example to PBE IPSAS 30 – see paragraphs IG13A to IG13C below. These paragraphs are based on IFRS 7 *Financial Instruments: Disclosures* paragraphs IG13C, IG13D and IG13E. IPSAS 41 did not add equivalent paragraphs to IPSAS 30 *Financial Instruments: Disclosures* but the IPSASB is expected to consider doing so in a future improvements project.

Hedge Accounting (paragraphs 28A–28C)

IG13A Paragraph 28A of PBE IPSAS 30 requires that an entity discloses amounts related to items designated as hedging instruments in a tabular format. The following example illustrates how that information might be disclosed.

	Nominal amount of the hedging instrument	**Carrying amount of the hedging instrument**		**Line item in the statement of financial position where the hedging instrument is located**	**Changes in fair value used for calculating hedge ineffectiveness for 20X1**
		Assets	**Liabilities**		
Cash flow hedges					
Commodity price risk - Forward sales contracts	xx	xx	xx	Line item XX	xx
Fair value hedges					
Interest rate risk - Interest rate swaps	xx	xx	xx	Line item XX	xx
Foreign exchange risk - Foreign currency loan	xx	xx	xx	Line item XX	xx

IG13B Paragraph 28A of PBE IPSAS 30 requires that an entity discloses amounts related to items designated as hedged items in a tabular format. The following example illustrates how that information might be disclosed.

	Carrying amount of the hedged item		**Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item**		**Line item in the statement of financial position in which the hedged item is included**	**Change in value used for calculating hedge ineffective-ness for 20X1**	**Cash flow hedge reserve**
	Assets	**Liabilities**	**Assets**	**Liabilities**			
Cash flow hedges							
Commodity price risk - Forecast sales - Discontinued hedges (forecast sales)	n/a n/a	n/a n/a	n/a n/a	n/a n/a	n/a n/a	xx n/a	xx xx
Fair value hedges							
Interest rate risk - Loan payable - Discontinued hedges (Loan payable)	– –	xx xx	– –	xx xx	Line item XX Line item XX	xx n/a	n/a n/a
Foreign exchange risk - Firm commitment	xx	xx	xx	xx	Line item XX	xx	n/a

IG13C Paragraph 28C of PBE IPSAS 30 requires that an entity discloses amounts that have affected the statement of comprehensive revenue and expense as a result of applying hedge accounting in a tabular format. The following example illustrates how that information might be disclosed.

Cash flow hedges[a]	**Separate line item recognised in surplus or deficit as a result of a hedge of a net position**[b]	**Change in the value of the hedging instrument recognised in other comprehensive revenue and expense**	**Hedge ineffectiveness recognised in surplus or deficit**	**Line item in surplus or deficit (that includes hedge ineffectiveness)**	**Amount reclassified from the cash flow hedge reserve to surplus or deficit**	**Line item affected in surplus or deficit because of the reclassification**
Commodity price risk						
Commodity X	n/a	xx	xx	Line item XX	xx	Line item XX
- Discontinued hedge	n/a	n/a	n/a	n/a	xx	Line item XX

(a) The information disclosed in the statement of changes in net assets/equity (cash flow hedge reserve) should have the same level of detail as these disclosures.

(b) This disclosure only applies to cash flow hedges of foreign currency risk.

Fair value hedges	**Ineffectiveness recognised in surplus or deficit**	**Line item(s) in surplus or deficit (that include(s) hedge ineffectiveness)**
Interest rate risk	xx	Line item XX
Foreign exchange risk	xx	Line item XX

…

Fair Value (paragraphs 31–34)

IG14. PBE IPSAS 30 requires disclosures about the level in the fair value hierarchy in which fair value measurements are categorised 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.)

Assets Measured at Fair Value

		Fair value measurement at end of the reporting period using:		
		Level 1	**Level 2**	**Level 3**
Description	**Dec 31, 20X2**	**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 assets at fair value through other comprehensive revenue and expense				
Equity investments	75	30	40	5
Total	214	87	115	12

Note: For liabilities, a similar table might be presented.

IG15. PBE 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		**Financial assets at fair value through other comprehensive revenue and expense** ~~**Available-for-sale financial assets**~~	**Total**
	Trading securities	Trading derivatives	Equity investments	
	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 other comprehensive revenue and expense	-	-	(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 AG151 of PBE IPSAS 41~~AG108 of PBE 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 recognised in surplus or deficit in subsequent periods in accordance with ~~PBE IPSAS 29~~ PBE IPSAS 41 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 AG151 of PBE IPSAS 41~~AG108 of PBE IPSAS 29~~). Paragraph ~~33~~34 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 34:

Background

…

Accounting Policies

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 ~~PBE IPSAS 29~~PBE IPSAS 41, 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].

In the Notes to the Financial Statements

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 ~~PBE IPSAS 29~~ PBE IPSAS 41, 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].

...

Credit Risk (paragraphs 42A–43, AG8A–AG10)

Note: This Appendix proposes to add a new credit risk example to PBE IPSAS 30 – see paragraphs IG22A to IG22D below. These paragraphs are based on IFRS 7 *Financial Instruments: Disclosures* paragraphs IG20A to IG20D. IPSAS 41 did not add equivalent paragraphs to IPSAS 30 *Financial Instruments: Disclosures* but the IPSASB is expected to consider doing so in a future improvements project.

IG22A The following examples illustrate possible ways in which an entity might provide the disclosures required by paragraphs 42A–42N of PBE IPSAS 30. However, these illustrations do not address all possible ways of applying the disclosure requirements.

Illustrating the application of paragraphs 42H and 42I

IG22B The following example illustrates one way of providing information about the changes in the loss allowance and the significant changes in the gross carrying amount of financial assets during the period that contributed to changes in the loss allowance as required by paragraphs 42H–42I. This example does not illustrate the requirements for financial assets that are purchased or originated credit-impaired.

Mortgage loans–loss allowance	**12-month expected credit losses**	**Lifetime expected credit losses (collectively assessed)**	**Lifetime expected credit losses (individually assessed)**	**Credit-impaired financial assets (lifetime expected credit losses)**
CU'000				
Loss allowance as at January 1	**X**	**X**	**X**	**X**
Changes due to financial instruments recognised as at 1 January:				
- Transfer to lifetime expected credit losses	(X)	X	X	–
- Transfer to credit-impaired financial assets	(X)	–	(X)	X
- Transfer to 12-month expected credit losses	X	(X)	(X)	–
- Financial assets that have been derecognised during the period	(X)	(X)	(X)	(X)
New financial assets originated or purchased	X	–	–	–
Write-offs	–	–	(X)	(X)
Changes in models/risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X

Mortgage loans–loss allowance	**12-month expected credit losses**	**Lifetime expected credit losses (collectively assessed)**	**Lifetime expected credit losses (individually assessed)**	**Credit-impaired financial assets (lifetime expected credit losses)**
Loss allowance as at December 31	**X**	**X**	**X**	**X**

Significant changes in the gross carrying amount of mortgage loans that contributed to changes in the loss allowance were:

- The acquisition of the ABC prime mortgage portfolio increased the residential mortgage book by x percent, with a corresponding increase in the loss allowance measured on a 12-month basis.
- The write off of the CUXX DEF portfolio following the collapse of the local market reduced the loss allowance for financial assets with objective evidence of impairment by CUX.
- The expected increase in unemployment in Region X caused a net increase in financial assets whose loss allowance is equal to lifetime expected credit losses and caused a net increase of CUX in the lifetime expected credit losses allowance.

The significant changes in the gross carrying amount of mortgage loans are further explained below:

Mortgage loans–gross carrying amount	**12-month expected credit losses**	**Lifetime expected credit losses (collectively assessed)**	**Lifetime expected credit losses (individually assessed)**	**Credit-impaired financial assets (lifetime expected credit losses)**
CU'000				
Gross carrying amount as at January 1	**X**	**X**	**X**	**X**
Individual financial assets transferred to lifetime expected credit losses	(X)	–	X	–
Individual financial assets transferred to credit-impaired financial assets	(X)	–	(X)	X
Individual financial assets transferred from credit-impaired financial assets	X	–	X	(X)
Financial assets assessed on collective basis	(X)	X	–	–
New financial assets originated or purchased	X	–	–	–
Write-offs	–	–	(X)	(X)
Financial assets that have been derecognised	(X)	(X)	(X)	(X)
Changes due to modifications that did not result in derecognition	(X)	–	(X)	(X)
Other changes	X	X	X	X
Gross carrying amount as at December 31	**X**	**X**	**X**	**X**

Illustrating the Application of Paragraphs 42M and 42N

IG22C The following example illustrates some ways of providing information about an entity's credit risk exposure and significant credit risk concentrations in accordance with paragraph 42M of PBE IPSAS 30. The number of grades used to disclose the information in accordance with paragraph 42M of PBE IPSAS 30 shall be consistent with the number that the entity uses to report internally to key management personnel for internal credit risk management purposes. However, if information about credit risk rating grades is not available without undue cost or effort and an entity uses past due information to assess whether credit risk has increased significantly since initial recognition in accordance with paragraph 83 of PBE IPSAS 41, the entity shall provide an analysis by past due status for those financial assets.

Consumer loan credit risk exposure by internal rating grades				
20XX	**Consumer—credit card**		**Consumer—automotive**	
CU'000	**Gross carrying amount**		**Gross carrying amount**	
	Lifetime	**12-month**	**Lifetime**	**12-month**
Internal Grade 1–2	X	X	X	X
Internal Grade 3–4	X	X	X	X
Internal Grade 5–6	X	X	X	X
Internal Grade 7	X	X	X	X
Total	**X**	**X**	**X**	**X**

Corporate loan credit risk profile by external rating grades				
20XX	**Corporate—equipment**		**Corporate—construction**	
CU'000	**Gross carrying amount**		**Gross carrying amount**	
	Lifetime	**12-month**	**Lifetime**	**12-month**
AAA-AA	X	X	X	X
A	X	X	X	X
BBB-BB	X	X	X	X
B	X	X	X	X
CCC-CC	X	X	X	X
C	X	X	X	X
D	X	X	X	X
Total	**X**	**X**	**X**	**X**

Corporate loan risk profile by probability of default				
20XX	**Corporate—unsecured**		**Corporate—secured**	
CU'000	**Gross carrying amount**		**Gross carrying amount**	
	Lifetime	**12-month**	**Lifetime**	**12-month**
0.00 – 0.10	X	X	X	X
0.11 – 0.40	X	X	X	X
0.41 – 1.00	X	X	X	X
1.01 – 3.00	X	X	X	X
3.01 – 6.00	X	X	X	X
6.01 – 11.00	X	X	X	X
11.01 – 17.00	X	X	X	X
17.01 – 25.00	X	X	X	X
25.01 – 50.00	X	X	X	X
50.01+	X	X	X	X
Total	**X**	**X**	**X**	**X**

IG22D Entity A manufactures cars and provides financing to both dealers and end customers. Entity A discloses its dealer financing and customer financing as separate classes of financial instruments and applies the simplified approach to its trade receivables so that the loss allowance is always measured at an amount equal to lifetime expected credit losses. The following table illustrates the use of a provision matrix as a risk profile disclosure under the simplified approach:

20XX CU'000	**Trade receivables days past due**				
Dealer financing	**Current**	**More than 30 days**	**More than 60 days**	**More than 90 days**	**Total**
Expected credit loss rate	0.10%	2%	5%	13%	
Estimated total gross carrying amount at default	CU20,777	CU1,416	CU673	CU235	CU23,101
Lifetime expected credit losses—dealer financing	CU21	CU28	CU34	CU31	CU114
Customer financing					
Expected credit loss rate	0.20%	3%	8%	15%	
Estimated total gross carrying amount at default	CU19,222	CU2,010	CU301	CU154	CU21,687
Lifetime expected credit losses— customer financing	CU38	CU60	CU24	CU23	CU145

IG25–IG31. [Deleted by IPSASB]

~~*Credit Quality (paragraph 43(c))*~~ …

~~*Financial Assets that are either Past Due or Impaired (paragraph 44)*~~ …

…

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 comprehensive revenue and expense 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.~~, other comprehensive revenue and expense 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). [footnote omitted]
>
> …

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 PBE IPSAS 41 might meet the quantitative disclosure requirements in paragraphs 49D and 49E.

Transferred Financial Assets that are not Derecognised in their Entirety

Illustrating the Application of Paragraph 49D(d) and (e)

	Financial assets at fair value through surplus or deficit		**Financial assets at amortised cost**		**Financial assets at fair value through other comprehensive revenue and expense**
	CU million		CU million		CU million
	Trading assets	Derivatives	Mortgages	Consumer loans	Equity investments
Carrying amount of assets	X	X	X	X	X
Carrying amount of associated liabilities	(X)	(X)	(X)	(X)	(X)
For those liabilities that have recourse only to the transferred assets:					
Fair value of assets	X	X	X	X	X
Fair value of associated liabilities	(X)	(X)	(X)	(X)	(X)
Net position	X	X	X	X	X

Transferred Financial Assets that are Derecognised in their Entirety

Illustrating the Application of Paragraph 49E(a)–(d)

	Cash outflows to repurchase transferred (derecognised) assets	**Carrying amount of continuing involvement in statement of financial position**			**Fair value of continuing involvement**		**Maximum exposure to loss**
	CU million	CU million			CU million		CU million
Type of continuing involvement		**Financial assets at fair value through surplus or deficit**	**Financial assets at fair value through other comprehend-sive revenue and expense**	**Financial liabilities at fair value through surplus or deficit**	**Assets**	**Liabilities**	
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)

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					

IG43 The following examples illustrate how an entity that has not adopted PBE IPSAS 41 might meet the quantitative disclosure requirements in paragraphs 49D and 49E.

Transferred Financial Assets that are not Derecognised in their Entirety

Illustrating the Application of Paragraph 49D(d) and (e)

	Financial assets at fair value through surplus or deficit		**Loans and receivables**		**Available-for-sale financial assets**
	CU million		CU million		CU million
	Trading securities	Derivatives	Mortgages	Consumer loans	Equity investments
Carrying amount of assets	X	X	X	X	X
Carrying amount of associated liabilities	(X)	(X)	(X)	(X)	(X)
For those liabilities that have recourse only to the transferred assets:					
Fair value of assets	X	X	X	X	X
Fair value of associated liabilities	(X)	(X)	(X)	(X)	(X)
Net position	X	X	X	X	X

Transferred Financial Assets that are Derecognised in their Entirety

Illustrating the Application of Paragraph 49E(a)–(d)

	Cash outflows to repurchase transferred (derecognised) assets	**Carrying amount of continuing involvement in statement of financial position**			**Fair value of continuing involvement**		**Maximum exposure to loss**
	CU million	**CU million**			**CU million**		**CU million**
Type of continuing involvement		**Held for trading**	**Available-for-sale financial assets**	**Financial liabilities at fair value through surplus or deficit**	**Assets**	**Liabilities**	
Written put options	(X)			(X)		(X)	X
Purchased call options	(X)	X			X		X
Securities lending	(X)		X	(X)	X	(X)	X
Total		X	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 recognised 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 PBE 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 PBE 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 PBE 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 PBE 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 collateralised 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 collateralised 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 collateralised lending. The fair value of the financial assets (bonds) received as collateral (and not recognised in the entity's statement of financial position) is CU105 million. The carrying amount of the collateralised 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 PBE 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 December 31, 20XX	(a)	(b)	(c)=(a)-(b)	(d)		(e)=(c)-(d)
				Related amounts not set off in the statement of financial position		
	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral received	Net amount
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 December 31, 20XX	(a)	(b)	(c)=(a)-(b)	(d)		(e)=(c)-(d)
				Related amounts not set off in the statement of financial position		
	Gross amounts of recognised financial liabilities	**Gross amounts of recognised financial assets set off in the statement of financial position**	**Net amounts of financial liabilities presented in the statement of financial position**	**(d)(i), (d)(ii) Financial instruments**	**(d)(ii) Cash collateral pledged**	**Net amount**
Description						
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 December 31, 20XX	(a)	(b)	(c)=(a)-(b)
	Gross amounts of recognised financial assets	**Gross amounts of recognised financial liabilities set off in the statement of financial position**	**Net amounts of financial assets presented in the statement of financial position**
Description			
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

As at December 31, 20XX	(c)	(d)		(e)=(c)-(d)
		Related amounts not set off in the statement of financial position		
	Net amounts of financial assets presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral received	Net amount
Counterparty A	20	–	(10)	10
Counterparty B	100	(80)	(20)	–
Counterparty C	90	(90)	–	–
Other	–	–	–	–
Total	210	(170)	(30)	10

Financial Liabilities Subject to Offsetting, Enforceable Master Netting Arrangements and Similar Agreements

CU million

As at December 31, 20XX	(a)	(b)	(c)=(a)-(b)
	Gross amounts of recognized financial liabilities	Gross amounts of recognized financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position
Description			
Derivatives	160	(80)	80
Repurchase, securities lending and similar agreements	80	–	80
Other financial instruments	–	–	–
Total	240	(80)	160

Net Financial Liabilities Subject to Enforceable Master Netting Arrangements and Similar Agreements, by Counterparty

CU million

As at December 31, 20XX	(c)	(d)		(e)=(c)-(d)
		Related amounts not set off in the statement of financial position		
	Net amounts of financial liabilities presented in the statement of financial position	**(d)(i), (d)(ii) Financial instruments**	**(d)(ii) Cash collateral pledged**	**Net amount**
Counterparty A	–	–	–	–
Counterparty B	80	(80)	–	–
Counterparty C	80	(80)	–	–
Other	–	–	–	–
Total	160	(160)	–	–

Transition from PBE IPSAS 29 to PBE IPSAS 41 (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 PBE IPSAS 30 at the date of initial application of PBE IPSAS 41. However, this illustration does not address all possible ways of applying the disclosure requirements of this PBE Standard.

Reconciliation of statement of financial position balances from PBE IPSAS 29 to PBE IPSAS 41 at January 1, 2022

Financial assets	**(i)**	**(ii)**	**(iii)**	**(iv) = (i) + (ii) + (iii)**	**(v) = (iii)**
	PBE IPSAS 29 carrying amount December 31, 2021[(1)]	**Reclassifications**	**Remeasurements**	**PBE IPSAS 41 carrying amount January 1, 2022**	**Accumulated comprehensive revenue and expense effect on January 1, 2022 [(2), (3)]**
Fair value through surplus or deficit					
Additions:					
From available for sale (PBE IPSAS 29)		(a)			(c)
From amortised cost (PBE IPSAS 29) – required reclassification		(b)			
From amortised cost (PBE IPSAS 29) – fair value option elected at January 1, 2022					
Subtractions:					
To amortised cost (PBE IPSAS 41)					
To fair value through other comprehensive revenue and expense – debt instruments (PBE IPSAS 41)					
To fair value through other comprehensive revenue and expense – equity instruments (PBE IPSAS 41)					
Total change to fair value through surplus or deficit					

Reconciliation of statement of financial position balances from PBE IPSAS 29 to PBE IPSAS 41 at January 1, 2022

Financial assets	**(i)**	**(ii)**	**(iii)**	**(iv) = (i) + (ii) + (iii)**	**(v) = (iii)**
	PBE IPSAS 29 carrying amount December 31, 2021[1]	**Reclassifications**	**Remeasurements**	**PBE IPSAS 41 carrying amount January 1, 2022**	**Accumulated comprehensive revenue and expense effect on January 1, 2022 [2], [3]**
Fair value through other comprehensive revenue and expense					
Additions – debt instruments:					
From available for sale (PBE IPSAS 29)					(g)
From amortised cost (PBE IPSAS 29)					(h)
From fair value through surplus or deficit (PBE IPSAS 29) – required reclassification based on classification criteria					(i)
From fair value through surplus or deficit (fair value option under PBE IPSAS 29) – fair value option criteria not met at January 1, 2022					(j)
From fair value through surplus or deficit (PBE IPSAS 29) – fair value option revoked at January 1, 2022 by choice					(k)
Additions – equity instruments:					
From available-for-sale (PBE IPSAS 29)					
From fair value through surplus or deficit (fair value option under PBE IPSAS 29)–fair value through other comprehensive revenue and expense elected at January 1, 2022					
From cost (PBE IPSAS 29)					
Subtractions – debt and equity instruments:					
Available for sale (PBE IPSAS 29) to fair value through surplus or deficit (PBE IPSAS 41) – required reclassification based on classification criteria					(d)
Available for sale (PBE IPSAS 29) to fair value through surplus or deficit (PBE IPSAS 41) – fair value option elected at January 1, 2022					
Available for sale (PBE IPSAS 29) to amortised cost (PBE IPSAS 41)					(e)

Reconciliation of statement of financial position balances from PBE IPSAS 29 to PBE IPSAS 41 at January 1, 2022

Financial assets	**(i)**	**(ii)**	**(iii)**	**(iv) = (i) + (ii) + (iii)**	**(v) = (iii)**
	PBE IPSAS 29 carrying amount December 31, 2021[(1)]	**Reclassifications**	**Remeasurements**	**PBE IPSAS 41 carrying amount January 1, 2022**	**Accumulated comprehensive revenue and expense effect on January 1, 2022** [(2), (3)]
Total change to fair value through other comprehensive revenue and expense					
Amortised cost					
Additions:					
From available for sale (PBE IPSAS 29)					(f)
From fair value through surplus or deficit (PBE IPSAS 29) – required reclassification					
From fair value through surplus or deficit (fair value option under PBE IPSAS 29) – fair value option criteria not met at January 1, 2022					
From fair value through surplus or deficit (PBE IPSAS 29) – fair value option revoked at January 1, 2022 by choice					
Subtractions:					
To fair value through other comprehensive revenue and expense (PBE IPSAS 41)					(l)
To fair value through surplus or deficit (PBE IPSAS 41) – required reclassification based on classification criteria					
To fair value through surplus or deficit (PBE IPSAS 41)– fair value option elected at January 1, 2022					
Total change to amortised cost					
Total financial asset balances, reclassifications and remeasurements at January 1, 2022	**(i)**	**Total (ii) = 0**	**(iii)**	**(iv) = (i) + (ii) + (iii)**	

1 Includes the effect of reclassifying hybrid instruments that were bifurcated under PBE IPSAS 29with host contract components of (a), which had associated embedded derivatives with a fair value of X at December 31, 2021, and (b), which had associated embedded derivatives with a fair value of Y at December 31, 2021.

2 Includes (c), (d), (e) and (f), which are amounts reclassified from other comprehensive revenue and expense to accumulated comprehensive revenue and expense at the date of initial application.

3 Includes (g), (h), (i), (j), (k) and (l), which are amounts reclassified from accumulated comprehensive revenue and expense to accumulated other comprehensive revenue and expense at the date of initial application.

PBE IPSAS 32 *Service Concession Arrangements: Grantor*

Paragraphs 20, 29 and 37.4 are amended. Paragraph 37.5 is added. New text is underlined and deleted text is struck through.

20. PBE IPSAS 28 *Financial Instruments: Presentation*, ~~the derecognition requirements in PBE IPSAS 29~~ ~~*Financial Instruments: Recognition and Measurement*, and~~ PBE IPSAS 30 *Financial Instruments: Disclosures* and the derecognition requirements in PBE IPSAS 41 *Financial Instruments* apply to the financial liability recognised under paragraph 14, except where this Standard provides requirements and guidance.

…

29. **The grantor shall account for other liabilities, commitments, contingent liabilities, and contingent assets arising from a service concession arrangement in accordance with PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, PBE IPSAS 28, ~~PBE IPSAS 29 and~~ PBE IPSAS 30 and PBE IPSAS 41.**

…

37.4 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 20, 29, AG37, AG45, AG52 and AG53. An entity shall apply those amendments when it applies PBE IFRS 9.*~~.~~**

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

37.5 **PBE IPSAS 41, issued in [date], amended paragraphs 20, 29, 37.4, AG37, AG45, AG52 and AG53. An entity shall apply those amendments when it applies PBE IPSAS 41.**

Paragraphs AG37, AG45, AG52 and AG53 are amended. New text is underlined and deleted text is struck through.

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 PBE IPSAS 28 *Financial Instruments: Presentation* ~~PBE 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 PBE IPSAS 28, ~~PBE IPSAS 29 and~~ PBE IPSAS 30 and PBE IPSAS 41 *Financial Instruments*.

…

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 PBE IPSAS 28, ~~PBE IPSAS 29 and~~ PBE IPSAS 30 and PBE IPSAS 41 in accounting for the guarantee. Where the guarantee is an insurance contract, the grantor can elect to apply [proposed] PBE IFRS 17 ~~PBE IFRS 4~~ *Insurance Contracts*. See PBE IPSAS 28, paragraphs AG3–AG9, for further guidance.

AG53. Guarantees and commitments that do not meet the requirements in PBE IPSAS 28 and PBE IPSAS 41 ~~PBE IPSAS 29~~ relating to financial guarantee contracts or are not insurance contracts are accounted for in accordance with PBE IPSAS 19.

Paragraph BC4 is deleted. New text is underlined and deleted text is struck through.

~~**Basis for Conclusions on IPSAS 32**~~

BC4. [Not used]~~The NZASB decided that the IPSASB's Basis for Conclusions on IPSAS 32 should be included in PBE IPSAS 32 as it contained information that would be useful for entities applying PBE IPSAS 32.~~

In the non-integral implementation guidance that accompanies PBE IPSAS 32, the final text box in the diagram following paragraph IG2 is amended. New text is underlined and deleted text is struck through.

WITHIN THE SCOPE OF THE STANDARD

- **Grantor recognises a service concession asset, or the grantor reclassifies an item of property, plant and equipment, an intangible asset, or a leased asset as a service concession asset**
- **Grantor accounts for the service concession asset as property, plant, and equipment or an intangible asset in accordance with PBE IPSAS 17 or PBE IPSAS 31, as appropriate**
- **Grantor follows impairment testing as set out in PBE IPSAS 21 and PBE IPSAS 26**
- **Grantor recognises related liability equal to the value of the SCA asset (PBE IPSAS 9, PBE IPSAS 28, ~~PBE IPSAS 29, and~~ PBE IPSAS 30 <u>and PBE IPSAS 41</u>)**
- **Grantor recognises revenues and expenses related to the SCA**

PBE IPSAS 34 *Separate Financial Statements*

Paragraphs 6, 12, 13, 14, 15, 26, 30 and 32.2 are amended. Paragraph 32.4 is added. New text is underlined and deleted text is struck through.[13]

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

…

<u>Separate financial statements</u> 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 <u>PBE IPSAS 41 *Financial Instruments*</u> ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~ or using the equity method as described in PBE IPSAS 36 *Investments in Associates and Joint Ventures*.

…

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 <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~; or**

(c) **Using the equity method as described in PBE IPSAS 36.**

…

13. **If an entity elects, in accordance with paragraph 24 of PBE IPSAS 36, to measure its investments in associates or joint ventures at fair value through surplus or deficit in accordance with <u>PBE IPSAS 41</u> ~~PBE 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 to measure its investment in a controlled entity at fair value through surplus or deficit in accordance with <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~, it shall also account for that investment in the same way in its separate financial statements. A controlling entity that is not itself an investment entity shall measure its investments in a controlled investment entity in accordance with paragraph 12 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) …

(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 <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~.** …

[13] The text of PBE IPSAS 34 shown here reflects the proposals in NZASB ED 2018-3 *2018 Omnibus Amendments to PBE Standards*.

…

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 PBE IPSAS 41 ~~PBE 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 58 of PBE IPSAS 35, to measure its investment in a controlled investment entity at fair value through surplus or deficit in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~, shall use the transitional provisions in paragraphs 24–29 in accounting for its investment in the controlled investment entity in its separate financial statements.**

…

32.2 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 12, 13, 14, 15, 22, 26 and 30. An entity shall apply those amendments when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

32.4 **PBE IPSAS 41, issued in [date], amended paragraphs 12, 13, 14, 15, 26, 30 and 34.2. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IPSAS 35 *Consolidated Financial Statements*

Paragraphs 22, 45, 52, 56, 58 and 79.2 are amended. Paragraph 79.5 is added. New text is underlined and deleted text is struck through.

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 PBE Standards, such as PBE IPSAS 36, PBE IPSAS 37 or the PBE Standards dealing with financial instruments (PBE IPSAS 28 *Financial Instruments: Presentation*, ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and~~ PBE IPSAS 30 *Financial Instruments: Disclosures* and PBE IPSAS 41 *Financial Instruments*).

…

45. PBE IPSAS 28 and ~~PBE IPSAS 29~~ PBE IPSAS 41 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 PBE IPSAS 28 and ~~PBE IPSAS 29~~ PBE IPSAS 41. In all other cases, instruments containing potential voting rights in a controlled entity are accounted for in accordance with PBE IPSAS 28 and ~~PBE IPSAS 29~~ PBE IPSAS 41.

…

52. **If a controlling entity loses control of a controlled entity, the controlling entity:**

(a) …

(b) **Recognises any investment retained in the former controlled entity at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former controlled entity in accordance with relevant PBE Standards. That fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with ~~PBE IPSAS 29~~ PBE IPSAS 41 or the cost on initial recognition of an investment in an associate or joint venture; and**

(c) …

56. Except as described in paragraph 57, an investment entity shall not consolidate its controlled entities or apply PBE IFRS 3[14] 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 ~~PBE IPSAS 29~~ <u>PBE IPSAS 41</u>.

…

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 ~~PBE IPSAS 29~~ <u>PBE IPSAS 41</u> 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.**

…

79.2 **PBE IFRS 9 *<u>Financial Instruments</u>*, issued in January 2017, amended paragraphs 22, 45, 52(b), 56, 58 and AG105, B12(b)(ii). An entity shall apply those amendments when it applies PBE IFRS 9.<u>*</u>**

<u>* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.</u>

…

<u>79.5</u> **<u>PBE IPSAS 41, issued in [date], amended paragraphs 22, 45, 52, 56, 58, 81.2, AG105, and B12. An entity shall apply those amendments when it applies PBE IPSAS 41.</u>**

Paragraph AG105 is amended. New text is underlined and deleted text is struck through.

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 PBE IPSAS 16 *Investment Property*;

(b) Elect the exemption from applying the equity method in PBE IPSAS 36 for its investments in associates and joint ventures; and

(c) Measure its financial assets at fair value using the requirements in ~~PBE IPSAS 29~~ <u>PBE IPSAS 41 *Financial Instruments*</u>.

Paragraph B12 is amended. New text is underlined and deleted text is struck through.

B12. Assuming that the impact of applying different accounting policies is material, consolidation adjustments are required in the following circumstances:

(a) …

(b) PBE Standards and NZ IFRS differ. Differences in the application of accounting policies can arise in the following circumstances:

(i) …

(ii) Either PBE Standards or NZ IFRS are silent or contain less guidance on a particular topic, for example, there is less guidance in NZ IFRS regarding concessionary loans. Therefore, a for-profit entity within the PBE group may have applied an accounting policy that differs from the requirements in <u>PBE IPSAS 41 *Financial Instruments*</u> ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~; or

(iii) …

[14] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 56 would refer to PBE IPSAS 40 rather than PBE IFRS 3.

PBE IPSAS 36 *Investments in Associates and Joint Ventures*

The amendments reflect narrow scope amendments issued by the IASB in *Long-term Interests in Associates and Joint Ventures* (Amendments to IAS 28) (October 2017): see paragraphs 20A (added) and 44 (deleted).

Paragraphs 20, 24, 25, 25.1, 26, 43–45 and 50.1 are amended. Paragraphs 20A, 44A–44C, 51.5 and 51.6 are added. New text is underlined and deleted text is struck through.

20. PBE IPSAS 41 *Financial Instruments* ~~PBE 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 ~~PBE IPSAS 29~~ PBE IPSAS 41. In all other cases, instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with ~~PBE IPSAS 29~~ PBE IPSAS 41.

20A. An entity also applies PBE IPSAS 41 to other financial instruments in an associate or joint venture to which the equity method is not applied. These include long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture (see paragraph 41). An entity applies PBE IPSAS 41 to such long-term interests before it applies paragraph 41 and paragraphs 43–48 of this Standard. In applying PBE IPSAS 41, the entity does not take account of any adjustments to the carrying amount of long-term interests that arise from applying this Standard.

…

24. When an investment in an associate or joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through surplus or deficit in accordance with ~~PBE IPSAS 29~~ PBE IPSAS 41. An example of an investment linked insurance fund is a fund held by an entity as the underlying items for a group of insurance contracts include investment contracts with discrete participation features. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture. (See [proposed] PBE IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard). An investment entity will, by definition, have made this election for its investments.

25. When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organisation, 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 ~~PBE IPSAS 29~~ PBE IPSAS 41 regardless of whether the venture capital organisation, 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 organisation, 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 ~~PBE IPSAS 29~~ PBE IPSAS 41.

Classification as Held for Sale

25.1 An entity shall apply PBE IFRS 5 to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale. Any retained portion of an investment in an associate or a joint venture that has not been classified as held for sale shall be accounted for using the equity method until disposal of the portion that is classified as held for sale takes place. After the disposal takes place, an entity shall account for any retained interest in the associate or joint venture in accordance with ~~PBE IPSAS 29~~ PBE IPSAS 41 unless the retained interest continues to be an associate or a joint venture, in which case the entity uses the equity method.

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) …

    (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 ~~PBE IPSAS 29~~ PBE IPSAS 41. ~~If an entity is precluded by PBE 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 PBE IPSAS 29.~~ The entity shall recognise 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 recognised in other comprehensive revenue and expense 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.**

…

43. After application of the equity method, including recognising the associate's or joint venture's deficits in accordance with paragraph 41, the entity applies ~~PBE IPSAS 29 to determine whether it is necessary to recognise any additional impairment loss with respect to its net investment in the associate or joint venture~~ paragraphs 44A–44C to determine whether there is any objective evidence that its net investment in the associate or joint venture is impaired.

44. [Deleted by the IPSASB]

~~44. The entity also applies PBE IPSAS 29 to determine whether any additional impairment loss is recognised with respect to its interests in the associate or joint venture that does 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 recognised. 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 reorganisation; 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 ~~PBE IPSAS 29~~ indicates that the investment in an associate or a joint venture may be impaired, an entity applies PBE IPSAS 26 *Impairment of Cash-Generating Assets* and possibly PBE IPSAS 21 *Impairment of Non-Cash-Generating Assets.*

…

51.2 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 20, 24, 25, 25.1 and 26, 43, 44 and 45 and added paragraphs 44A–44C. An entity shall apply those amendments when it applies PBE IFRS 9.*[*]***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

51.5 **PBE IPSAS 41, issued in [date], amended paragraphs 20, 24, 25, 25.1 and 26, 43, 44, 45 and 51.2 and added paragraphs 20A and 44A–44C. An entity shall apply those amendments when it applies PBE IPSAS 41, except as specified in paragraph 51.6.**

51.6 An entity transitioning to PBE IPSAS 41 from PBE IFRS 9 shall apply the transition requirements in paragraphs 158–184 of PBE IPSAS 41 to the long-term interests described in paragraph 20A. The entity is not required to restate prior periods to reflect the application of the requirements in paragraph 20A. The entity may restate prior periods only if it is possible without the use of hindsight. If an entity does not restate prior periods, at the date of initial application of PBE IPSAS 41 it shall recognise in the opening accumulated comprehensive revenue and expense (or other component of net assets/equity, as appropriate) any difference between:

(a) the previous carrying amount of long-term interests described in paragraph 20A at that date; and

(b) the carrying amount of those long-term interests at that date.

Paragraph BC6 is added. New text is underlined and deleted text is struck through.

Long-term Interests in Associates and Joint Ventures

BC6 In October 2017 the IASB issued *Long-term Interests in Associates and Joint Ventures* (Amendments to IAS 28) to clarify that an entity is required to apply IFRS 9 *Financial Instruments*, including its impairment requirements, to long-term interests in an associate or joint venture to which the equity method is not applied but that, in substance, form part of the net investment in the associate or joint venture (long-term interests). Following the issue of IPSAS 41 *Financial Instruments* in August 2018 the IPSASB issued an amending standard (*Long-term Interests in Associates and Joint Ventures* (Amendments to IPSAS 36) *and Prepayment Features with Negative Compensation* (Amendments to IPSAS 41) to incorporate equivalent amendments in IPSAS 36 *Investments in Associates and Joint Ventures*. The NZASB amended PBE IPSAS 36 when it issued PBE IPSAS 41 *Financial Instruments*.

A non-integral illustrative example is added. New text is underlined.

Illustrative Example—Long-term Interests in Associates and Joint Ventures

This example accompanies, but is not part of, PBE IPSAS 36.

This example portrays a hypothetical situation illustrating how an entity (investor) accounts for long-term interests that, in substance, form part of the entity's net investment in an associate (long-term interests) applying PBE IPSAS 41 *Financial Instruments* and PBE IPSAS 36 based on the assumptions presented. The entity applies PBE IPSAS 41 in accounting for long-term interests. The entity applies PBE IPSAS 36 to its net investment in the associate, which includes long-term interests. The analysis in this example is not intended to represent the only manner in which the requirements in PBE IPSAS 36 could be applied.

Assumptions

The investor has the following three types of interests in the associate:

(a) O Shares—ordinary shares representing a 40% ownership interest to which the investor applies the equity method. This interest is the least senior of the three interests, based on their relative priority in liquidation.

(b) P Shares—non-cumulative preference shares that form part of the net investment in the associate and that the investor measures at fair value through surplus or deficit applying PBE IPSAS 41.

(c) LT Loan—a long-term loan that forms part of the net investment in the associate and that the investor measures at amortised cost applying PBE IPSAS 41, with a stated interest rate and an effective interest rate of 5% a year. The associate makes interest-only payments to the investor each year. The LT Loan is the most senior of the three interests.

The LT Loan is not an originated credit-impaired loan. Throughout the years illustrated, there has not been any objective evidence that the net investment in the associate is impaired applying PBE IPSAS 36, nor does the LT Loan become credit-impaired applying PBE IPSAS 41.

The associate does not have any outstanding cumulative preference shares classified as equity, as described in paragraph 40 of PBE IPSAS 36. Throughout the years illustrated, the associate neither declares nor pays dividends on O Shares or P Shares.

The investor has not incurred any legal or constructive obligations, nor made payments on behalf of the associate, as described in paragraph 42 of PBE IPSAS 36. Accordingly, the investor does not recognise its share of the associate's deficits once the carrying amount of its net investment in the associate is reduced to zero.

The amount of the investor's initial investment in O Shares is CU200,* in P Shares is CU100 and in the LT Loan is CU100. On acquisition of the investment, the cost of the investment equals the investor's share of the net fair value of the associate's identifiable assets and liabilities.

This table summarises the carrying amount at the end of each year for P Shares and the LT Loan applying PBE IPSAS 41 but before applying PBE IPSAS 36, and the associate's surplus (deficit) for each year. The amounts for the LT Loan are shown net of the loss allowance.

At the end of	**P Shares applying PBE IPSAS 41 (fair value)**	**LT Loan applying PBE IPSAS 41 (amortised cost)**	**Surplus (deficit) of the associate**
Year 1	CU110	CU90	CU50
Year 2	CU90	CU70	CU(200)
Year 3	CU50	CU50	CU(500)
Year 4	CU40	CU50	CU(150)
Year 5	CU60	CU60	–
Year 6	CU80	CU70	CU500
Year 7	CU110	CU90	CU500

Analysis

Year 1

The investor recognises the following in Year 1:

Investments in the associate:

Dr O Shares	CU200	
Dr P Shares	CU100	
Dr LT Loan	CU100	
Cr Cash		CU400
To recognise the initial investment in the associate		
Dr P Shares	CU10	
Cr Surplus or deficit		CU10
To recognise the change in fair value (CU110 − CU100)		
Dr Surplus or deficit	CU10	
Cr Loss allowance (LT Loan)		CU10
To recognise an increase in the loss allowance (CU90 − CU100)		
Dr O Shares	CU20	
Cr Surplus or deficit		CU20
To recognise the investor's share of the associate's surplus (CU50 × 40%)		

At the end of Year 1, the carrying amount of O Shares is CU220, P Shares is CU110 and the LT Loan (net of loss allowance) is CU90.

Year 2

The investor recognises the following in Year 2:

Dr Surplus or deficit	CU20	
Cr P Shares		CU20
To recognise the change in fair value (CU90 − CU110)		
Dr Surplus or deficit	CU20	
Cr Loss allowance (LT Loan)		CU20
To recognise an increase in the loss allowance (CU70 – CU90)		
Dr Surplus or deficit	CU80	
Cr O Shares		CU80
To recognise the investor's share of the associate's loss (CU200 × 40%)		

At the end of Year 2, the carrying amount of O Shares is CU140, P Shares is CU90 and the LT Loan (net of loss allowance) is CU70.

Year 3

Applying paragraph 20A of PBE IPSAS 36, the investor applies PBE IPSAS 41 to P Shares and the LT Loan before it applies paragraph 41 of PBE IPSAS 41. Accordingly, the investor recognises the following in Year 3:

Dr Surplus or deficit	CU40	
Cr P Shares		CU40
To recognise the change in fair value (CU50 − CU90)		
Dr Surplus or deficit	CU20	
Cr Loss allowance (LT Loan)		CU20
To recognise an increase in the loss allowance (CU50 – CU70)		

Dr Surplus or deficit	CU200	
Cr O Shares		CU140
Cr P Shares		CU50
Cr LT Loan		CU10

To recognise the investor's share of the associate's deficit in reverse order of seniority as specified in paragraph 41 of PBE IPSAS 36 (CU500 × 40%)

At the end of Year 3, the carrying amount of O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is CU40.

Year 4

Applying PBE IPSAS 41 to its interests in the associate, the investor recognises the following in Year 4:

Dr Surplus or deficit	CU10	
Cr P Shares		CU10

To recognise the change in fair value (CU40 − CU50)

Recognition of the change in fair value of CU10 in Year 4 results in the carrying amount of P Shares being negative CU10. Consequently, the investor recognises the following to reverse a portion of the associate's deficits previously allocated to P Shares:

Dr P Shares	CU10	
Cr Surplus or deficit		CU10

To reverse a portion of the associate's deficits previously allocated to P Shares

Applying paragraph 41 of PBE IPSAS 36, the investor limits the recognition of the associate's deficits to CU40 because the carrying amount of its net investment in the associate is then zero. Accordingly, the investor recognises the following:

Dr Surplus or deficit	CU40	
Cr LT Loan		CU40

To recognise the investor's share of the associate's deficit

At the end of Year 4, the carrying amount of O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is zero. There is also an unrecognised share of the associate's deficits of CU30 (the investor's share of the associate's cumulative deficits of CU340 – CU320 deficits recognised cumulatively + CU10 deficits reversed).

Year 5

Applying PBE IPSAS 41 to its interests in the associate, the investor recognises the following in Year 5:

Dr P Shares	CU20	
Cr Surplus or deficit		CU20
To recognise the change in fair value (CU60 − CU40)		
Dr Loss allowance (LT Loan)	CU10	
Cr Surplus or deficit		CU10

To recognise a decrease in the loss allowance (CU60 – CU50)

After applying PBE IPSAS 41 to P Shares and the LT Loan, these interests have a positive carrying amount. Consequently, the investor allocates the previously unrecognised share of the associate's deficits of CU30 to these interests.

Dr Surplus or deficit	CU30	
Cr P Shares		CU20
Cr LT Loan		CU10
To recognise the previously unrecognised share of the associate's deficits		

At the end of Year 5, the carrying amount of O Shares is zero, P Shares is zero and the LT Loan (net of loss allowance) is zero.

Year 6

Applying PBE IPSAS 41 to its interests in the associate, the investor recognises the following in Year 6:

Dr P Shares	CU20	
Cr Surplus or deficit		CU20
To recognise the change in fair value (CU80 − CU60)		
Dr Loss allowance (LT Loan)	CU10	
Cr Surplus or deficit		CU10
To recognise a decrease in the loss allowance (CU70 – CU60)		

The investor allocates the associate's surplus to each interest in the order of seniority. The investor limits the amount of the associate's surplus it allocates to P Shares and the LT Loan to the amount of equity method deficits previously allocated to those interests, which in this example is CU60 for both interests.

Dr O Shares	CU80	
Dr P Shares	CU60	
Dr LT Loan	CU60	
Cr Surplus or deficit		CU200
To recognise the investor's share of the associate's surplus (CU500 × 40%)		

At the end of Year 6, the carrying amount of O Shares is CU80, P Shares is CU80 and the LT Loan (net of loss allowance) is CU70.

Year 7

The investor recognises the following in Year 7:

Dr P Shares	CU30	
Cr Surplus or deficit		CU30
To recognise the change in fair value (CU110 − CU80)		
Dr Loss allowance (LT Loan)	CU20	
Cr Surplus or deficit		CU20
To recognise a decrease in the loss allowance (CU90 – CU70)		
Dr O Shares	CU200	
Cr Surplus or deficit		CU200
To recognise the investor's share of the associate's surplus (CU500 × 40%)		

At the end of Year 7, the carrying amount of O Shares is CU280, P Shares is CU110 and the LT Loan (net of loss allowance) is CU90.

Years 1–7

When recognising interest revenue on the LT Loan in each year, the investor does not take account of any adjustments to the carrying amount of the LT Loan that arose from applying PBE IPSAS 36 (paragraph 20A of PBE IPSAS 36). Accordingly, the investor recognises the following in each year:

Dr Cash	CU5	
Cr Surplus or deficit		CU5

To recognise interest revenue on LT Loan based on the effective interest rate of 5%

Summary of amounts recognised in surplus or deficit

This table summarises the amounts recognised in the investor's surplus or deficit.

Items recognised **During**	**Impairment (losses), including reversals, applying PBE IPSAS 41**	**Gains (losses) of P Shares applying PBE IPSAS 41**	**Share of surplus (deficit) of the associate recognised applying the equity method**	**Interest revenue applying PBE IPSAS 41**
Year 1	CU(10)	CU10	CU20	CU5
Year 2	CU(20)	CU(20)	CU(80)	CU5
Year 3	CU(20)	CU(40)	CU(200)	CU5
Year 4	–	CU(10)	CU(30)	CU5
Year 5	CU10	CU20	CU(30)	CU5
Year 6	CU10	CU20	CU200	CU5
Year 7	CU20	CU30	CU200	CU5

* In this Illustrative Example, currency amounts are denominated in currency units (CU).

PBE IPSAS 37 *Joint Arrangements*

Paragraphs 28, 30, 41 and 43.1 are amended. Paragraph 43.4 is added. New text is underlined and deleted text is struck through.

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 PBE Standards dealing with financial instruments, being PBE IPSAS 28 *Financial Instruments: Presentation,* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and~~ PBE IPSAS 30 *Financial Instruments: Disclosures* <u>and PBE IPSAS 41 *Financial Instruments*</u> unless it has significant influence over the joint venture, in which case it shall account for it in accordance with PBE IPSAS 36.**

…

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 ~~PBE IPSAS 29~~ <u>PBE IPSAS 41</u>, unless the entity has significant influence over the joint venture, in which case it shall apply paragraph 12 of PBE IPSAS 34.**

…

41. **An entity that, in accordance with paragraph 58 of PBE 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 ~~PBE IPSAS 29~~ <u>PBE IPSAS 41</u> shall:**

    (a) **Derecognise the investment and recognise 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 derecognised, and the assets and liabilities recognised, together with any remaining difference adjusted in accumulated surplus or deficit, at the beginning of the immediately preceding period.**

…

43.1 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 28, 30, 41, AG11 and AG33.1. An entity shall apply those amendments when it applies PBE IFRS 9.*~~.~~**

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

43.4 **PBE IPSAS 41, issued in [date], amended paragraphs 28, 30, 41, 43.1, AG11 and AG33.1 (and renumbered AG33.1 as AG31.A). An entity shall apply those amendments when it applies PBE IPSAS 41.**

Paragraphs AG11 and AG33.1 are amended. Paragraph AG33.1 is renumbered as AG31.A.
New text is underlined and deleted text is struck through.

AG11. When an arrangement is outside the scope of PBE IPSAS 37 *Joint Arrangements*, an entity accounts for its interest in the arrangement in accordance with relevant PBE Standards, such as PBE IPSAS 35, PBE IPSAS 36 *Investments in Associates and Joint Ventures* or PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~.

…

AG33~~.1~~A When an entity acquires an interest in a joint operation ….:

(a) …

(b) Recognising 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 recognised in accordance with PBE IPSAS 28 and PBE IPSAS 41 ~~PBE IPSAS 29~~;

(c) …

PBE IPSAS 38 *Disclosure of Interests in Other Entities*

Paragraphs 4 and 61.2 are amended. Paragraph 61.5 is added. New text is underlined and deleted text is struck through.

4. **This Standard does not apply to:**

(a) …

…

(d) **An interest in another entity that is accounted for in accordance with PBE IPSAS 41 *Financial Instruments* ~~PBE 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 PBE 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.**

…

61.2 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 4. An entity shall apply those amendments when it applies PBE IFRS 9.*~~.~~**

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

61.5 **PBE IPSAS 41, issued in [date], amended paragraphs 4 and 61.2. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IFRS 3 *Business Combinations*

Paragraphs 16, 42, 53, 56, 58 and 64.5 are amended. Paragraph 64.8 is added. New text is underlined and deleted text is struck through.

16. In some situations, PBE Standards 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 ~~a financial asset or liability~~ at fair value through surplus or deficit or at amortised cost, or as a financial asset measured at fair value through other comprehensive revenue and expense ~~available for sale or held to maturity~~, in accordance with PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~;

    (b) Designation of a derivative instrument as a hedging instrument in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~; and

    (c) Assessment of whether an embedded derivative should be separated from ~~the~~a host contract in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~ (which is a matter of 'classification' as this Standard uses that term).

…

42. In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in surplus or deficit or other comprehensive revenue and expense, as appropriate. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive revenue and expense ~~(for example, because the investment was classified as available for sale)~~. If so, the amount that was recognised in other comprehensive revenue and expense shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

…

53. Acquisition-related costs are costs the acquirer incurs to effect a business combination. 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 recognised in accordance with PBE IPSAS 28 and PBE IPSAS 41 ~~PBE IPSAS 29~~.

…

56. After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:

    (a) The amount that would be recognised in accordance with PBE IPSAS 19; and

    (b) The amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with PBE IPSAS 9 *Revenue from Exchange Transactions*.

    This requirement does not apply to contracts accounted for in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~.

…

58. Some changes in the fair value of contingent consideration that the acquirer recognises 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 45–49. 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) …

(b) Other contingent consideration that:

(i) Is within the scope of PBE IPSAS 41 ~~PBE IPSAS 29~~ shall be measured at fair value at each reporting date, and changes in fair value shall be recognised in surplus or deficit in accordance with PBE IPSAS 41 ~~that PBE Standard~~.

(ii) Is not within the scope of PBE IPSAS 41 ~~PBE IPSAS 29~~ shall be measured at fair value at each reporting date and changes in fair value shall be recognised in surplus or deficit.

…

64.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 16, 42, 53, 56, 58 and B41. An entity shall apply those amendments when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

64.8 **PBE IPSAS 41, issued in [date], amended paragraphs 16, 42, 53, 56, 58, 64.5 and B41. An entity shall apply those amendments when it applies PBE IPSAS 41.**

In Appendix B, paragraph B41 is amended. New text is underlined.

B41. The acquirer shall not recognise a separate valuation allowance as of the acquisition date for assets acquired in a business combination 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 Standard requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values in accounting for a business combination, the acquirer does not recognise a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date or a loss allowance for expected credit losses.

Forthcoming PBE IPSAS 40

Note: NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3 *Business Combinations*. The amendments that would be required to PBE IPSAS 40, if PBE IPSAS 40 were to be issued before PBE IPSAS 41, are set out below.

Paragraphs 25, 45, 70, 98, 111, 115 and 117 are amended. Paragraph 126.2 is added. New text is underlined and deleted text is struck through.

25. In some situations, PBE Standards 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 amortised cost, or as a financial asset measured at fair value through other comprehensive revenue and expense in accordance with PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~;*

(b) Designation of a derivative instrument as a hedging instrument in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~; and

(c) Assessment of whether an embedded derivative should be separated from a host contract in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~ (which is a matter of 'classification' as this Standard uses that term).

* If an entity applies this Standard and early adopts PBE IFRS 9 *Financial Instruments*, the references to PBE IPSAS 41~~29~~ in this paragraph shall be read as references to PBE IFRS 9, including the classification of financial assets and financial liabilities in accordance with PBE IFRS 9.

…

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 recognised in accordance with PBE IPSAS 28 *Financial Instruments: Presentation*, and PBE IPSAS 41 ~~PBE IPSAS 29~~.*

* If an entity applies this Standard and early adopts PBE IFRS 9 *Financial Instruments*, the references to PBE IPSAS 41~~29~~ in this paragraph shall be read as references to PBE IFRS 9.

…

70. In some situations, PBE Standards 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 through surplus or deficit or at amortised cost, or as a financial asset measured at fair value through other comprehensive revenue and expense in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~;*

(b) Designation of a derivative instrument as a hedging instrument in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~; and

(c) Assessment of whether an embedded derivative should be separated from a host contract in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~ (which is a matter of ‘classification’ as this Standard uses that term).

* If an entity applies this Standard and early adopts PBE IFRS 9 *Financial Instruments*, the references to PBE IPSAS 41~~29~~ in this paragraph shall be read as references to PBE IFRS 9.

…

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 recognised in accordance with PBE IPSAS 28 and PBE IPSAS 41 ~~PBE IPSAS 29~~.*

* If an entity applies this Standard and early adopts PBE IFRS 9 *Financial Instruments*, the references to PBE IPSAS 41~~29~~ in this paragraph shall be read as references to PBE IFRS 9.

…

115. After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in an acquisition at the higher of:

(a) The amount that would be recognised in accordance with PBE IPSAS 19; and

(b) The amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with PBE IPSAS 9 *Revenue from Exchange Transactions*.

(c) This requirement does not apply to contracts accounted for in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~.*

* If an entity applies this Standard and early adopts PBE IFRS 9 *Financial Instruments*, the references to PBE IPSAS 41~~29~~ in this paragraph shall be read as references to PBE IFRS 9.

…

Contingent Consideration

117. Some changes in the fair value of contingent consideration that the acquirer recognises 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 103–107. 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 PBE IPSAS 41 ~~PBE IPSAS 29~~* shall be measured at fair value at each reporting date and changes in fair value shall be recognised in surplus or deficit in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~.

(ii) Is not within the scope of PBE IPSAS 41 ~~PBE IPSAS 29~~shall be measured at fair value at each reporting date and changes in fair value shall be recognised in surplus or deficit.

* If an entity applies this Standard and early adopts PBE IFRS 9 *Financial Instruments*, the references to PBE IPSAS 41~~29~~ in this paragraph shall be read as references to PBE IFRS 9.

…

126.2 **PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraphs 25, 45, 70, 98, 111, 115 and 117. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Paragraphs 5 and 44.5 are amended. Paragraph 44.9 is added. New text is underlined and deleted text is struck through.

5. The measurement provisions of this Standard [footnote omitted] do not apply to the following assets, which are covered by the Standards listed, either as individual assets or as part of a disposal group:

(a) ...

(c) Financial assets within the scope of PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~.

(d) ...

…

44.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 5. An entity shall apply that amendment when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

44.9 **PBE IPSAS 41, issued in [date], amended paragraphs 5 and 44.5. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE IAS 12 *Income Taxes*

Paragraphs 20 and 98.5 are amended. Paragraph 98.9 is added. New text is underlined and deleted text is struck through.

20. PBE Standards permit or require certain assets to be carried at fair value or to be revalued (see, for example, PBE IPSAS 17 *Property, Plant and Equipment*, PBE IPSAS 31 *Intangible Assets*, ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and~~ PBE IPSAS 16 *Investment Property* and PBE IPSAS 41 *Financial Instruments*). The revaluation or other restatement of an asset used in a taxable activity to fair value affects taxable profit (tax loss) for the current period. As a result, the tax base of the asset is adjusted and no temporary difference arises. In other jurisdictions, the revaluation or restatement of an asset does not affect taxable profit in the period of the revaluation or

restatement and, consequently, the tax base of the asset is not adjusted. Nevertheless, the future recovery of the carrying amount will result in a taxable flow of economic benefits to the entity and the amount that will be deductible for tax purposes will differ from the amount of those economic benefits. The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset. This is true even if:

…

98.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 20. An entity shall apply that amendment when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

98.9 **PBE IPSAS 41, issued in [date], amended paragraphs 20 and 98.5. An entity shall apply that amendment when it applies PBE IPSAS 41.**

PBE IAS 34 *Interim Financial Reporting*

Paragraphs 28.1 and 49.8 are amended. Paragraph 49.12 is added. New text is underlined and deleted text is struck through.

28.1 **Application of paragraph 28 means that an entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill ~~or an investment in either an equity instrument or a financial asset carried at cost~~. An entity shall not extend this requirement by analogy to other areas of potential conflict between PBE IAS 34 and other PBE Standards.**

…

49.8 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraph 28.1. An entity shall apply that amendment when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

49.12 **PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraphs 28.1 and 49.8. An entity shall apply those amendments when it applies PBE IPSAS 41.***

PBE FRS 45 *Service Concession Arrangements: Operator*

Paragraphs 21–23 and 30.1 are amended. Paragraph 30.2 is added. New text is underlined and deleted text is struck through.

21. PBE IPSAS 28 *Financial Instruments: Presentation,* ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and~~ PBE IPSAS 30 *Financial Instruments: Disclosures* and PBE IPSAS 41 *Financial Instruments* apply to the financial asset recognised under paragraphs 14 and 16.

22. The amount due from or at the direction of the grantor is accounted for in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~ as measured at:

    (a) Amortised cost ~~A loan or receivable~~;

    (b) Fair value through other comprehensive revenue and expense ~~An available-for-sale financial asset~~; or

    (c) Fair value through surplus or deficit ~~If so designated upon initial recognition, a financial asset at fair value through surplus or deficit, if the conditions for that classification are met~~.

23. If the amount due from the grantor is measured at amortised cost or fair value through other comprehensive revenue and expense ~~accounted for either as a loan or receivable or as an available-for-sale financial asset~~, PBE IPSAS 41 ~~PBE IPSAS 29~~ requires interest calculated using the effective interest method to be recognised in surplus or deficit.

…

30.1 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 21–23. An entity shall apply those amendments when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

30.2 **PBE IPSAS 41, issued in [date], amended paragraphs 21–23 and 30.1. An entity shall apply those amendments when it applies PBE IPSAS 41.**

PBE FRS 47 *First-time Adoption of PBE Standards by Entities Other Than Those Previously Applying NZ IFRS*

Paragraphs 36 and 42.5 are amended. Paragraphs 36A, RDR 36.1 and 42.9 are added. New text is underlined and deleted text is struck through.

Designation of Financial Assets or Financial Liabilities

~~*~~36. **An entity is permitted to designate a previously recognised financial asset ~~or financial liability~~ as a financial asset ~~or financial liability~~ measured at fair value through surplus or deficit ~~or a financial asset as available for sale~~ in accordance with paragraph C16A. The entity shall disclose the fair value of financial assets ~~or financial liabilities~~ so designated ~~into each category~~ at the date of designation and their classification and carrying amount in the previous financial statements.**

36A. **An entity is permitted to designate a previously recognised financial liability as a financial liability at fair value measured through surplus or deficit in accordance with paragraph C16. The entity shall disclose the fair value of financial liabilities so designated at the date of designation and their classification and carrying amount in the previous financial statements.**

RDR36.1 **A Tier 2 entity is not required to make the disclosure required by paragraphs 36 and 36A.**

…

42.5 **PBE IFRS 9 *Financial Instruments*, issued in January 2017, amended paragraphs 36, A1–A6, C1, C11, C12, C16 and C17, and added paragraphs 36A, A8–A8G, A9, C16A–C16C, C32, E1 and E2. An entity shall apply those amendments when it applies PBE IFRS 9.***

* PBE IFRS 9 was subsequently withdrawn by PBE IPSAS 41. The amendments in Appendix D of PBE IFRS 9 were not compiled.

…

42.9 **PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraphs 36, 42.5, A1–A6, C1, C11, C12, C16 and C17, and added paragraphs 36A, RDR36.1, A8–A8G, A9, C16A–C16C, C32, and E1 and E2. An entity shall apply those amendments when it applies PBE IPSAS 41.**

In Appendix A, paragraphs A1–A6 are amended. Paragraphs A8–A8G and A9 and related headings are added. New text is underlined and deleted text is struck through.

A1. An entity shall apply the following exceptions:

(a) Derecognition of financial assets and financial liabilities (paragraphs A2 and A3); ~~and~~

(b) Hedge accounting (paragraphs A4–A6);~~.~~

(c) Non-controlling interests (paragraph A7);

(d) Classification and measurement of financial assets (paragraphs A8–A8C);

(e) Impairment of financial assets (paragraphs A8D–A8G);

(f) Embedded derivatives (paragraph A9);

(g) Insurance contracts (paragraph A10);

…

Derecognition of Financial Assets and Financial Liabilities

A2. Except as permitted by paragraph A3, a first-time adopter shall apply the derecognition requirements in <u>PBE IPSAS 41 *Financial Instruments*</u> ~~PBE IPSAS 29 *Financial Instruments: Recognition and Measurement*~~ prospectively for transactions occurring on or after the date of transition to PBE Standards. For example, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before the date of transition to PBE Standards, it shall not recognise those assets and liabilities in accordance with PBE Standards (unless they qualify for recognition as a result of a later transaction or event).

A3. <u>Despite</u> ~~Notwithstanding~~ paragraph A2, an entity may apply the derecognition requirements in <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~ retrospectively from a date of the entity's choosing, provided that the information needed to apply <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~ to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Hedge Accounting

A4. As required by <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~, at the date of transition to PBE Standards, an entity shall:

(a) Measure all derivatives at fair value; and

(b) Eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.

A5. An entity shall not reflect in its opening statement of financial position under PBE Standards a hedging relationship of a type that does not qualify for hedge accounting in accordance with <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~ (for example, <u>many hedging relationships where the hedging instrument is a stand-alone written option or a net written option; or where the hedged item is a net position in a cash flow hedge for another risk than foreign currency risk</u> ~~many hedging relationships where the hedging instrument is a cash instrument or written option; or where the hedged instrument is a net position~~). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate <u>as a hedged item in accordance with PBE Standards an individual item within that net position, or a net position if that meets the requirements in paragraph 146 of PBE IPSAS 41</u>, ~~an individual item within that net position as a hedged item in accordance with PBE Standards~~, provided that it does so no later than the date of transition to PBE Standards.

A6. If, before the date of transition to PBE Standards, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in <u>PBE IPSAS 41</u> ~~PBE IPSAS 29~~, the entity shall apply paragraphs <u>135</u>~~102~~ and <u>136</u>~~112~~ of <u>PBE IPSAS 41</u>~~PBE IPSAS 29~~ to discontinue hedge accounting. Transactions entered into before the date of transition to PBE Standards shall not be retrospectively designated as hedges.

<u>**Classification and Measurement of Financial Instruments**</u>

<u>A8. An entity shall assess whether a financial asset meets the conditions in paragraph 40 of PBE IPSAS 41 or the conditions in paragraph 41 of PBE IPSAS 41 on the basis of the facts and circumstances that exist at the date of transition to PBE Standards.</u>

<u>A8A. If it is impracticable to assess a modified time value of money element in accordance with paragraphs AG68–AG70 of PBE IPSAS 41 on the basis of the facts and circumstances that exist at the date of transition to PBE Standards, 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 transition to PBE Standards without taking into account the requirements related to the modification of the time value of money element in paragraphs AG68–AG70 of PBE IPSAS 41. (In this case, the entity shall also apply paragraph 49R of PBE IPSAS 30 but references to 'paragraph 160 of PBE IPSAS 41' 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 transition to PBE Standards'.)</u>

<u>A8B. If it is impracticable to assess whether the fair value of a prepayment feature is insignificant in accordance with paragraph AG74 of PBE IPSAS 41 on the basis of the facts and circumstances that exist at the date of transition to PBE Standards, 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 transition to PBE Standards without taking into account the exception for prepayment features in paragraph AG74 of PBE IPSAS 41. (In this case, the entity shall also apply paragraph 49S of PBE IPSAS 30 but references</u>

to 'paragraph 161 of PBE IPSAS 41' 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 transition to PBE Standards'.)

A8C. If it is impracticable (as defined in PBE IPSAS 3) for an entity to apply retrospectively the effective interest method in PBE IPSAS 41, the fair value of the financial asset or the financial liability at the date of transition to PBE Standards shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to PBE Standards.

Impairment of Financial Assets

A8D. An entity shall apply the impairment requirements in paragraphs 57–112 of PBE IPSAS 41 retrospectively subject to paragraphs A8E–A8G and E1–E2.

A8E. At the date of transition to PBE Standards, 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 financial instruments were initially recognised (or for loan commitments and financial guarantee contracts the date that the entity became a party to the irrevocable commitment in accordance with paragraph 78 of PBE IPSAS 41) and compare that to the credit risk at the date of transition to PBE Standards (also see paragraphs AG350–AG351 of PBE IPSAS 41).

A8F. When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:

(a) The requirements in paragraph 82 and AG186–AG188 of PBE IPSAS 41; and

(b) The rebuttable presumption in paragraph 83 of PBE IPSAS 41 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.

A8G. If, at the date of transition to PBE Standards, 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 recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial instrument is low credit risk at a reporting date, in which case paragraph A8F(a) applies).

Embedded Derivatives

A9. 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 PBE IPSAS 41.

In Appendix C, paragraphs C1, C11, C12, C16 and C17 are amended and paragraphs C16A–C16C and, after paragraph C31, a heading and paragraph C32 are added. New text is underlined and deleted text is struck through.

C1. An entity may elect to use one or more of the following exemptions:

(a) …

(h) Designation of previously recognised financial instruments (paragraphs C16–C16C);

(i) …

(s) Designation of contracts to buy or sell a non-financial item (paragraph C32).

An entity shall not apply these exemptions by analogy to other items.

…

C11. When an entity prepares separate financial statements, PBE IPSAS 34 *Separate Financial Statements* requires it to account for its investments in controlled entities, joint ventures and associates either:

(a) Using the equity method as described in PBE IPSAS 36;

(b) At cost; or

(c) As a financial instrument in accordance with PBE IPSAS 41 *Financial Instruments* ~~PBE IPSAS 29~~.

C12. If a first-time adopter measures such an investment at cost in accordance with PBE IPSAS 34~~35~~, it shall measure that investment at one of the following amounts in its separate opening statement of financial position under PBE Standards:

(a) Cost determined in accordance with PBE IPSAS 34~~35~~; or

(b) Deemed cost. The deemed cost of such an investment shall be its:

(i) Fair value (determined in accordance with PBE IPSAS 41 ~~PBE IPSAS 29~~) at the entity's date of transition to PBE Standards in its separate financial statements; or

(ii) Previous GAAP carrying amount at that date.

A first-time adopter may choose either (i) or (ii) above to measure its investment in each controlled entity, joint venture or associate that it elects to measure using a deemed cost.

Designation of Previously Recognised Financial Instruments

C16. PBE IPSAS 41 ~~PBE IPSAS 29~~ permits a financial liability (provided it meets certain criteria) ~~asset~~ to be designated as a financial liability at fair value through surplus or deficit. Despite this requirement an entity is permitted to designate, at the date of transition to PBE Standards, any financial liability as at fair value through surplus or deficit provided the liability meets the criteria in paragraph 46 of PBE IPSAS 41 at that date. ~~on initial recognition as available-for-sale or a financial instrument (provided 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) An entity is permitted to make an available-for-sale designation at the date of transition to PBE Standards.~~

~~(b) An entity is permitted to designate, at the date of transition to PBE Standards, any financial asset or financial liability as at fair value through surplus or deficit provided the asset or liability meets the criteria in paragraphs 10 or 13 of PBE IPSAS 29 at that date.~~

C16A. An entity may designate a financial asset as measured at fair value through surplus or deficit in accordance with paragraph 44 of PBE IPSAS 41 on the basis of the facts and circumstances that exist at the date of transition to PBE Standards.

C16B. An entity may designate an investment in an equity instrument as at fair value through other comprehensive revenue and expense in accordance with paragraph 106 of PBE IPSAS 41 on the basis of the facts and circumstances that exist at the date of transition to PBE Standards.

C16C. For a financial liability that is designated as a financial liability at fair value through surplus or deficit, an entity shall determine whether the treatment in paragraph 108 of PBE IPSAS 41 would create an accounting mismatch in surplus or deficit on the basis of the facts and circumstances that exist at the date of transition to PBE Standards.

Fair Value Measurement of Financial Assets or Financial Liabilities at Initial Recognition

C17. Despite ~~Notwithstanding~~ the requirements of paragraphs 11~~7~~ and 13~~9~~, an entity may apply the requirements in ~~the last sentence of~~ paragraph AG117(b)~~AG108 and in paragraph AG109~~ of PBE IPSAS 41~~PBE IPSAS 29~~ prospectively to transactions entered into on or after the date of transition to PBE Standards.

Designation of Contracts to Buy or Sell a Non-financial Item

C32. PBE IPSAS 41 permits some contracts to buy or sell a non-financial item to be designated at inception as measured at fair value through surplus or deficit (see paragraph 6 of PBE IPSAS 41). Despite this requirement an entity is permitted to designate, at the date of transition to PBE Standards, contracts that already exist on that date as measured at fair value through surplus or deficit but only if they meet the requirements of paragraph 6 of PBE IPSAS 41 at that date and the entity designates all similar contracts.

Appendix E is added. In Appendix E, a heading and paragraphs E1 and E2 are added. New text is underlined.

Appendix E

Short-term exemptions from PBE Standards

E1. If an entity's first PBE Standards reporting period begins before 1 January 2023 and the entity applies PBE IPSAS 41 *Financial Instruments*, the comparative information in the entity's first set of financial statements under PBE Standards need not comply with PBE IPSAS 30 *Financial Instruments:*

Disclosures or PBE IPSAS 41, to the extent that the disclosures required by PBE IPSAS 30 relate to items within the scope of PBE IPSAS 41. For such entities, references to the 'date of transition to PBE Standards' shall mean, in the case of PBE IPSAS 30 and PBE IPSAS 41 only, the beginning of the first reporting period under PBE Standards.

E2. An entity that chooses to present comparative information that does not comply with PBE IPSAS 30 and PBE IPSAS 41 in its first year of transition shall:

(a) Apply the requirements of its previous GAAP in place of the requirements of PBE IPSAS 41 to comparative information about items within the scope of PBE IPSAS 41.

(b) Disclose this fact together with the basis used to prepare this information.

(c) Treat any adjustment between the statement of financial position at the comparative period's reporting date (i.e., the statement of financial position that includes comparative information under previous GAAP) and the statement of financial position at the start of the first reporting period under PBE Standards (i.e., the first period that includes information that complies with PBE IPSAS 30 and PBE IPSAS 41 as arising from a change in accounting policy and give the disclosures required by paragraph 33(a)–(e) and (f) of PBE IPSAS 3. Paragraph 33(f) applies only to amounts presented in the statement of financial position at the comparative period's reporting date.

(d) Apply paragraph 29(c) of PBE IPSAS 1 to provide additional disclosures when compliance with the specific requirements in PBE Standards is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

XRB A1 Application of the Accounting Standards Framework

Appendix C is amended. New text is underlined. Deleted text is struck through.

Accounting Standards

…

PBE IFRS 9 *Financial Instruments* (superseded on adoption of PBE IPSAS 41)

…

PBE IPSAS 41 *Financial Instruments*

PBE SFR–A (NFP) *Public Benefit Entity Simple Format Reporting–Accrual (Not-For-Profit)*

Paragraph 7 is amended and paragraph 15 is added. New text is underlined and deleted text is struck through.

7. An entity that is eligible to apply this Standard, and elects to do so, may elect to apply the requirements of a PBE Standard that is part of the Tier 2 PBE Accounting Requirements to a specific type of transaction, as long as it applies that option to all transactions of that type. For example, an entity may decide to opt up to PBE IPSAS 17 *Property, Plant and Equipment* for a class of assets, such as buildings, so that it can revalue that class of assets, or an entity may decide to opt up to the financial instruments standards (PBE IPSAS 28 *Financial Instruments: Presentation*, PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* (in limited circumstances), ~~(or PBE IFRS 9 *Financial Instruments*)~~ PBE IPSAS 41 *Financial Instruments* and PBE IPSAS 30 *Financial Instruments: Disclosures*) for a class* of financial instruments, such as investments in shares, so that it can measure that class of financial instruments at fair value (in which case it must apply the whole standard to that class).

* [Footnote not shown]

Effective Date

…

15. PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraph 7. An entity shall apply those amendments if and when it applies PBE IPSAS 41.

PBE SFR–A (PS) *Public Benefit Entity Simple Format Reporting –Accrual (Public Sector)*

Paragraph 7 is amended and paragraph 15 is added. New text is underlined and deleted text is struck through.

7. An entity that is eligible to apply this Standard, and elects to do so, may elect to apply the requirements of a PBE Standard that is part of the Tier 2 PBE Accounting Requirements to a specific type of transaction, as long as it applies that option to all transactions of that type. For example, an entity may decide to opt up to PBE IPSAS 17 *Property, Plant and Equipment* for a class of assets, such as buildings, so that it can revalue that class of assets, or an entity may decide to opt up to the financial instruments standards (PBE IPSAS 28 *Financial Instruments: Presentation*, PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* (in limited circumstances), (~~or PBE IFRS 9 *Financial Instruments*)~~ PBE IPSAS 41 *Financial Instruments* and PBE IPSAS 30 *Financial Instruments: Disclosures*) for a class* of financial instruments, such as investments in shares, so that it can measure that class of financial instruments at fair value (in which case it must apply the whole standard to that class).

* [Footnote not shown]

Effective Date

…

15. PBE IPSAS 41 *Financial Instruments*, issued in [date], amended paragraph 7. An entity shall apply those amendments if and when it applies PBE IPSAS 41.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, PBE IPSAS 41.

Background to the Development of IPSAS 41

BC1. In 2010 the International Public Sector Accounting Standards Board (IPSASB) issued three new standards dealing with financial instruments. These standards substantially aligned the requirements for financial instruments in IPSAS with the requirements in IFRS Standards. Even as the IPSASB issued its 2010 standards it was aware that the IASB was already in the process of updating requirements for the recognition and measurement of financial instruments. The IPSASB was also aware that the completion of IFRS 9 *Financial Instruments* could take a number of years. It therefore decided to monitor the IASB's project to develop IFRS 9, with the intention of initiating a project to develop a standard based on IFRS 9, once IFRS 9 had been completed.

BC2. The IASB issued the final version of IFRS 9 in July 2014. IFRS 9 introduced 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 a new impairment model for financial assets. IFRS 9 was effective for annual periods beginning on or after 1 January 2018.

BC3. The IPSASB began work on a project to update its financial instrument standards in 2016 and issued IPSAS 41 *Financial Instruments* in August 2018. IPSAS 41 is substantially converged with IFRS 9. It supersedes most of the requirements in IPSAS 29 *Financial Instruments: Recognition and Measurement*. Consistent with the fact that IFRS 9 permitted entities to continue applying the hedge accounting requirements in IAS 39 *Financial Instruments Recognition and Measurement*, IPSAS 41 permitted entities to continue applying the hedge accounting requirements in IPSAS 29.

PBE IFRS 9 – An Interim Standard

BC4. In 2016 the NZASB noted that, pending the development and completion of IPSAS 41, for-profit entities applying *NZ IFRS 9 Financial Instruments* and PBEs applying PBE IPSAS 29 would be subject to different requirements. These differences were expected to have a significant impact on mixed groups with requirements to report in accordance with standards issued by the XRB.

BC5. The NZASB considered whether to wait for the IPSASB to develop a new standard based on IFRS 9 or whether to develop an interim PBE Standard based on IFRS 9 for application by PBEs. In considering these options the NZASB had regard to the *Policy Approach to Developing the Suite of PBE Standards* (*PBE Policy Approach*) and sought feedback from constituents. After careful consideration (as documented in the Basis for Conclusions on PBE IFRS 9), the NZASB decided to develop an interim PBE Standard based on IFRS 9. The NZASB issued PBE IFRS 9 *Financial Instruments* in January 2017. PBE IFRS 9 was available for early adoption but had an extended effective date (1 January 2021) in order to allow time for the IPSASB to develop a standard based on IFRS 9.[15]

BC6. PBE IFRS 9 was developed as a limited scope project. It was intended to meet the most pressing issues that mixed groups would encounter when NZ IFRS 9 became effective. In order to minimise differences between PBE IFRS 9 and a future IPSAS the NZASB:

(a) incorporated the modifications that the IPSASB made when developing IPSAS 29 in PBE IFRS 9; and

(b) limited the scope of the project to the updated recognition and measurement requirements in IFRS 9. The project did not address other updated requirements (such as the more recent offsetting requirements in NZ IFRS), preferring instead to wait for the IPSASB to consider these matters.

Decision to develop PBE IPSAS 41

BC7. Following the issue of IPSAS 41 in 2018 the NZASB proposed to develop a PBE Standard based on IPSAS 41 and to withdraw PBE IFRS 9. The NZASB noted that this would be in accordance with New Zealand's Accounting Standards Framework and would:

[15] The NZASB subsequently proposed to defer this effective date to 1 January 2022 so that PBE IFRS 9 did not become mandatorily effective before PBE IPSAS 41. See NZASB ED 2018-6 *Effective Date of PBE IFRS 9*.

(a) substantially align the requirements in PBE Standards with the most recent IPSAS;

(b) substantially align the requirements in PBE Standards with the equivalent requirements in NZ IFRS and minimise mixed group issues; and

(c) allow entities to adopt updated hedge accounting requirements that align more closely with an entity's risk management practices and that can be applied more broadly than the hedge accounting requirements in PBE IPSAS 29.

BC8. The NZASB considered that the requirements of IPSAS 41 were generally appropriate for application by public benefit entities and followed its usual processes in modifying IPSAS 41 for application by Tier 1 and Tier 2 public benefit entities. Most of the changes made to IPSAS 41 were to ensure coherence within the suite of PBE Standards (in terms of aligning terminology and requirements with other PBE Standards). In the case of disclosure requirements added to PBE IPSAS 30 *Financial Instruments: Disclosures* as a result of this project the NZASB identified disclosure concessions for Tier 2 entities and aligned these with the disclosure concessions in NZ IFRS 7 *Financial Instruments: Disclosures.* The NZASB issued ED 2018-5 in November 2018 with comments due by 28 February 2019.

BC9. The specific modifications considered or made by the NZASB in developing PBE IPSAS 41 are outlined below.

Dividend and interest revenue

BC10. Consistent with IFRS 9, IPSAS 41 includes requirements in relation to dividend and interest revenue. However, Appendix D of IPSAS 41 did not remove the previous requirements for dividend and interest revenue from IPSAS 9 *Revenue from Exchange Transactions*. When it issued PBE IPSAS 41 the NZASB removed the dividend and interest requirements from PBE IPSAS 9 *Revenue from Exchange Transactions*, in anticipation of the IPSASB making equivalent amendments to IPSAS 9 at a future date.

Transition from PBE IFRS 9

BC11. Because the majority of the requirements in the proposed PBE IPSAS 41 are identical or almost identical to the requirements in PBE IFRS 9, the NZASB included transitional provisions to minimise the amount of effort required to transition between the two standards. The NZASB proposed that entities that had previously applied PBE IFRS 9:

(a) continue to classify, recognise and measure financial instruments in the same way – except as expressly permitted by PBE IPSAS 41;

(b) apply specific transition provisions in respect of the revised requirements such as to the designation of financial instruments with prepayment features that give rise to negative compensation;

(c) have the option of picking up the new hedge accounting requirements in PBE IPSAS 41 on adoption of PBE IPSAS 41, even if they did not pick up the new hedge accounting requirements on adoption of PBE IFRS 9. However, any entities already applying the new hedge accounting requirements in PBE IFRS 9 would be required to apply the hedge accounting requirements in PBE IPSAS 41 (using the same designations and hedge accounting relationships at the point of transition); and

(d) apply most of the revised disclosure requirements in PBE IPSAS 30 *Financial Instruments: Disclosures* retrospectively.

ILLUSTRATIVE EXAMPLES

CONTENTS

Illustrative Examples

These examples accompany, but are not part of, PBE IPSAS 41.

Note: PBE IFRS 9 did not include illustrative examples or guidance. Examples 1–18 are marked-up from the illustrative examples that accompany IFRS 9. Examples 19–33 are marked-up from the equivalent illustrative examples in IPSAS 41. Some of these examples were originally in IPSAS 29/PBE IPSAS 29.

Financial Liabilities at Fair Value Through Surplus or Deficit~~Profit or Loss~~

IE1 The following example illustrates the calculation that an entity might perform in accordance with paragraph AG241~~B5.7.18~~ of PBE IPSAS 41~~IFRS 9~~.

IE2 On ~~1~~ January 1, 20X1 an entity issues a 10-year bond with a par value of CU150,000[16] 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:

(a) LIBOR has decreased to 4.75 per cent.

(b) The fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.[17]

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:

[paragraph AG241~~B5.7.18~~(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.	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. 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.
[paragraph AG241(b)~~B5.7.18(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 accordance with paragraph AG241~~B5.7.18~~(a).	The contractual cash flows of the instrument at the end of the period are: • Interest: CU12,000[(a)] per year for each of years 2-10. • Principal: CU150,000 in year 10. 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. This gives a present value of CU152,367.[(b)]

16 In this guidance monetary amounts are denominated in 'currency units' (CU).

17 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 AG241~~B5.7.18~~(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 AG241~~B5.7.18~~(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 other comprehensive income in accordance with paragraph 108~~5.7.7~~(a).	The market price of the liability at the end of the period is CU153,811.(c) Thus, the entity presents CU1,444 in other comprehensive income, 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 × 8% = CU12,000.
(b) PV = [CU12,000 × (1 – (1 + 0.0775)$^{-9}$)/0.0775] + CU150,000 × (1 + 0.0775)$^{-9}$.
(c) market price = [CU12,000 × (1 – (1 + 0.076)$^{-9}$)/0.076] + CU150,000 × (1 + 0.076)$^{-9}$.

Impairment (Paragraphs 73–93~~Section 5.5~~)

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 recognised 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 tranches.[18] Company Y qualifies for assistance from the National Development Bank~~ X~~ which provides a tranche of the~~that~~ loan facility to Company Y. At the time of origination of the loan by the National Development Bank~~ X~~, 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~~ X~~ 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~~Appendix A~~ of PBE IPSAS 41~~IFRS 9~~.

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 materialised. 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 close to breaching its covenants on the senior secured loan facility with the National Development Bank~~ X~~.

IE10 The National Development Bank~~ X~~ 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~~ X~~'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.

[18] The security on the loan affects the loss that would be realised 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 75~~5.5.3~~ of PBE IPSAS 41~~IFRS 9~~.

(c) The National Development Bank~~ X~~’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~~ X~~ 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~~ X~~ determines that there has been a significant increase in credit risk since initial recognition of the loan in accordance with paragraph 75~~ 5.5.3~~ of PBE IPSAS 41~~IFRS 9~~. Consequently, the National Development Bank~~ X~~ recognises lifetime expected credit losses on its senior secured loan to Company Y. Even if the National Development Bank~~ X~~ 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~~Bank~~ 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 analyse 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 ~~Bank~~ 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~~Bank~~ B, Company C’s leverage was in line with that of other borrowers~~customers~~ 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 ~~Bank~~ B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its loans. State Government~~Bank~~ 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 ~~Bank~~ 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~~Bank~~ 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 ~~Appendix A~~ of PBE IPSAS 41~~IFRS 9~~.

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 ~~Bank~~ B determines, in accordance with paragraph 75~~5.5.3~~ of PBE IPSAS 41~~IFRS 9~~, 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 ~~Bank~~ 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 ~~Bank~~ 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 ~~Bank~~ 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 ~~Bank~~ B does not recognise 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 Collateralised Financial Asset

IE18 Company H owns land~~real estate assets~~ which is~~are~~ financed by a five-year loan from the State-owned Agricultural Bank ~~Z~~ with a loan-to-value (LTV) ratio of 50 per cent. The loan is secured by a first-ranking security over the land~~real estate assets~~. At initial recognition of the loan, the State-owned Agricultural Bank ~~Z~~ does not consider the loan to be originated credit-impaired as defined in paragraph 9 ~~Appendix A~~ of PBE IPSAS 41~~IFRS 9~~.

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 ~~Z~~ 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~~real estate properties~~, 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 82~~5.5.10~~ of PBE IPSAS 41~~IFRS 9~~. The State-owned Agricultural Bank ~~Z~~ therefore needs to assess whether there has been a significant increase in credit risk since initial recognition in accordance with paragraph 75~~5.5.3~~ of PBE IPSAS 41~~IFRS 9~~, 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 ~~Z~~ 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 ~~Z~~ recognises lifetime expected credit losses on the loan to Company H.

IE23 Although lifetime expected credit losses should be recognised, 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 AG219~~B5.5.55~~ of PBE IPSAS 41~~IFRS 9~~ 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 ~~Entity B~~ is one of many investors in the bond. The Investment Fund~~Entity B~~ considers the bond to have low credit risk at initial recognition in accordance with paragraph 82~~5.5.10~~ of PBE IPSAS 41~~IFRS 9~~. 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~~Entity B~~'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~~Entity B~~'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~~Entity B~~ 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~~Entity B~~ applies the low credit risk simplification in paragraph 82 ~~5.5.10~~ of PBE IPSAS 41~~IFRS 9~~. Accordingly, at the reporting date, the Investment Fund~~Entity B~~ 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~~Entity B~~ 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~~Entity B~~ 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~~Entity B~~ determines that the bond does not have low credit risk at the reporting date. As a result, the Investment Fund~~Entity B~~ needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, the Investment Fund~~Company B~~ 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 recognised in accordance with paragraph 75~~5.5.3~~ of PBE IPSAS 41~~IFRS 9~~.

Example 5—Responsiveness to Changes in Credit Risk

IE29 Housing Corporation~~Bank~~ 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~~customers~~ are required to provide information such as the industry within which the borrower~~customer~~ is employed and the post code of the property that serves as collateral on the mortgage.

IE30 Housing Corporation~~Bank~~ 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~~Bank~~ ABC uses the credit score to determine the risk of a default occurring as at initial recognition.

IE31 At the reporting date Housing Corporation~~Bank~~ 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~~Bank~~ ABC expects default rates on the mortgage portfolio to increase.

Individual Assessment

IE32 In Region One, Housing Corporation~~Bank~~ ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process. Its scoring models are based on current and historical past due statuses, levels of borrower~~customer~~ indebtedness, LTV measures, ~~customer behaviour on other financial instruments with Bank ABC,~~ the loan size and the time since the origination of the loan. Housing Corporation~~Bank~~ 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~~Bank~~ 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~~customer~~ 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 behavioural scoring model, an increased risk of a default occurring due to an expected decline in residential property value adjusts the behavioural scores. The behavioural 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~~Bank~~ ABC is able to identify significant increases in credit risk since initial recognition on individual borrowers~~customers~~ before a mortgage becomes past due if there has been a deterioration in the behavioural score.

IE35 When the increase in credit risk has been significant, a loss allowance at an amount equal to lifetime expected credit losses is recognised. Housing Corporation~~Bank~~ 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~~Bank~~ ABC was unable to update behavioural 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 recognise lifetime expected credit losses for those loans.

Collective Assessment

IE37 In Regions Two and Three, Housing Corporation~~Bank~~ ABC does not have an automated scoring capability. Instead, for credit risk management purposes, Housing Corporation~~Bank~~ ABC tracks the risk of a default occurring by means of past due statuses. It recognises 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~~Bank~~ 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 recognised on loans that are not more than 30 days past due. This is necessary in order to meet the objective in paragraph 76 ~~5.5.4~~ of PBE IPSASA 41~~IFRS 9~~ of recognising 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~~Bank~~ 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~~customers~~ are not past due at the reporting date. Housing Corporation~~Bank~~ ABC therefore segments its mortgage portfolio by the industry within which borrowers~~customers~~ are employed (using the information recorded as part of the mortgage application process) to identify borrowers~~customers~~ 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~~Bank~~ ABC recognises a loss allowance at an amount equal to lifetime expected credit losses while it continues to recognise a loss allowance at an amount equal to 12-month expected credit losses for all other mortgages in Region Two.[19] Newly originated mortgages to borrowers who are economically dependent~~rely~~ on the coal mines ~~for employment~~ 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~~Bank~~ 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~~customers~~ do not have a fixed interest rate mortgage. Housing Corporation~~Bank~~ 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~~customers~~ 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~~Bank~~ 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~~Bank~~ 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~~Bank~~ ABC determines that the credit risk on 20 per cent of mortgages in Region Three has increased significantly since initial recognition. Accordingly Housing Corporation~~Bank~~ ABC recognises 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.[20]

Example 6—Comparison to Maximum Initial Credit Risk

IE40 The Economic Development Agency~~Bank A~~ has two portfolios of small business~~automobile~~ loans with similar terms and conditions in Region W. The Economic Development Agency~~Bank A~~'s policy on financing decisions for each loan is based on an internal credit rating system that considers a borrower's~~customer's~~ credit history, payment behaviour ~~on other products with Bank A~~ 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 ~~existing customers~~ 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~~Bank A~~ 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~~customers~~ that responded to an advertisement for small business ~~automobile~~ loans and the internal credit risk ratings of these borrowers~~customers~~ range between 4 and 7 on the internal rating scale. The Economic Development Agency~~Bank A~~ never originates a~~n~~ small business ~~automobile~~ 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~~Bank A~~ 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~~Bank A~~ 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

[19] 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 recognised on those mortgages.

[20] 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 recognised on those mortgages.

expected credit losses should be recognised in accordance with paragraph 75~~5.5.3~~ of PBE IPSAS 41~~IFRS 9~~.

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 76~~5.5.4~~ of PBE IPSAS 41~~IFRS 9~~. This is because the Economic Development Agency~~Bank A~~ 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~~Bank A~~ never originates a~~n~~ small business ~~automobile~~ 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~~Bank A~~ 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~~ A~~ 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~~ A~~ 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~~ A~~ 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~~ A~~ 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 recognising lifetime expected credit losses on all loans granted to Company Q, meets the objective of the impairment requirements as stated in paragraph 76 ~~5.5.4~~ of PBE IPSAS 41~~IFRS 9~~. 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 instalment to the Infrastructure Bank~~ A~~. The Infrastructure Bank~~ A~~ re-assesses Company X's internal credit risk rating, and determines it to be 7 at the reporting date. The Infrastructure Bank~~ A~~ 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 recognises lifetime expected credit losses on the loan of CU150,000.

IE46 Despite the recent downgrade of the internal credit risk rating, the Infrastructure Bank~~ A~~ grants 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 recognised on the new loan. This is because the credit risk on the new loan has not increased significantly since the loan was initially recognised. If the Infrastructure Bank~~ A~~ 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~~customer~~, the objective in paragraph 76~~5.5.4~~ of PBE IPSAS 41~~IFRS 9~~ 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 73–93~~Section 5.5~~ of PBE IPSAS 41~~IFRS 9~~, 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~~Entity~~ A originates a single 10 year amortising 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~~Entity~~ 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~~Entity~~ 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 due[21]), there has been no change in the 12-month PD and Government~~Entity~~ A determines that there was no significant increase in credit risk since initial recognition. Government~~Entity~~ 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).[22] Government~~Entity~~ 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% × 25% × CU1,000,000).

Scenario 2

IE51 Government~~Entity~~ 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~~Entity~~ 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~~Entity~~ 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~~Entity~~ 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. Government~~Entity~~ B determines that it is appropriate to measure the loss allowance on a collective basis in accordance with PBE IPSAS 41~~IFRS 9~~. The 12-month PD remains at 0.5 per cent at the reporting date. Government~~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% × 25% × CU1,000,000).

Example 9—12-Month Expected Credit Loss Measurement Based on a Loss Rate Approach

IE53 Government~~Bank~~ A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. Government~~Bank~~ A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per borrower~~client~~ of CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per borrower~~client~~ of CU300, for a total

[21] Thus for simplicity of illustration it is assumed there is no amortisation of the loan.

[22] 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.

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~~Bank~~ 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~~Bank~~ A considers samples of its own historical default and loss experience for those types of loans. In addition, Government~~Bank~~ 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 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, 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 90~~5.5.17~~(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~~Bank~~ A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Government~~Bank~~ 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~~Bank~~ 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~~Bank~~ 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%
Y	1,000	CU300	CU300,000	3	CU900	CU675	0.225%

IE57 Government~~Bank~~ 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 companies that deliver public infrastructure~~Bank A provides co-branded credit cards to customers in conjunction with a local department store~~. These revolving loans provide small construction companies with liquidity when cash inflows are limited. The revolving loans~~credit cards~~ have a one-day notice period after which the Development Agency~~Bank A~~ has the contractual right to cancel the loan~~credit card~~ (both the drawn and undrawn components). However, the Development Agency~~Bank A~~ does not enforce its contractual right to cancel the revolving loans ~~credit cards~~ 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~~customers~~ on an individual basis. The Development Agency ~~Bank A~~ therefore does not consider the contractual right to cancel the revolving loans ~~credit cards~~ to limit its exposure to credit losses to the contractual notice period.

IE59 For credit risk management purposes the Development Agency ~~Bank A~~ considers that there is only one set of contractual cash flows from borrowers ~~customers~~ 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 ~~credit card~~ portfolio is CU60,000 and the available undrawn facility is CU40,000. The Development Agency~~Bank A~~ 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:

(a) The period over which it was exposed to credit risk on a similar portfolio of revolving construction loans~~credit cards~~;

(b) The length of time for related defaults to occur on similar financial instruments; and

(c) 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~~Bank A~~ determines that the expected life of the revolving loan~~credit card~~ portfolio is 30 months.

IE62 At the reporting date the Development Agency~~Bank A~~ assesses the change in the credit risk on the portfolio since initial recognition and determines in accordance with paragraph 75~~5.5.3~~ of PBE IPSAS 41~~IFRS 9~~ that the credit risk on a portion of the loan~~credit card~~ 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 recognised is CU20,000 and the available undrawn facility is CU10,000.

IE63 When measuring the expected credit losses in accordance with paragraph 93~~5.5.20~~ of PBE IPSAS 41~~IFRS 9~~, Development Agency ~~Bank A~~ considers its expectations about future draw-downs over the expected life of the portfolio (i.e., 30 months) in accordance with paragraph AG195~~B5.5.31~~ and estimates what it expects the outstanding balance (i.e., exposure at default) on the portfolio would be if borrowers~~customers~~ were to default. By using its credit risk models Development Agency ~~Bank A~~ determines that the exposure at default on the revolving loan~~credit card~~ facilities for which lifetime expected credit losses should be recognised, 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~~credit card~~ facilities for which 12-month expected credit losses are recognised, 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~~Bank A~~ are used to measure the lifetime expected credit losses and 12-month expected credit losses on its loan~~credit card~~ portfolio.

IE65 The Development Agency~~Bank A~~ 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 recognises 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 PBE IPSAS 30~~IFRS 7~~ *Financial Instruments: Disclosures*).

Example 11—Modification of Contractual Cash Flows

IE66 Government~~Bank~~ 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~~Bank~~ A recognises 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 recognised.

IE67 In the subsequent reporting period (Period 2), Government~~Bank~~ A determines that the credit risk on the loan has increased significantly since initial recognition. As a result of this increase, Government~~Bank~~ A recognises 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~~Bank~~ 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~~Bank~~ A.

IE69 As a result of that modification, Government~~Bank~~ 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 71~~5.4.3~~ of PBE IPSAS 41~~IFRS 9~~, the difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognised as a modification gain or loss. Government~~Bank~~ A recognises 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~~profit or loss~~.

IE70 Government~~Bank~~ 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~~Bank~~ 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~~Bank~~ 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 × 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~~Bank~~ 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 84~~5.5.12~~ of PBE IPSAS 41~~IFRS 9~~.

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~~Bank~~ A adjusts the borrower's internal credit rating at the end of the reporting period.

IE73 Given the positive overall development, Government~~Bank~~ 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~~Bank~~ 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 ~~Company M, a manufacturer, has~~ a portfolio of trade receivables of CU30 million in 20X1 for Municipality M~~and operates only in one geographical region~~. The portfolio~~customer base~~ consists of a large number of households~~small clients~~ with small balances outstanding. ~~and~~ The trade receivables are categorised by common risk characteristics that are representative of the households~~customers~~' 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 IFRS 15 *Revenue from Contracts with Customers*~~. In accordance with paragraph~~ –~~ 87~~5.5.15~~ of PBE IPSAS 41~~IFRS 9~~ 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~~Company~~ 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 analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

IE76 On that basis, Municipality~~Company~~ 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~~small customers~~ 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 other Comprehensive Revenue and Expense~~income~~

IE78 Public Investment Fund A~~An entity~~ purchases a debt instrument with a fair value of CU1,000 on ~~15~~ December 15, 20X0 and measures the debt instrument at fair value through other comprehensive revenue and expense~~income~~. 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 Other Comprehensive Revenue and Expense~~I~~ ~~(a)~~	CU1,000	
Cash		CU1,000
(To recognise the debt instrument measured at its fair value)		
~~(a) FVOCI means fair value through other comprehensive income.~~		

IE79 On ~~31~~ December 31, 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~~profit or loss~~)	CU30	
Other comprehensive revenue or expense~~income~~(a)	CU20	
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense~~I~~		CU50
(To recognise 12-month expected credit losses and other fair value changes on the debt instrument)		
(a) The cumulative loss in other comprehensive revenue and expense~~income~~ 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 recognised (CU30).		

IE80 Disclosure would be provided about the accumulated impairment amount of CU30.

IE81 On ~~1~~ January 1, 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 Other Comprehensive Revenue and Expense~~I~~		CU950
Loss (surplus or deficit~~profit or loss~~)	CU20	
Other comprehensive revenue and expense~~income~~		CU20
(To derecognise the fair value through other comprehensive revenue and expense~~income~~ asset and recycle amounts accumulated in other comprehensive revenue and expense~~income~~ to surplus or deficit~~profit or loss~~)		

Example 14—Interaction Between the Fair Value Through Other Comprehensive Revenue and Expense~~Income~~ 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 other comprehensive revenue and expense~~income~~ 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 1, 20X0 and classifies the bond as measured at fair value through other comprehensive revenue and expense~~income~~. 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 1, 20X0. At initial recognition the entity determines that the bond is not purchased or originated credit-impaired. In addition, as at ~~1~~ January 1, 20X0 the 12-month expected credit losses are determined to be FC1,200. Its amortised cost in FC as at ~~1~~ January 1, 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:[23] 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

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[23] The cumulative loss in other comprehensive revenue and expense~~income~~ 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 recognised (CU30).This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 129~~6.4.1~~ of PBE IPSAS 41~~IFRS 9~~). 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 129~~6.4.1~~ of PBE IPSAS 41~~IFRS 9~~).

the accounting mechanics in a situation that entails measurement at fair value through other comprehensive revenue and expense~~income~~ 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 recognise the bond and the swap on ~~1~~ January 1, 20X0:

	Debit LC	**Credit LC**
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense~~I~~	100,000	
Cash		100,000
(To recognise the bond at its fair value)		
Impairment loss (surplus or deficit~~profit or loss~~)	1,200	
Other comprehensive revenue and expense~~income~~		1,200
(To recognise the 12-month expected credit losses)[(a)]		
Swap	–	
Cash		–
(To recognise the swap at its fair value)		
(a) In case of items measured in the functional currency of an entity the journal entry recognising expected credit losses will usually be made at the reporting date.		

IE89 As of ~~31~~ December 31, 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 31, 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.[24] As at ~~31~~ December 31, 20X0, the exchange rate is FC1 to LC1.4. This is reflected in the following table:

	~~1~~ January 1, 20X0	**~~31~~ December 31, 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
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 recognises the changes arising from movements in foreign exchange rates in surplus or deficit~~profit or loss~~ in accordance with paragraphs 27~~23~~(a) and 32~~28~~ of PBE IPSAS 4~~IAS 21~~ *The Effects of Changes in Foreign Exchange Rates* and recognises other changes in accordance with PBE IPSAS 41~~IFRS 9~~. For the purposes of applying paragraph 32~~28~~ of PBE IPSAS 4~~IAS 21~~ the asset is treated as an asset measured at amortised cost in the foreign currency.

IE91 As shown in the table, on ~~31~~ December 31, 20X0 the fair value of the bond is LC134,918 (FC96,370 × 1.4) and its amortised cost is LC138,320 (FC(100,000–1,200) × 1.4).

[24] For the purposes of simplicity the example ignores the impact of discounting when computing expected credit losses.

IE92 The gain recognised in surplus or deficit~~profit or loss~~ that is due to the changes in foreign exchange rates is LC39,520 (LC138,320 – LC98,800), i.e., the change in the amortised 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 recognised as an adjustment to the carrying amount. The difference between the fair value of the bond and its amortised cost in LC is LC3,402 (LC134,918 – LC138,320). However, the change in the cumulative gain or loss recognised in other comprehensive revenue and expense~~income~~ 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 recognised in surplus or deficit~~profit or loss~~ and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive revenue and expense~~income~~ 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 31, 20X0:

	Debit LC	**Credit LC**
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense~~I~~	34,918	
Other comprehensive revenue and expense~~income~~	4,602	
Surplus or deficit~~Profit or loss~~		39,520
(To recognise 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)		
Swap	2,572	
Surplus or deficit~~Profit or loss~~		2,572
(To remeasure the swap at fair value)		
Surplus or deficit~~Profit or loss~~	2,572	
Other comprehensive revenue and expense~~income~~		2,572
(To recognise in surplus or deficit~~profit or loss~~ the change in fair value of the bond due to a change in the hedged risk)		

IE95 In accordance with paragraph 20A~~16A~~ of PBE IPSAS 30~~IFRS 7~~, the loss allowance for financial assets measured at fair value through other comprehensive revenue and expense~~income~~ 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 recognised in other comprehensive revenue and expense~~income~~.

IE96 As at ~~31~~ December 31, 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 31, 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 recognised.[25] The estimate of lifetime expected credit losses as at ~~31~~ December 31, 20X1 is FC9,700. As at ~~31~~ December 31, 20X1, the exchange rate is FC1 to LC1.25. This is reflected in the following table:

[25] For simplicity this example assumes that credit risk does not dominate the fair value hedge relationship.

	~~31~~ December 31, 20X0	~~31~~ December 31, 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
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 31, 20X1 the fair value of the bond is LC108,893 (FC87,114 × 1.25) and its amortised 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 31, 20X1. Thus the impairment loss recognised in profit or loss in LC is LC10,625 (FC(9,700 – 1,200) x 1.25).

IE99 The loss recognised in surplus or deficit~~profit or loss~~ 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 amortised cost during 20X1 in LC, adjusted for the impairment loss. The difference between the fair value of the bond and its amortised cost in the functional currency of the entity on ~~31~~ December 31, 20X1 is LC3,982 (LC108,893 – LC112,875). However, the change in the cumulative gain or loss recognised in other comprehensive revenue and expense~~income~~ during 20X1 as a reduction in other comprehensive revenue and expense~~income~~ is LC11,205 (LC3,982 – LC3,402 + LC10,625).

IE100 A gain of LC43 (LC2,615 – LC2,572) on the swap is recognised in surplus or deficit~~profit or loss~~ and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive revenue and expense~~income~~ in the same period.

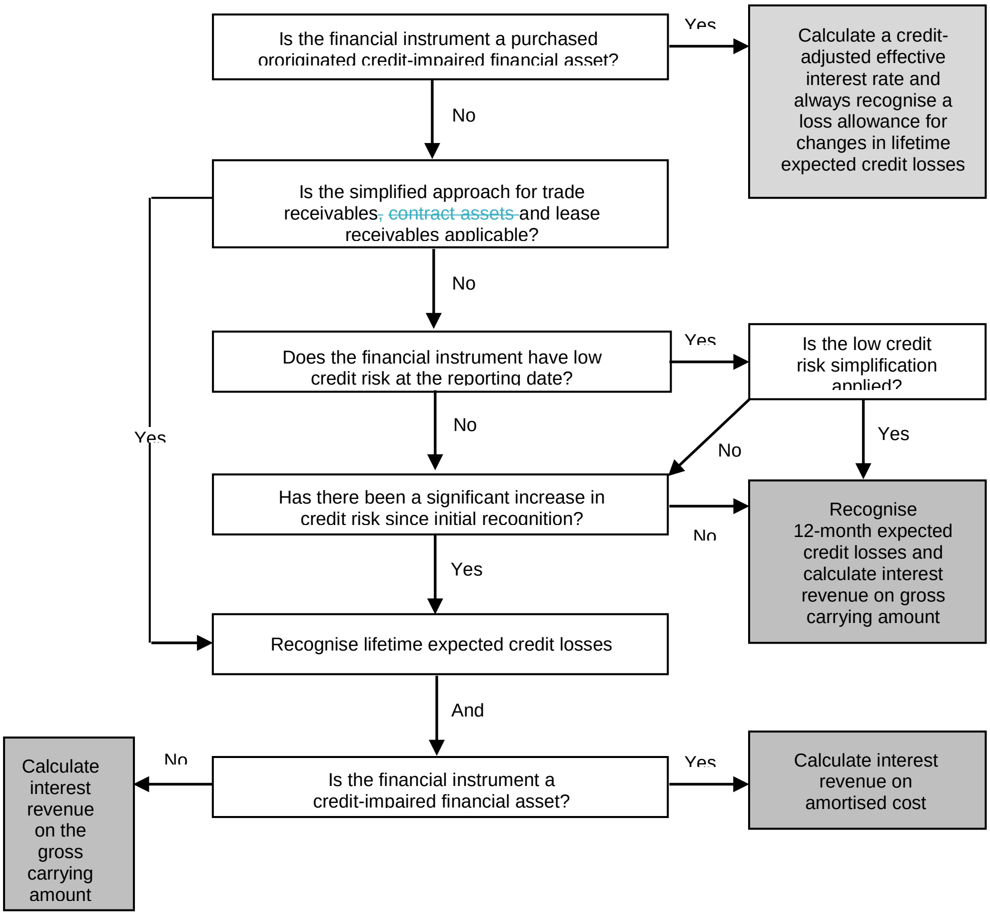
IE101 The entity makes the following journal entries on ~~31~~ December 31, 20X1:

	Debit LC	**Credit LC**
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense~~I~~		26,025
Other comprehensive revenue and expense~~income~~	11,205	
Surplus or deficit~~Profit or loss~~	14,820	
(To recognise 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)		
Swap	43	
Surplus or deficit~~Profit or loss~~		43
(To remeasure the swap at fair value)		
Surplus or deficit~~Profit or loss~~	43	
Other comprehensive revenue and expense~~income~~		43
(To recognise in surplus or deficit~~profit or loss~~ the change in fair value of the bond due to a change in the hedged risk)		
Surplus or deficit~~Profit or loss~~ (impairment loss)	10,625	
Other comprehensive revenue and expense~~income~~ (accumulated impairment amount)		10,625
(To recognise lifetime expected credit losses)		

IE102 On ~~1~~ January 1, 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 31, 20X1. The journal entries to derecognise the bond and reclassify the gains and losses that have accumulated in other comprehensive revenue and expense~~income~~ would be as follows:

	Debit LC	**Credit LC**
Cash	108,893	
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense~~I~~		108,893
Loss on sale (surplus or deficit~~profit or loss~~)	1,367[(a)]	
Other comprehensive revenue and expense~~income~~		1,367
(To derecognise the bond)		
Swap		2,615
Cash	2,615	
(To close out the swap)		
(a) This amount consists of the changes in fair value of the bond, the accumulated impairment amount and the changes in foreign exchange rates recognised in other comprehensive revenue and expense~~income~~ (LC2,572 + LC1,200 + LC43 + LC10,625 – LC4,602 – LC11,205 = -LC1,367, which is recycled as a loss in surplus or deficit~~profit or loss~~).		

Application of the Impairment Requirements on a Reporting Date



Reclassification of Financial Assets (Paragraphs 94–100~~Section 5.6~~)

IE103 This example illustrates the accounting requirements for the reclassification of financial assets between measurement categories in accordance with 94–100~~Section 5.6~~ of PBE IPSAS 41~~IFRS 9~~. The example illustrates the interaction with the impairment requirements in paragraphs 73–93~~Section 5.5~~ of PBE IPSAS 41~~IFRS 9~~.

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~~business~~ model for managing the bonds in accordance with paragraph 54~~4.4.1~~ of PBE IPSAS 41~~IFRS 9~~. The fair value of the portfolio of bonds at the reclassification date is CU490,000.

IE106 If the portfolio was measured at amortised cost or at fair value through other comprehensive revenue and expense~~income~~ immediately prior to reclassification, the loss allowance recognised 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 Amortised Cost Measurement Category and into the Fair Value Through Surplus ~~Profit~~ or Deficit~~Loss~~ Measurement Category

IE109 Department of Treasury~~Bank~~ A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through surplus or deficit~~profit or loss~~ 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 amortised cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognised in surplus or deficit~~profit or loss~~ on reclassification.

	Debit	Credit
Bonds (~~FVPL~~ Fair Value Through Surplus or Deficit assets)	CU490,000	
Bonds (gross carrying amount of the amortised cost assets)		CU500,000
Loss allowance	CU6,000	
Reclassification loss (surplus or deficit~~profit or loss~~)	CU4,000	
(To recognise the reclassification of bonds from amortised cost to fair value through surplus or deficit~~profit or loss~~ and to derecognise the loss allowance.)		

Scenario 2: Reclassification Out of the Fair Value Through Surplus ~~Profit~~ or Deficit~~Loss~~ Measurement Category and into the Amortised Cost Measurement Category

IE110 Department of Treasury~~Bank~~ A reclassifies the portfolio of bonds out of the fair value through surplus or deficit~~profit or loss~~ measurement category and into the amortised 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 recognising 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 amortised cost assets)	CU490,000	
Bonds (~~FVPL~~Fair Value Through Surplus or Deficit assets)		CU490,000
Impairment loss (surplus or deficit~~profit or loss~~)	CU4,000	
Loss allowance		CU4,000
(To recognise reclassification of bonds from fair value through surplus or deficit~~profit or loss~~ to amortised cost including commencing accounting for impairment.)		

Scenario 3: Reclassification Out of the Amortised Cost Measurement Category and into the Fair Value Through Other Comprehensive Income Measurement Category

IE111 Department of Treasury~~Bank~~ A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through other comprehensive revenue and expense~~income~~ 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 amortised cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognised in other comprehensive revenue and expense~~income~~. 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 recognised as an adjustment to the gross carrying amount of the bond and is recognised as an accumulated impairment amount, which would be disclosed.

	Debit	Credit
Bonds (~~FVOCI~~ Fair Value Through Other Comprehensive Revenue and Expense assets)	CU490,000	
Bonds (gross carrying amount of amortised cost assets)		CU500,000
Loss allowance	CU6,000	
Other comprehensive revenue and expense~~income~~(a)	CU4,000	
(To recognise the reclassification from amortised cost to fair value through other comprehensive revenue and expense~~income~~. The measurement of expected credit losses is however unchanged.) (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 Other comprehensive revenue and expense~~income~~ CU10,000 (fair value changes) and CR other comprehensive revenue and expense~~income~~ CU6,000 (accumulated impairment amount).		

Scenario 4: Reclassification Out of the Fair Value Through Other Comprehensive Revenue and Expense~~Income~~ Measurement Category and into the Amortised Cost Measurement Category

IE112 Department of Treasury~~Bank~~ A reclassifies the portfolio of bonds out of the fair value through other comprehensive revenue and expense~~income~~ measurement category and into the amortised cost measurement category. The portfolio of bonds is reclassified at fair value. However, at the reclassification date, the cumulative gain or loss previously recognised in other comprehensive revenue and expense~~income~~ is removed from 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 amortised 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 recognised as an adjustment to the gross carrying amount of the bond (to reflect the amortised cost amount) from the reclassification date.

	Debit	Credit
Bonds (gross carrying value of the amortised cost assets)	CU490,000	
Bonds (~~FVOCI~~Fair Value Through Other Comprehensive Revenue and Expense assets)		CU490,000
Bonds (gross carrying value of the amortised cost assets)	CU10,000	
Loss allowance		CU6,000
Other comprehensive revenue and expense~~income~~[(a)]		CU4,000
(To recognise the reclassification from fair value through other comprehensive revenue and expense~~income~~ to amortised cost including the recognition of the loss allowance deducted to determine the amortised cost amount. The measurement of expected credit losses is however unchanged.)		
(a) The cumulative loss in other comprehensive revenue and expense~~income~~ 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 recognised (CU6,000) while the assets were measured at fair value through other comprehensive revenue and expense~~income~~.		

Scenario 5: Reclassification Out of the Fair Value Through Surplus or Deficit~~Profit or Loss~~ Measurement Category and into the Fair Value Through Other Comprehensive Revenue and Expense~~income~~ Measurement Category

IE113 Department of Treasury~~Bank~~ A reclassifies the portfolio of bonds out of the fair value through surplus or deficit~~profit or loss~~ measurement category and into the fair value through other comprehensive revenue and expense~~income~~ 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 recognising 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 Other Comprehensive Revenue and Expense~~FVOCI~~ assets)	CU490,000	
Bonds (Fair Value Through Surplus or Deficit~~FVPL~~ assets)		CU490,000
Impairment loss (surplus or deficit~~profit or loss~~)	CU4,000	
Other comprehensive revenue and expense ~~income~~[(a)]		CU4,000
(To recognise the reclassification of bonds from fair value through surplus or deficit~~profit or loss~~ to fair value through other comprehensive revenue and expense~~income~~ including commencing accounting for impairment. The other comprehensive revenue and expense~~income~~ amount reflects the loss allowance at the date of reclassification (an accumulated impairment amount relevant for disclosure purposes) of CU4,000.)		

Scenario 6: Reclassification Out of the Fair Value Through Other Comprehensive Revenue and Expense ~~Income~~ Measurement Category and into the Fair Value Through Surplus or Deficit~~Profit or Loss~~ Measurement Category

IE114 Department of Treasury~~Bank~~ A reclassifies the portfolio of bonds out of the fair value through other comprehensive revenue and expense~~income~~ measurement category and into the fair value through surplus or deficit~~profit or loss~~ measurement category. The portfolio of bonds continues to be measured at fair value. However, the cumulative gain or loss previously recognised in other comprehensive revenue and expense~~income~~ is reclassified from net assets/equity to surplus or deficit~~profit or loss~~ as a reclassification adjustment (see PBE IPSAS 1~~IAS 1~~ *Presentation of Financial Reports~~Statements~~*).

	Debit	Credit
Bonds (Fair Value Through Surplus or Deficit~~FVPL~~ assets)	CU490,000	
Bonds (Fair Value Through Other Comprehensive Revenue and Expense~~FVOCI~~ assets)		CU490,000
Reclassification loss (surplus or deficit~~profit or loss~~)	CU4,000	
Other comprehensive revenue and expense~~income~~		CU4,000
(To recognise the reclassification of bonds from fair value through other comprehensive revenue and expense~~income~~ to fair value through surplus or deficit~~profit or loss~~.) (a) The cumulative loss in other comprehensive revenue and expense~~income~~ 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 recognised (CU6,000) while the assets were measured at fair value through other comprehensive revenue and expense~~income~~.		

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~~Entity~~ A wants to hedge a highly probable forecast electricity ~~coffee~~ purchase (which is expected to occur at the end of Period 5). Municipality~~Entity~~ A's functional currency is its Local Currency (LC). Electricity~~Coffee~~ is traded in Foreign Currency (FC). Municipality~~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~~coffee~~ 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~~Entity~~ A hedges its risk exposures using the following risk management strategy:

(a) Municipality~~Entity~~ A uses benchmark commodity forward contracts, which are denominated in FC, to hedge its electricity~~coffee~~ purchases four periods before delivery. The electricity~~coffee~~ price that Municipality~~Entity~~ A actually pays for its purchase is different from the benchmark price because of differences in the type of electricity~~coffee~~, the location and delivery arrangement.[26] This gives rise to the risk of changes in the relationship between the two electricity~~coffee~~ prices (sometimes referred to as 'basis risk'), which affects the effectiveness of the hedging relationship. Municipality~~Entity~~ A does not hedge this risk because it is not considered economical under cost/benefit considerations.

(b) Municipality~~Entity~~ A also hedges its FX risk. However, the FX risk is hedged over a different horizon—only three periods before delivery. Municipality~~Entity~~ A considers the FX exposure from the variable payments for the electricity~~coffee~~ purchase in FC and the gain or loss on the commodity forward contract in FC as one aggregated FX exposure. Hence, Municipality~~Entity~~ A uses one single FX forward contract to hedge the FX cash flows from a forecast electricity~~coffee~~ purchase and the related commodity forward contract.

[26] For the purpose of this example it is assumed that the hedged risk is not designated based on a benchmark electricity~~coffee~~ price risk component. Consequently, the entire electricity~~coffee~~ price risk is hedged.

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~~coffee~~ that Municipality~~Entity~~ A actually buys and the price for the benchmark electricity~~coffee~~):

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~~lb~~]	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 Entity A designates as cash flow hedges the following two hedging relationships:[27]

(a) A commodity price risk hedging relationship between the electricity~~coffee~~ price related variability in cash flows attributable to the forecast electricity~~coffee~~ 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~~coffee~~ that Municipality~~Entity~~ A actually buys and the price for the benchmark electricity~~coffee~~, Municipality~~Entity~~ A designates a volume of 112,500 MWh~~pounds (lbs)~~ of electricity~~coffee~~ as the hedging instrument and a volume of 118,421 MWh~~lbs~~ as the hedged item.[28]

(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~~coffee~~ purchase and the commodity forward contract. Municipality~~Entity~~ A's long-term view of the basis spread between the price of the electricity~~coffee~~ that it actually buys and the price for the benchmark electricity~~coffee~~ has not changed from the end of Period 1. Consequently, the actual volume of hedging instrument that Municipality~~Entity~~ 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~~Entity~~ 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~~Entity~~ 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:[29]

[27] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 129~~6.4.1~~ of PBE IPSAS 41~~IFRS 9~~). 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 129(b)~~IFRS 9.6.4.1(b)~~ of PBE IPSAS 41).

[28] In this example, the current basis spread at the time of designation is coincidentally the same as Municipality~~Entity~~ A's long-term view of the basis spread (-5 per cent) that determines the volume of electricity~~coffee~~ purchases that it actually hedges. Also, this example assumes that Municipality~~Entity~~ 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 129~~6.4.1~~ of PBE IPSAS 41~~IFRS 9~~).

[29] 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~~profit or loss~~) are in the format of positive (plus) and negative (minus) numbers (e.g., a surplus or deficit~~profit or loss~~ amount that is a negative number is a loss).

Example 16—Calculations							
		Period	**1**	**2**	**3**	**4**	**5**
Commodity Price Risk Hedging Relationship (First Level Relationship)							
Forward Purchase Contract for Electricity~~coffee~~							
Volume (MWh~~lbs~~)	112,500						
Forward price [FC/MWh~~lb~~]	1.25	Price (fwd) [FC/MWh~~lb~~]	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
Hedged Forecast Electricity~~Coffee~~ Purchase							
Hedge ratio	105.26%	Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
Hedged volume	118,421	Price (fwd) [FC/MWh~~lb~~]	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)
Accounting			*LC*	*LC*	*LC*	*LC*	*LC*
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~~Profit or loss~~				0	1,199	(2,781)	5,143
Accumulated surplus or deficit~~Retained earnings~~			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
FX forward contract (Buy FC/Sell LC)							
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
Hedged FX risk							
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)
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~~Profit or loss~~					(76)	76	(291)
Accumulated surplus or deficit~~Retained earnings~~				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:[30]

(a) The hedged electricity~~coffee~~ purchase volume multiplied by the current forward price (this represents the expected spot price of the actual electricity~~coffee~~ purchase); and

[30] For example, at the end of Period 3 the aggregated FX exposure is determined as: 118,421 MWh~~lbs~~ × 1.34 FC/MWh~~lb~~ = FC159,182 for the expected price of the actual electricity~~coffee~~ purchase and 112,500 MWh~~lbs~~ × (1.25 [FC/MWh~~lb~~] – 1.43 [FC/MWh~~lb~~]) = 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.

(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~~coffee~~ price movements in FC that Municipality~~Entity~~ 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).[31]

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 140~~6.5.11~~ of PBE IPSAS 41~~IFRS 9~~).

IE125 The following table shows the effect on Municipality~~Entity~~ A's statement of ~~profit or loss and other~~ comprehensive revenue~~income~~ and expense and its statement of financial position (for the sake of transparency the line items[32] 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 Comprehensive Revenue and Expense~~Financial Performance~~ and Financial Position

[All amounts in LC]

Period	**1**	**2**	**3**	**4**	**5**
Statement of ~~profit or loss and other~~ comprehensive revenue and expense~~income~~					
Hedge ineffectiveness					
Commodity hedge		0	(1,199)	2,781	(5,143)
FX hedge		0	76	(76)	291
Surplus or deficit~~Profit or loss~~	0	0	(1,123)	2,705	(4,852)
Other comprehensive revenue and expense~~income (OCI)~~					
Commodity hedge		20,258	(33,399)	13,868	(67,971)
FX hedge		0	6,237	3,604	(2,096)
Total other comprehensive revenue and expense~~income~~	0	20,258	(27,162)	17,472	(70,067)
Comprehensive revenue and expense~~income~~	0	20,258	(28,285)	20,177	(74,920)
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
Net assets/~~e~~Equity					
Accumulated other comprehensive revenue and expense~~OCI~~					
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~~Retained earnings~~					
Commodity hedge	0	0	(1,199)	1,582	(3,561)
FX hedge		0	76	0	291
	0	0	(1,123)	1,582	(3,270)
Total net assets/equity	0	20,258	(8,027)	12,150	(62,769)

[31] 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.

[32] 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 (PBE IPSAS 30~~IFRS 7~~ 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).

IE126 The total cost of inventory after hedging is as follows:[33]

Cost of inventory [all amounts in LC]	
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~~coffee~~ 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~~Entity~~ 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~~Entity~~ B's functional currency is its Local Currency (LC). State Government~~Entity~~ 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~~Entity~~ B's risk management strategy for FC denominated fixed rate liabilities (see paragraph IE129(a) below).

IE129 State Government~~Entity~~ B hedges its risk exposures using the following risk management strategy:

(a) State Government~~Entity~~ B uses cross-currency interest rate swaps to swap its FC denominated fixed rate liabilities into a variable rate exposure in LC. State Government~~Entity~~ B hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, State Government~~Entity~~ 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~~Entity~~ B receives fixed interest in FC (used to pay the interest on the liability) and pays variable interest in LC.

(b) State Government~~Entity~~ 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~~Entity~~ 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~~Entity~~ 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).[34] Consequently, State Government~~Entity~~ 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:

[33] 'CFHR' is the cash flow hedge reserve, i.e., the amount accumulated in other comprehensive revenue and expense~~income~~ for a cash flow hedge.

[34] 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
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%			
	3.14%	6.31%			
	3.27%	6.36%			
	3.21%	6.40%			
	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%		
	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~~Entity~~ B designates the following hedging relationships:[35]

(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~~Entity~~ 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).

35 This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 129~~6.4.1~~ of PBE IPSAS 41~~IFRS 9~~). 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 129~~6.4.1~~(b) of PBE IPSAS 41~~IFRS 9~~.

IE132 The following table[36] 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.[37] In this example, hedge ineffectiveness arises on both hedging relationships.[38]

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
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., t_0) 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]**
	Time								
	t_0								
Period 1	t_1								

[36] 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.

[37] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and net assets/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).

[38] 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—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]**
	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]			0 ← Σ						

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								
Period 1	t_0								
	t_1								
	t_2								
	t_3								
	t_4								
Period 2	t_5	0	0	0	0	0	0	0	0
	t_6	0	0	0	0	0	0	0	0
	t_7	0	0	0	0	0	0	0	0
	t_8	0	0	0	0	0	0	0	0

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**	
		CF(s)	**PV**	**CF(s)**	**PV**	**CF(s)**	**PV**	**1,200,000 Nominal 5.6963% Rate 4 Frequency**	**PV**
		[FC]	**[FC]**	**[FC]**	**[FC]**	**[LC]**	**[LC]**	**[LC]**	**[LC]**
Period 3	t_9	0	0	0	0	(18,120)	(17,850)	17,089	16,835
	t_{10}	(20,426)	(20,173)	20,358	20,106	(18,360)	(17,814)	17,089	16,581
	t_{11}	0	0	0	0	(18,683)	(17,850)	17,089	16,327
	t_{12}	(20,426)	(19,965)	20,582	20,117	(19,203)	(18,058)	17,089	16,070
Period 4	t_{13}	0	0	0	0	(19,718)	(18,243)	17,089	15,810
	t_{14}	(20,426)	(19,726)	20,246	19,553	(20,279)	(18,449)	17,089	15,547
	t_{15}	0	0	0	0	(21,014)	(18,789)	17,089	15,280
	t_{16}	(1,020,426)	(971,144)	1,020,582	971,292	(1,221,991)	(1,072,947)	1,217,089	1,068,643
Totals			(1,031,008)		1,031,067		(1,200,000)		1,181,092
Totals in LC			(1,464,031)		1,464,116		(1,200,000)		1,181,092
PV of all CF(s) [LC]			(18,824) ← Σ						

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.[39]

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 140~~6.5.11~~ of PBE IPSAS 41~~IFRS 9~~).

IE136 The following table shows the effect on State Government~~Entity~~ B's statement of ~~profit or loss and other~~ comprehensive revenue and expense~~income~~ and its statement of financial position (for the sake of transparency some line items[40] 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):[41]

Example 17—Overview of Effect on Statements of Comprehensive Revenue and Expense~~financial performance~~ and Financial Position *[All amounts in LC]*					
	t_0	**Period 1**	**Period 2**	**Period 3**	**Period 4**
Statement of ~~profit or loss and other~~ comprehensive revenue and expense~~income~~					
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)

[39] 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.

[40] 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 (PBE IPSAS 30~~IFRS 7~~ 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).

[41] 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 retained earnings would be nil).

Example 17—Overview of Effect on Statements of Comprehensive Revenue and Expense~~financial performance~~ and Financial Position

[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Total other gains/losses		(29)	(127)	68	(57)
Surplus or deficit~~Profit or loss~~		33,198	68,255	68,438	68,313
Other comprehensive revenue and expense~~income (OCI)~~					
Effective CFH gain/loss			(12,834)	71,713	229
Reclassifications			(5,990)	5,863	(58,982)
Total other comprehensive revenue and expense~~income~~			(18,842)	77,577	(58,753)
Comprehensive revenue and expense~~income~~		33,198	49,432	146,015	9,560

	t_0	Period 1	Period 2	Period 3	Period 4
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
Total net assets	0	(33,198)	(82,630)	(228,645)	(238,205)
Net assets/equity					
Accumulated other comprehensive revenue and expense~~OCI~~		0	(18,824)	58,753	0
Accumulated surplus or deficit~~Retained earnings~~	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~~profit or loss~~ reflects State Government~~Entity~~ 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~~Entity~~ 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.[42] 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.[43]

[42] 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 recognised in surplus or deficit~~profit or loss~~ because the hedge ineffectiveness is not recognised (see paragraph 140~~6.5.11~~ of PBE IPSAS 41~~IFRS 9~~). The hedge ineffectiveness arising on the fair value hedge affects surplus or deficit~~profit or loss~~ in all periods.

[43] 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 recognised in surplus or deficit~~profit or loss~~ (see paragraph 140~~6.5.11~~ of PBE IPSAS 41~~IFRS 9~~). The hedge ineffectiveness arising on the fair value hedge affects surplus or deficit~~profit or loss~~ in all periods.

Example 18—Combined Interest Rate Risk and Foreign Currency Risk Hedge (Cash Flow Hedge/Fair Value Hedge Combination)

Fact Pattern

IE138 State Government~~Entity~~ 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~~Entity~~ C's functional currency is its Local Currency (LC). State Government~~Entity~~ 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~~Entity~~ C's risk management strategy for FC denominated variable rate liabilities (see paragraph IE139(a) below).

IE139 State Government~~Entity~~ C hedges its risk exposures using the following risk management strategy:

(a) State Government~~Entity~~ C uses cross-currency interest rate swaps to swap its FC denominated variable rate liabilities into a fixed rate exposure in LC. State Government~~Entity~~ C hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, State Government~~Entity~~ 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~~Entity~~ C receives variable interest in FC (used to pay the interest on the liability) and pays fixed interest in LC.

(b) State Government~~Entity~~ 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 Government~~Entity~~ 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~~Entity~~ 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	**t_0**	**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%	

Example 18—Parameter Overview	t_0	Period 1	Period 2	Period 3	Period 4
	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

IE141 State Government~~Entity~~ C designates the following hedging relationships:[44]

(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~~Entity~~ 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).

IE142 The following table[45] 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.[46] In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made.[47]

Example 18—Calculations	t_0	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

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[44] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 129~~6.4.1~~ of PBE IPSAS 41~~IFRS 9~~). 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 129~~6.4.1~~(b) of PBE IPSAS 41~~IFRS 9~~).

[45] 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.

[46] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and net assets/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).

[47] 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').

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)
	t_0	**Period 1**	**Period 2**	**Period 3**	**Period 4**
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)
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., t_0) 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~~profit or loss~~ 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 recognised in other comprehensive revenue and expense~~income~~ 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).[48] 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 recognised in other comprehensive revenue and expense~~income~~ 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~~profit or loss~~. That reclassification adjustment offsets the gain or loss on the interest rate swap that is recognised in surplus or deficit~~profit or loss~~.[49] 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 amortised cost, the aggregated exposure is already remeasured for changes regarding the hedged risk but the resulting gain or loss is recognised in other comprehensive revenue and expense~~income~~ 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 recognised (i.e., reclassification from the cash flow hedge reserve to surplus or deficit~~profit or loss~~).

48 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~~Entity~~ C in effect assumed an exposure to fair value interest rate risk (see paragraph IE139).

49 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~~profit or loss~~—see paragraph IE144 for how that amount is calculated).

(b) The amount in the cash flow hedge reserve at the end of Period 1 (LC42,310) is amortised over the remaining life of the cash flow hedge for the first level relationship (i.e., over Periods 2 to 4).[50]

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) [FC]	**PV [FC]**	**CF(s) [FC]**	**PV [FC]**	**CF(s) [LC]**	**PV [LC]**
	Time						
	t_0						
	t_1						
Period 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)
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)
		Present Value of the Aggregated Exposure					
		FX liability		**CCIRS FC leg**		**CCIRS LC leg**	
		CF(s) [FC]	**PV [FC]**	**CF(s) [FC]**	**PV [FC]**	**CF(s) [LC]**	**PV [LC]**
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.[51]

(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

[50] In the table with the overview of the calculations (see paragraph IE142) this amortisation results in a periodic reclassification adjustment of LC14,103 that is included in the line item "Amortisation of CFHR" in the reconciliation of the cash flow hedge reserve.

[51] 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.

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:

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) [FC]	**PV [FC]**	**CF(s) [FC]**	**PV [FC]**	**CF(s) [LC]**	**PV [LC]**
	Time						
Period 1	t_0						
	t_1						
	t_2						
	t_3						
	t_4						
Period 2	t_5	0	0	0	0	0	0
	t_6	0	0	0	0	0	0
	t_7	0	0	0	0	0	0
	t_8	0	0	0	0	0	0
Period 3	t_9	(6,969)	(6,921)	6,969	6,921	(9,117)	(9,030)
	t_{10}	(5,544)	(5,475)	5,544	5,475	(9,117)	(8,939)
	t_{11}	(4,971)	(4,885)	4,971	4,885	(9,117)	(8,847)
	t_{12}	(5,401)	(5,280)	5,401	5,280	(9,117)	(8,738)
Period 4	t_{13}	(5,796)	(5,632)	5,796	5,632	(9,117)	(8,624)
	t_{14}	(6,277)	(6,062)	6,277	6,062	(9,117)	(8,511)
	t_{15}	(6,975)	(6,689)	6,975	6,689	(9,117)	(8,397)
	t_{16}	(1,007,725)	(959,056)	1,007,725	956,056	(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]			(1,159,654) ←		Σ		

(1,159,654)

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.[52]

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~~profit or loss~~ (reclassification adjustments) are then determined.

IE146 The following table shows the effect on State Government~~Entity~~ C's statement of ~~profit or loss and other~~ comprehensive revenue and expense~~income~~ and its statement of financial position (for the sake of transparency some line items[53] 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):[54]

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52 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.

53 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 (PBE IPSAS 30~~IFRS 7~~ 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).

54 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~~retained earnings~~ would be nil).

Example 18—Overview of Effect on Statements of Comprehensive Revenue and Expense~~financial performance~~ and Financial Position

[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Statement of ~~profit or loss and other~~ comprehensive revenue and expense~~income~~					
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)
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~~Profit or loss~~		36,466	30,092	67,087	23,788
Other comprehensive revenue and expense~~income (OCI)~~					
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 other comprehensive revenue and expense~~income~~		42,310	(14,103)	(14,103)	(14,103)
Comprehensive revenue and expense~~income~~		78,776	15,989	52,983	9,685

	t_0	Period 1	Period 2	Period 3	Period 4
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
Total net assets/equity	0	(78,776)	(94,765)	(147,748)	(157,433)
Accumulated other comprehensive revenue and expense~~OCI~~	0	42,310	28,207	14,103	0
Accumulated surplus or deficit~~Retained earnings~~	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~~profit or loss~~ reflects State Government~~Entity~~ 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 amortisation of the amount that was in the cash flow hedge reserve for the first level relationship at the end of Period 1.[55]

55 See paragraph IE143(b). That amortisation becomes an expense that has an effect like a spread on the variable interest rate.

Foreign Operations (Appendix B)

Note: Paragraphs IE148 to IE152 are based on IPSAS 41 paragraphs IE148 to IE152. Equivalent paragraphs were previously found in IPSAS 29/PBE IPSAS 29 paragraphs IE32 to IE36. Equivalent guidance is also found in the illustrative example that accompanies IFRIC 16 *Hedges of a Net investment in a Foreign Operation*.

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 recognised 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

IE152. When the investment in Controlled Entity C is disposed of, PBE IPSAS 41 requires the full €24 million gain on the hedging instrument to be reclassified 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–AG126)

Example 20—Receipt of a Concessionary Loan (Interest Concession)

Note: Paragraphs IE153 to IE155 are based on IPSAS 41 paragraphs IE153 to IE155. There is a similar example in IPSAS 29/PBE IPSAS 29 paragraphs IE37 to IE39.

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 principal repayments

Year 2: 10 per cent of the principal

Year 3: 20 per cent of the principal

Year 4: 30 per cent of the principal

Year 5: 40 per cent of the principal

Interest is paid annually in arrears, at a rate of 5 per cent per annum on the outstanding balance of the loan. A market-related rate of interest for a similar transaction is 10 per cent.

IE154. The local authority has received a concessionary loan of CU5 million, which will be repaid at 5 per cent 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 recognised in accordance with PBE IPSAS 23.

IE155. The journal entries to account for the concessionary loan are as follows:

1. On initial recognition, the entity recognises 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

PBE IPSAS 23 is considered in recognising 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 recognises 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 per cent)

Dr	Loan (refer to Table 1 below)	250,000	
Cr	Bank		250,000

Recognition of interest paid on outstanding balance (CU5m × 5 per cent)

3. Year 2: The entity recognises the following:

Dr	Interest	438,700	
Cr	Loan		438,700

Recognition of interest using the effective interest method (CU4,386,995 × 10 per cent)

Dr	Loan	750,000	
Cr	Bank		750,000

Recognition of interest and principal paid on outstanding balance (CU5m × 5 per cent + CU500,000)

4. Year 3: The entity recognises the following:

Dr	Interest	407,569	
Cr	Loan		407,569

Recognition of interest using the effective interest method (CU4,075,695 × 10 per cent)

Dr	Loan	1,225,000	
Cr	Bank		1,225,000

Recognition of interest and principal paid on outstanding balance (CU4.5m × 5 per cent + CU1m)

5. Year 4: The entity recognises the following:

Dr	Interest	325,827	
Cr	Loan		325,827

Recognition of interest using the effective interest method (CU 3,258,264 × 10 per cent)

Dr	Loan	1,675,000	
Cr	Bank		1,675,000

Recognition of interest and principal paid on outstanding balance (CU3.5m × 5 per cent + CU1.5m)

6. Year 5: The entity recognises the following:

Dr	Interest	190,909	

Cr	Loan		190,909

Recognition of interest using the effective interest method (CU1,909,091 × 10 per cent)

Dr	Loan	2,100,000	
Cr	Bank		2,100,000

Recognition of interest and principal paid on outstanding balance (CU2m × 5 per cent + CU2m)

Calculations:

Table 1: Amortisation Schedule (Using Contractual Repayments at 5 per cent Interest)

	Year 0 CU	**Year 1 CU**	**Year 2 CU**	**Year 3 CU**	**Year 4 CU**	**Year 5 CU**
Principal	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 per cent)

	Year 1 CU	**Year 2 CU**	**Year 3 CU**	**Year 4 CU**	**Year 5 CU**
Principal 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 (principal 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 recognised 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**
Principal	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 payments	(250,000)	(250,000)	(225,000)	(175,000)	(100,000)
Principal 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	–

Note: Paragraphs IE156 to IE161 are based on IPSAS 41 paragraphs IE156 to IE161. There is a similar example in IPSAS 29/PBE IPSAS 29 paragraphs IE40 to IE42. The example in IPSAS 29 illustrated subsequent measurement at amortised cost. Example 21 illustrates two scenarios: amortised cost (Scenario 1) and fair value through surplus or deficit (Scenario 2).

Example 21—Payment of a Concessionary Loan (Principal Concession)[56]

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:

Principal to be repaid as follows:

Year 1 to 3: no principal repayments

[56] For simplicity, this example excludes any considerations in relation to calculating expected credit losses.

Year 4: 30 per cent principal to be repaid

Year 5: 30 per cent principal to be repaid

Year 6: 30 per cent principal to be repaid

The remaining principal balance (10 per cent of CU250 million) outstanding at the end of year 6 is to be forgiven.

Interest is calculated at 11.5 per cent 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 per cent.

Scenario 1: Amortised Cost

IE158. After assessing the substance of the concessionary loan, the department of education classifies the financial asset in accordance with paragraphs 39–44. Based on the facts in the example, the department of education classifies the financial assets as measured at amortised cost.

IE159. The aggregated journal entries to account for the concessionary loans when measured at amortised cost are as follows:

1. On initial recognition, the entity recognises the following:

Dr		Loan	236,989,595	
Dr		Expense	13,010,405	
	Cr	Bank		250,000,000

Recognition of the advance of the loans at fair value
Paragraph AG125(b) is considered in recognising an expense for the off-market portion of the loan deemed to be a non-exchange expense.

2. Year 1: The entity recognises the following

Dr		Loan	27,253,803	
	Cr	Interest revenue		27,253,803

Interest accrual using the effective interest method (CU236,989,595 × 11.5 per cent)

Dr		Bank	28,750,000	
	Cr	Loan		28,750,000

Interest payment of CU250m × 11.5 per cent

3. Year 2: The entity recognises the following:

Dr		Loan	27,081,741	
	Cr	Interest revenue		27,081,741

Interest accrual using the effective interest method (CU235,493,398 × 11.5 per cent)

Dr		Bank	28,750,000	
	Cr	Loan		28,750,000

Interest payment of CU250m × 11.5 per cent

4. Year 3: The entity recognises the following:

Dr		Loan	26,889,891	
	Cr	Interest revenue		26,889,891

Interest accrual using the effective interest method (CU233,825,139 × 11.5 per cent)

Dr		Bank	28,750,000	
	Cr	Loan		28,750,000

Interest payment of (CU250m × 11.5 per cent)

5. Year 4: The entity recognises the following:

Dr		Loan	26,675,979	
	Cr	Interest revenue		26,675,979

Interest accrual using the effective interest method (CU231,965,030 × 11.5 per cent)

Dr		Bank	103,750,000	
	Cr	Loan		103,750,000

Recognition of interest and principal received on outstanding balance (CU250m × 11.5 per cent + CU75m)

6. Year 5: The entity recognises 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 per cent)

Dr		Bank	95,125,000	
	Cr	Loan		95,125,000

Recognition of interest and principal received on outstanding balance (CU175m

×11.5 per cent + CU75m)

7. Year 6: The entity recognises 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 per cent)

Dr		Bank	86,500,000	
	Cr	Loan		86,500,000

Recognition of interest and principal received on outstanding balance (CU100m × 11.5 per cent + CU75m)

Scenario 2: Fair Value through Surplus/Deficit

IE160. In addition to the terms outlined in paragraph IE157, the loans provide 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 loans, the department of education determines the classification of the financial asset in accordance with paragraphs 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 assets are classified at fair value through surplus/deficit.

IE161. The aggregated journal entries to account for the concessionary loans when classified at fair value through surplus/deficit are as follows:

1. On initial recognition, the entity recognises the following:

Dr		Loan	236,989,595	
Dr		Expense	13,010,405	
	Cr	Bank		250,000,000

Recognition of the advance of the loans at fair value
Paragraph AG125(b) is considered in recognising an expense for the off-market portion of the loan deemed to be a non-exchange expense.

2. Year 1: The entity recognises the following

Dr		Loan	27,253,803	
	Cr	Interest revenue		27,253,803

Interest accrual of CU236,989,595 × 11.5 per cent

Dr		Bank	28,750,000	
	Cr	Loan		28,750,000

Interest payment of CU250m × 11.5 per cent

3. Year 2: The entity recognises the following:

Dr		Loan	27,081,741	
	Cr	Interest revenue		27,081,741

Interest accrual of CU235,493,398 × 11.5 per cent

Dr		Bank	28,750,000	
	Cr	Loan		28,750,000

Interest payment of CU250m × 11.5 per cent

Dr		Fair value adjustment	2,766,221	
	Cr	Loan		2,766,221

Fair value adjustment (CU231,058,918[57] – (CU235,493,398 + CU27,081,741 – CU28,750,000))

4. Year 3: The entity recognises the following:

Dr		Loan	26,571,776	
	Cr	Interest revenue		26,571,776

Interest accrual of CU231,058,918 × 11.5 per cent

Dr		Bank	28,750,000	
	Cr	Loan		28,750,000

Interest payment of CU250m × 11.5 per cent

Dr		Fair value adjustment	2,620,867	
	Cr	Loan		2,620,867

Fair value adjustment (CU226,259,827[47] – (CU231,058,918 + CU26,571,776 – CU28,750,000))

57 See table 4 in this example for reference to fair values.

5. Year 4: The entity recognises the following:

Dr		Loan	26,019,880	
	Cr	Interest revenue		26,019,880

Interest accrual of CU226,259,827 × 11.5 per cent

Dr		Bank	103,750,000	
	Cr	Loan		103,750,000

Interest payment of CU250m × 11.5 per cent + CU75m principal repaid

Dr		Loan	1,472,217	
	Cr	Fair value adjustment		1,472,217

Fair value adjustment (CU150,001,924[47] – (CU226,259,827 + CU26,019,880 – CU103,750,000))

6. Year 5: The entity recognises the following:

Dr		Loan	17,250,221	
	Cr	Interest revenue		17,250,221

Interest accrual of CU150,001,924 × 11.5 per cent

Dr		Bank	95,125,000	
	Cr	Loan		95,125,000

Interest payment of CU175m × 11.5 per cent + CU75m principal repaid

Dr		Loan	3,750,048	
	Cr	Fair value adjustment		3,750,048

Fair value adjustment (CU75,877,193[47] – (CU150,001,924 + CU17,250,221 – CU95,125,000))

7. Year 6: The entity recognises the following:

Dr		Loan	8,725,877	
	Cr	Interest revenue		8,725,877

Interest accrual of CU75,877,193 × 11.5 per cent

Dr		Bank	86,500,000	
	Cr	Loan		86,500,000

Interest payment of CU100m × 11.5 per cent + CU75m principal repaid

Dr		Loan	1,896,930	
	Cr	Fair value adjustment		1,896,930

Fair value adjustment (CU0[47] – (CU75,877,193 + CU8,725,877 – CU86,500,000))

Calculations

Table 1: Amortisation Schedule (Using Contractual Repayments at 11.5 per cent 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**
Principal	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 Per cent)

	Year 1 CU	**Year 2 CU**	**Year 3 CU**	**Year 4 CU**	**Year 5 CU**	**Year 6 CU**
Principal balance	250,000,000	250,000,000	250,000,000	175,000,000	100,000,000	25,000,000
Interest receivable	28,750,000	28,750,000	28,750,000	28,750,000	20,125,000	11,500,000
Total receipts (principal and interest)	28,750,000	28,750,000	28,750,000	103,750,000	95,125,000	86,500,000
Present value of cash flows	25,784,753	23,125,339	20,740,215	67,125,670	55,197,618	45,016,000
Total present value of cash flows						236,989,595
Proceeds paid						250,000,000
Less: Present value of inflows (fair value of loan on initial recognition)						236,989,595
Off-market portion of loan to be recognised as expense						13,010,405

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
Principal	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)
Principal receipts	-	-	-	(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 per cent	11.5 per cent	12 per cent	13 per cent	14 per cent	14 per cent
Market interest rate (end of year)	11.5 per cent	12 per cent	13 per cent	14 per cent	14 per cent	14 per cent
Interest accrual (11.5 per cent)	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)
Principal receipts	-	-	-	(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	–

Note: Paragraphs IE162 to IE172 are based on IPSAS 41 paragraphs IE162 to IE172. Example 22 is new.

Example 22—Payment of a Concessionary Loan (Loan Commitment)

IE162. Prior to the beginning of every wheat agricultural season, the department of agriculture makes low-interest loans available to qualifying farmers as a means of promoting the cultivation of wheat within the jurisdiction. These loans are available on demand by individual farmers at any time during the planting season and must be repaid prior to the subsequent planting season.

IE163. The department makes available CU100 million to various farmers at the beginning of the harvest season in 20x1. By the end of the harvest season the department has distributed all CU100 million with the following terms and conditions:

- Principal is to be repaid prior to the next harvest season.
- No interest is charged on the outstanding loan balance. Assume the market rate of interest for similar loans is 1.5 per cent.

At the origination of the loan commitments, there is no indication that the instruments are credit-impaired.

Scenario 1: No expected credit losses identified during the loan commitment period

IE164. As the department of agriculture has committed to issue below-market-rate loans, the commitments are accounted for in accordance with paragraphs 45(d) and 57. The aggregated journal entries to initially account for the loan commitments are as follows:

1. On initial recognition, the entity recognises the following:

Dr		Expense	1,477,833	
	Cr	Loan commitment liability		1,477,833

Recognition of commitments to issue loans at below-market rates
The loan commitments are initially measured at fair value in accordance with paragraph 57.

IE165. No further entries are required during the commitment period. This is a result of the department of agriculture electing not to charge a commitment fee, resulting in no revenue to recognise associated with the loan commitments, and the department identifying no credit losses during the commitment period.

IE166. When the concessionary loans are granted, and the loan commitments are satisfied, the substance of the concessionary loans is assessed. The department of agriculture classifies the financial assets in accordance with paragraphs 39–44. Based on the facts in the example, the department of agriculture classifies the financial assets as measured at amortised cost.

IE167. The aggregated journal entries to account for the concessionary loans are as follows:

2. On initial recognition, the entity recognises the following:

Dr		Loan	98,522,167	
Dr		Loan commitment liability	1,477,833	
	Cr	Cash		100,000,000

Recognition of the advance of the loans at fair value
Paragraph AG125(b) is considered in recognising an expense for the off-market portion of the loan deemed to be a non-exchange expense. However, as an expense was previously recognised as part of the loan commitment, no further expense is required.

3. Interest is recognised as follows:

Dr		Loan	1,477,833	
	Cr	Interest revenue		1,477,833

Interest accrual using the effective interest method (CU98,522,167× 1.5 per cent)

4. Loan repayments are recognised as follows:

Dr		Cash	100,000,000	
	Cr	Loan		100,000,000

Department of agriculture collects principal repayments of CU100 million

Scenario 2: Evidence of credit impairment identified during the loan commitment period

IE168. As the department of agriculture has committed to issue below-market-rate loans, the commitments are accounted for in accordance with paragraphs 45(d) and 57. The aggregated journal entries to initially account for the loan commitments are as follows:

1. On initial recognition, the entity recognises the following:

Dr		Expense	1,477,833	
	Cr	Loan commitment liability		1,477,833

Recognition of commitments to issue loans at below-market rates
The loan commitments are initially measured at fair value in accordance with paragraph 57.

IE169. During the loan commitment period, the department of agriculture noted the yield from the current season's wheat harvest was expected to be lower than initially projected. Using the most recent information available, the department of agriculture makes the following estimates:

- The portfolio of loans has a lifetime probability of default of 5 per cent; and
- The loss given default is 35 per cent, and would occur when the principal is repaid.

2. The impairment is recognised as follows:

Dr		Impairment expense	1,724,137	
Dr		Loan commitment liability	1,477,833	
	Cr	Loss allowance		3,201,970

Recognition of impairment expense of CU 1.724 million
The impairment expense is CU1.724 million, which is calculated by multiplying the amount of cash flows receivable (CU 100 million) by the probability of default (5 per cent) and by the loss given default (35 per cent), and discounting at the effective interest rate for one year (1.5 per cent).

IE170. As the concessionary loans are provided, and the loan commitments are satisfied, the substance of the concessionary loans is assessed. The department of agriculture classifies the financial assets in accordance with paragraphs 39–44. Based on the facts in the example, the department of agriculture classifies the financial assets as measured at amortised cost.

IE171. The aggregated journal entries to account for the concessionary loans are as follows:

3. On initial recognition, the entity recognises the following:

Dr	Loan	96,798,030	
Dr	Loss allowance-	3,201,970	
Cr	Cash		100,000,000

Recognition of the advance of the loans at fair value
Paragraph AG125(b) is considered in recognising an expense for the off-market portion of the concessionary originated credit-impaired loan. However, as an expense was previously recognised as part of the loan commitment, no further expense is required.

4. Interest is recognised as follows:

Dr	Loan	1,451,970	
Cr	Interest revenue		1,451,970

Interest accrual using the effective interest method (CU96,798,030 × 1.5 per cent)

IE172. Prior to the loan maturing, the harvest was stronger than projected during the commitment period. Credit losses on the principal balance are expected to be CU 500,000.

5. The impairment gain is recognised as follows:

Dr	Loan	1,250,000	
Cr	Impairment gain		1,250,000

Recognition of the impairment gain of CU1.25 million
Reduction of CU1.25 million is required in order to recognise total expected credit losses of CU500,000 (CU99,500,000 – CU96,798,030 – CU1,451,970).

6. Loan repayments are recognised as follows:

Dr	Cash	99,500,000	
Cr	Loan		99,500,000

Department of agriculture collects principal repayments of CU99.5 million

Calculations

Table 1: Amortisation Schedule (Using Contractual Repayments at 1.5 Per cent Interest)

	Year 0	**Year 1**
Principal	100,000,000	100,000,000
Interest	–	-
Payments	–	100,000,000
Balance	**100,000,000**	**-**

Table 2: Discounting Contractual Cash Flows (Based on a Market Rate of 1.5 Per cent)

	Year 1 CU
Principal balance	100,000,000
Interest payable	-
Total payments (principal and interest)	100,000,000
Present value of payments	98,522,167
Total present value of payments	98,522,167
Proceeds paid	100,000,000
Less: Present value of outflows (fair value of loan on initial recognition)	98,522,167
Off-market portion of loan to be recognised as expense	1,477,833

Table 3: Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1 CU
Principal	98,522,167
Interest accrual	1,477,833
Interest	-
Principal payments	100,000,000
Balance	-

Financial Guarantee (Paragraphs AG131–AG136)

Example 23—Financial Guarantee Contract Provided at Nominal Consideration

Note: Paragraphs IE173 to IE176 are based on IPSAS 41 paragraphs IE173 to IE176. There was a similar example in IPSAS 29/PBE IPSAS 29 (paragraphs IE43 to IE45) but the example has been rewritten to reflect the requirements in IPSAS 41/PBE IPSAS 41.

IE173. 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 instalments of CU25 million in 20X3 and 20X5. Entity C provides nominal consideration of CU5,000 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 CU5,000,000.

IE174. 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 paragraph 45(c), Government A measures the financial guarantee contract at the higher of:

(a) The amount of the loss allowance calculated in accordance with this standard; and

(b) The amount initially recognised, less the cumulative amount of revenue recognised.

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 recognised. Government A therefore does not recognise an additional liability in its statement of financial position. Government A makes the disclosures relating to fair value and credit risk in PBE IPSAS 30, *Financial Instruments: Disclosures* in respect of the financial guarantee contract. In its statement of comprehensive revenue and expense~~financial performance~~ Government A recognises revenue of CU1,000,000 in respect of the initial fair value of the instrument (total consideration of CU5,000,000 / 5 years).

IE175. 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 instalment of the loan with Entity B, but not the initial instalment. 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 CU25.5 million and recognises an expense for, and increases its liability by, CU22.5 million (after the sale to Entity D, the Government has an expected loss of 25 million CUs on the first instalment and CU500,000 on the final instalment, for a total liability of CU25.5 million. The current balance of the financial guarantee of CU3 million is required to be increased by CU22.5 million).

IE176. The journal entries at initial acquisition and at the reporting dates are as follows:

1. On initial recognition, the entity recognises the following:

Dr		Bank	5,000	
Dr		Expense	4,995,000	
	Cr	Financial guarantee contract		5,000,000

2. Year 1: The entity recognises the following

Dr		Financial guarantee contract	1,000,000	
	Cr	Revenue		1,000,000

Revenue of CU5,000,000 is recognised over a 5 year period

3.	Year 2: The entity recognises the following:			
Dr		Financial guarantee contract	1,000,000	
	Cr	Revenue		1,000,000

Revenue of CU5,000,000 is recognised over a 5 year period

Dr		Expense	22,500,000	
	Cr	Financial guarantee contract		22,500,000

Lifetime expected credit losses of CU25.5 million less CU3,000,000 recognised as a liability

Fair Value Measurement Considerations (Paragraphs 66–68)

IE177. Illustrative examples 23–26 demonstrate different valuation techniques for valuing unquoted equity instruments. When selecting an appropriate valuation technique, professional judgement is exercised in considering the requirements in **Error! Reference source not found.**–**Error! Reference source not found.**.

Example 24—Valuation of Unquoted Equity Instruments (Transaction Price Paid for an Identical or Similar Instrument)

IE178. 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 December 31, 20X2 (i.e., the measurement date).

IE179. 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.

IE180. 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

IE181. 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 25—Valuation of Unquoted Equity Instruments (Discounted Cash Flow)

IE182. 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).

IE183. 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

	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[58]	-	100	100	100	100	100
Terminal value[59]						1,121.8
DCF Method using enterprise value less fair value of debt						
Discount factors[60]		0.9182	0.8430	0.7740	0.7107	0.6525
Present value of FCF and terminal value[61]		91.8	84.3	77.4	71.1	797.2
Enterprise value	1,121.8					
Less fair value of debt	(240.0)					
Indicated fair value of equity	**881.8**					

IE184. 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;[62] 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]

IE185. 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 per cent (i.e., CU881.8 x 5 per cent)	44.09
Non-controlling interest discount	(8.00)
Discount for lack of liquidity	(4.09)
Fair value of 5 per cent non-controlling equity interest	**32.00**

Example 26—Valuation of Unquoted Equity Instruments (Constant Growth with Limited Information)

IE186. 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.

58 FCF represent cash flows before interest expense and debt movements. The tax charge has been computed considering no deduction for interest expense.

59 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).

60 The discount factors have been computed using the formula: 1/(1 + WACC) ^ 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).

61 The present value amounts have been computed by multiplying the FCF and terminal value by the corresponding discount factors.

62 The process shown above is not the only possible method that a public benefit~~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.

IE187. 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.

IE188. 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:[63]

	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**

IE189. 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.[64]

IE190. Finally, Public Investment Fund T cross-checks this valuation by comparing Entity S's implied multiples to those of its comparable company peers.[65]

Example 27—Valuation of Unquoted Equity Instruments (Adjusted Net Assets)

IE191. 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.

IE192. 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.

IE193. The following are the adjustments performed by State Government A to the latest statement of financial position of Entity V:

- 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

63 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.

64 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.

65 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.

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 management model and profitability, State Government A estimates that unrecognised 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**
NET ASSETS/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**

IE194. 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 per cent 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.

IE195. 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).[66]

Example 28—Valuation of Unquoted Equity Instruments with Non-Exchange Component

IE196. 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).

[66] The process shown above is not the only possible method that a public benefit~~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.

IE197. 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 benefit~~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 recognises an expense for the concessionary portion of the consideration because the transaction includes a payment for the equity instrument and subsidy.

Example 29—Valuation of Unquoted Equity Instruments Arising from a Non-Exchange Transaction

IE198. 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.

IE199. 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 AG128–AG130 when accounting for this component.

IE200. The second component is the 100 common shares in Bank B. PBE IPSAS 41 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.

IE201. 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.

IE202. 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 30—Valuation of Debt Obligations: Quoted Price

IE203. 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.

IE204. 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 (CU929 × [CU2 million ÷ CU1,000] = CU1,858,000).

IE205. 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 categorises and discloses the fair value measurement of its debt instrument within Level 1 of the fair value hierarchy in accordance with PBE IPSAS 30 *Financial Instruments: Disclosures*.

Example 31—Valuation of Debt Obligations: Present Value Technique

IE206. 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.

IE207. 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, National Government~~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.

IE208. 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).

IE209. 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.

IE210. 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 32—Capital Subscriptions Held with Redemption Features

IE211. 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.

IE212. Government B is evaluating the appropriate classification of the financial asset based on the terms of the subscription rights.

IE213. 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 PBE IPSAS 28 *Financial Instruments: Presentation*.[67] As a result, Government B concludes the election available in paragraph 43 to measure an equity instrument at fair value through other comprehensive revenue and expense~~net assets/equity~~ is not available.

IE214. 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 amortised cost or fair value through other comprehensive revenue and expense~~net assets/equity~~. Government B concludes puttable subscription rights are required to be classified at fair value through surplus or deficit.

[67] Based on guidance in paragraphs 15, 16, 17 and 18 of PBE IPSAS 28 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 PBE IPSAS 28 do not meet the definition of an equity instrument in PBE IPSAS 28.

Effective Interest Method (Paragraphs 69–70)

Example 33—Measuring the Effective Interest Rate of a Bond Issued at a Discount with Transaction Costs

IE215. State Government A issues a 3-year bond with a face value of CU500,000. The instrument carries a fixed yield of 4 per cent, with interest payments paid annually. The bond was issued at a discount of 2 per cent and State Government A was required to pay the bond underwriters a fee equal to CU12,000 on the transaction date.

IE216. In determining the amortised 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.

IE217. 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 (CU20,000 = CU500,000 x 4 per cent), with an additional CU500,000 principal payment made at maturity.

IE218. 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 (CU500,000 x (100 per cent – 2 per cent)). Taking transaction costs into account, the next proceeds on issue were CU478,000 (CU490,000 – CU12,000).

Year	**(a)**	**(b)**	**(c)**	**(d = a – b – c)**
	Cash inflows	**Cash outflows (transaction costs and interest)**	**Cash outflows (principal)**	**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)

IE219. 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.

IE220. In this example, the effective interest rate is 5.02 per cent. This is appropriate as the bond yield was stated to be 4 per cent 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

CONTENTS

Implementation Guidance

This guidance accompanies, but is not part of, PBE IPSAS 41~~IFRS 9~~. ~~The numbers used for the questions are carried forward from the implementation guidance accompanying IAS 39 Financial Instruments: Recognition and Measurement.~~

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 1 million barrels ~~kilograms~~ of oil~~copper~~ in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the oil~~copper~~ 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~~copper~~. 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~~copper~~, 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~~copper~~ 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 PBE IPSAS 41~~IFRS 9~~. Instead, it is accounted for as an executory contract (unless the entity irrevocably designates it as measured at fair value through surplus or deficit~~profit or loss~~ in accordance with paragraph 6~~2.5~~ of PBE IPSAS 41~~IFRS 9~~).

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.[68] **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~~2.4~~ of PBE IPSAS 41~~IFRS 9~~; but see also paragraph 6~~2.5~~ of PBE IPSAS 41~~IFRS 9~~).

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 (PBE IPSAS 41~~IFRS 9~~, paragraph 8~~2.7~~). 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 PBE IPSAS 41~~IFRS 9~~ 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~~2.5~~ of PBE IPSAS 41~~IFRS 9~~).

[68] 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?

PBE IPSAS 41~~IFRS 9~~ 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)
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 PBE IPSAS 41~~IFRS 9~~. 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~~B2.1~~ of PBE IPSAS 41~~IFRS 9~~), a contract to buy or sell a non-financial item such as commodity (see paragraphs 6–8~~2.5–2.7~~ and AG8~~BA.2~~ of PBE IPSAS 41~~IFRS 9~~) or a contract settled in an entity's own shares (see paragraphs 25–29~~21–24~~ of PBE IPSAS 28~~IAS 32~~). 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 PBE IPSAS 41~~IFRS 9~~, 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 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on ~~the basis of~~ 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 per cent 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 per cent per year. Entity S prepays its fixed obligation under the swap of CU50 million (CU100 million × 10% × 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 fulfils 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 PBE IPSAS 41~~IFRS 9~~. 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 PBE IPSAS 41~~IFRS 9~~.

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 per cent 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 per cent 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 PBE IPSAS 41~~IFRS 9~~. Therefore, the contract is not accounted for as a derivative under PBE IPSAS 41~~IFRS 9~~. 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 PBE IPSAS 41~~IFRS 9~~?

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 PBE IPSAS 41~~IFRS 9~~ does not require net settlement.

B.7 Definition of a Derivative: Option Not Expected to be Exercised

The definition of a derivative in PBE IPSAS 41~~IFRS 9~~ 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~~US dollar~~, sells electricity to Mozambique~~products in France~~ denominated in US dollars~~euro~~. XYZ enters into a contract with an investment bank to convert ~~euro to~~ US dollars to rand at a fixed exchange rate. The contract requires XYZ to remit US dollars~~euro~~ based on its sales volume in Mozambique~~France~~ in exchange for rand~~US dollars~~ 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. PBE IPSAS 41~~IFRS 9~~ 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 1 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, 1 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 amortised 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 PBE IPSAS 41~~IFRS 9~~, 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 PBE IPSAS 41~~Appendix A of IFRS 9~~). 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~~24~~ 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 amortised 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 amortised immediately on initial recognition for the purpose of determining amortised 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 amortisation 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 amortised 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~~25~~ 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 per cent for the first 10 years and as zero per cent in subsequent periods. In that case, the initial amount is amortised to zero over the first 10 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 10 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~~26~~ Example of Calculating the Gross Carrying Amount: Financial Asset

How is the gross carrying amount calculated for financial assets measured at amortised cost in accordance with PBE IPSAS 41~~IFRS 9~~?

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 per cent that is paid annually (CU1,250 × 4.7% = 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 recognised).

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

Year	(a) Gross carrying amount at the beginning of the year	(b = a × 10%) Interest revenue	(c) Cash flows	(d = a + b – c) 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 per cent of the contractual par amount will be prepaid at the end of 20X2 and the remaining 50 per cent at the end of 20X4. In accordance with paragraph AG161~~B5.4.6~~ of PBE IPSAS 41~~IFRS 9~~, 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 per cent). 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~~profit or loss~~ 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) Gross carrying amount at the beginning of the year	(b = a × 10%) Interest revenue	(c) Cash flows	(d = a + b – c) 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~~27~~ 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 ~~1~~ 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 ~~31~~ 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 per cent in 20X0 (CU75), 8.0 per cent in 20X1 (CU100), 10.0 per cent in 20X2 (CU125), 12.0 per cent in 20X3 (CU150), and 16.4 per cent in 20X4 (CU205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 per cent. 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 10 per cent 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) Gross carrying amount at the beginning of the year	(b = a × 10%) Interest revenue	(c) Cash flows	(d = a + b – c) 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~~28~~ 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. PBE IPSAS 41~~IFRS 9~~ 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 organised 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~~29~~ Regular Way Contracts: Forward Contract

Entity ABC enters into a forward contract to purchase 1 million of M's ordinary shares in two months for CU10 per share. The contract is ~~with an individual and 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~~30~~ 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 1 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~~31~~ 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~~32~~ Recognition and Derecognition of Financial Liabilities Using Trade Date or Settlement Date Accounting

PBE IPSAS 41~~IFRS 9~~ 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. PBE IPSAS 41~~IFRS 9~~ 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~~3.1.1~~ and 35~~3.3.1~~ of PBE IPSAS 41~~IFRS 9~~ apply. Paragraph 10~~3.1.1~~ of PBE IPSAS 41~~IFRS 9~~ states that financial liabilities are recognised on the date the entity 'becomes a party to the contractual provisions of the instrument'. Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of PBE IPSAS 41~~IFRS 9~~. Paragraph 35~~3.3.1~~ of PBE IPSAS 41~~IFRS 9~~ specifies that financial liabilities are derecognised 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 judgement 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 behaviour 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, caption, 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 behaviour 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 behaviour 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~~4~~ Embedded Derivatives: Equity Kicker

In some instances, investment~~venture capital~~ 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 recognised in surplus or deficit~~profit or loss~~ (paragraph 49~~4.3.3~~(c) of PBE IPSAS 41~~IFRS 9~~), 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~~4.3.3~~(a) of PBE IPSAS 41~~IFRS 9~~). 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~~4.3.3~~(b) and paragraph 9~~Appendix A~~ of PBE IPSAS 41~~IFRS 9~~). 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~~BA.1~~ of PBE IPSAS 41~~IFRS 9~~ 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~~6~~ 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~~B4.3.8~~(a) of PBE IPSAS 41~~IFRS 9~~ 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 PBE IPSAS 41~~IFRS 9~~. 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~~7~~ 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 PBE IPSAS 41~~IFRS 9~~?

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 contact 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~~profit or loss~~ unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.6~~8~~ 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 PBE IPSAS 41~~IFRS 9~~ 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~~2.4~~ and AG8~~BA.2~~ of PBE IPSAS 41~~IFRS 9~~) and the entity has not irrevocably designated it as measured at fair value through surplus or deficit~~profit or loss~~ in accordance with paragraph 6~~2.5~~ of PBE IPSAS 41~~IFRS 9~~. 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~~4.3.3~~ of PBE IPSAS 41~~IFRS 9~~, 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~~B4.3.8~~(d) of PBE IPSAS 41~~IFRS 9~~).

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~~B4.3.8~~(d) of PBE IPSAS 41~~IFRS 9~~ 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~~4.3.3~~ of PBE IPSAS 41~~IFRS 9~~.

C.7~~9~~ Embedded Foreign Currency Derivatives: Currency of International Commerce

Paragraph AG106~~B4.3.8~~(d) of PBE IPSAS 41~~IFRS 9~~ 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~~10~~ Embedded Derivatives: Holder Permitted, but not Required, to Settle Without Recovering Substantially all of its Recognised 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 recognised 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~~B4.3.8~~(a) of PBE IPSAS 41~~IFRS 9~~ that the holder would not recover substantially all of its recognised investment?

No. The condition that 'the holder would not recover substantially all of its recognised 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 recognised 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 recognised 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 recognised 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 recognise the cash collateral it has received as an asset?

Yes. The ultimate realisation 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 realised by Entity A. Therefore, Entity A recognises the cash as an asset and a payable to Entity B while Entity B derecognises the cash and recognises 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 PBE IPSAS 41~~IFRS 9~~ applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in PBE IPSAS 41~~IFRS 9~~ for a purchase of a financial asset. On ~~29~~ 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 ~~31~~ December 31, 20X1 (financial year-end) and on ~~4~~ January 4, 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 amortised cost**	**Financial assets measured at fair value through other comprehensive revenue and expense~~income~~**	**Financial assets measured at fair value through surplus or deficit~~profit or loss~~**
~~29~~ December 29, 20X1			
Financial asset	–	–	–
Financial liability	–	–	–
~~31~~ December 31, 20X1			
Receivable	–	2	2
Financial asset	–	–	–
Financial liability	–	–	–
Other comprehensive revenue and expense~~income~~ (fair value adjustment)	–	(2)	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	–	–	(2)
~~4~~ January 4, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive revenue and expense~~income~~ (fair value adjustment)	–	(3)	–
Accumulated surplus or deficit ~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	–	–	(3)

Trade date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive revenue and expense~~income~~**	**Financial assets measured at fair value through surplus or deficit~~profit or loss~~**
~~29~~ December 29, 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
~~31~~ December 31, 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Other comprehensive revenue and expense~~income~~ (fair value adjustment)	–	(2)	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	–	–	(2)
~~4~~ January 4, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive ~~income~~ revenue and expense (fair value adjustment)	–	(3)	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	–	–	(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 PBE IPSAS 41~~IFRS 9~~ applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in PBE IPSAS 41~~IFRS 9~~ for a sale of a financial asset. On ~~29~~ 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 ~~31~~ December 31, 20X2 (financial year-end), the fair value of the asset is CU1,012. On ~~4~~ 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 amortised cost**	**Financial assets measured at fair value through other comprehensive revenue and expense~~income~~**	**Financial assets measured at fair value through surplus or deficit~~profit or loss~~**
~~29~~ December 29, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Other comprehensive ~~income~~ revenue and expense (fair value adjustment)	–	10	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	–	–	10
~~31~~ December 31, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Other comprehensive ~~income~~ revenue and expense (fair value adjustment)	–	10	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	–	–	10
~~4~~ January 4, 20X3			
Other comprehensive revenue and expense~~income~~ (fair value adjustment)	–	–	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	10	10	10

Trade date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive revenue and expense~~income~~**	**Financial assets measured at fair value through surplus or deficit~~profit or loss~~**
~~29~~ December 29, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Other comprehensive revenue and expense~~income~~ (fair value adjustment)	–	–	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	10	10	10

Trade date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive revenue and expense~~income~~**	**Financial assets measured at fair value through surplus or deficit~~profit or loss~~**
~~31~~ December 31, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Other comprehensive revenue and expense~~income~~ (fair value adjustment)	–	–	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	10	10	10
~~4~~ January 4, 20X3			
Other comprehensive revenue and expense~~income~~ (fair value adjustment)	–	–	–
Accumulated surplus or deficit~~Retained earnings~~ (through surplus or deficit~~profit or loss~~)	10	10	10

D.2.3 Settlement Date Accounting: Exchange of Non-cash Financial Assets

If an entity recognises 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 recognised in accordance with paragraph 105~~5.7.4~~ of PBE IPSAS 41~~IFRS 9~~?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under paragraph 105~~5.7.4~~ of PBE IPSAS 41~~IFRS 9~~ 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 recognised on the trade date as described in paragraph AG19~~B3.1.5~~ of PBE IPSAS 41~~IFRS 9~~. In that case, the entity recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on ~~29~~ December 29, 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is measured at amortised 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 ~~29~~ December 29, while the amortised cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for financial assets measured at amortised cost and trade date accounting for assets that meet the definition of held for trading. On ~~31~~ 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 ~~4~~ 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:

~~29~~ December 29, 20X2			
Dr	Bond B	CU1,010	
	Cr Payable		CU1,010
~~31~~ December 31, 20X2			
Dr	Trading loss	CU1	
	Cr Bond B		CU1
~~4~~ 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~~profit or loss~~. How should this requirement be applied in practice?

For financial assets not measured at fair value through surplus or deficit~~profit or loss~~, 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 amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method and, in effect, amortised through surplus or deficit~~profit or loss~~ over the life of the instrument.

For financial instruments that are measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with either paragraphs 41~~4.1.2A~~ and 111~~5.7.10~~ or paragraphs 43~~4.1.4~~ and 106~~5.7.5~~ of PBE IPSAS 41~~IFRS 9~~, transaction costs are recognised in other comprehensive revenue and expense~~income~~ as part of a change in fair value at the next remeasurement. If the financial asset is measured in accordance with paragraphs 441~~.1.2A~~ and 111~~5.7.10~~ of PBE IPSAS 41~~IFRS 9~~, those transaction costs are amortised to surplus or deficit~~profit or loss~~ using the effective interest method and, in effect, amortised through surplus or deficit~~profit or loss~~ 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.~~3~~2 Gains and L~~l~~osses

E.~~3~~2.1~~2~~ PBE IPSAS 41~~IFRS 9~~ and PBE IPSAS 4~~IAS 21~~—Financial Assets Measured at Fair Value Through Other Comprehensive Revenue and Expense~~income~~: Separation of Currency Component

A financial asset measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~ of PBE IPSAS 41~~IFRS 9~~ is treated as a monetary item. Therefore, the entity recognises changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit~~profit or loss~~ in accordance with paragraphs 27~~23~~(a) and 32~~28~~ of PBE IPSAS 4~~IAS 21~~ and other changes in the carrying amount in other comprehensive revenue and expense~~income~~ in accordance with PBE IPSAS 41~~IFRS 9~~. How is the cumulative gain or loss that is recognised in other comprehensive revenue and expense~~income~~ determined?

It is the difference between the amortised cost of the financial asset[69] and the fair value of the financial asset in the functional currency of the reporting entity. For the purpose of applying paragraph 32~~28~~ of PBE IPSAS 4~~IAS 21~~ the asset is treated as an asset measured at amortised cost in the foreign currency.

To illustrate: on ~~31~~ 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 per cent that is paid annually (FC1,250 × 4.7% = FC59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as subsequently measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~ of PBE IPSAS 41~~IFRS 9~~, and thus recognises gains and losses in other comprehensive revenue and expense~~income~~. 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 × 1.5).

Dr	Bond	LC1,500	
	Cr Cash		LC1,500

On ~~31~~ 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 × 2). The amortised cost is FC1,041 (= LC2,082). In this case, the cumulative gain or loss to be recognised in other comprehensive revenue and expense~~income~~ and accumulated in net assets/equity is the difference between the fair value and the amortised cost on ~~31~~ December 31, 20X2, i.e., LC38 (= LC2,120 – LC2,082).

Interest received on the bond on ~~31~~ December 31, 20X2 is FC59 (= LC118). Interest revenue determined in accordance with the effective interest method is FC100 (= FC1,000 × 10 per cent). 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~~22~~ of PBE IPSAS 4~~IAS 21~~). Thus, reported interest revenue is LC175 (= FC100 × 1.75) including accretion of the initial discount of LC72 (= [FC100 – FC59] × 1.75). Accordingly, the exchange difference on the bond that is recognised in surplus or deficit~~profit or loss~~ is LC510 (= LC2,082 – LC1,500 – LC72). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.00 – 1.75]).

Dr	Bond	LC620	
Dr	Cash	LC118	
	Cr Interest revenue		LC175
	Cr Exchange gain		LC525
	Cr Fair value change in other comprehensive revenue and expense~~income~~		LC38

69 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 other comprehensive revenue and expense~~income~~ in accordance with paragraph 41~~4.1.2A~~ of PBE IPSAS 41~~IFRS 9~~. Consequently, for simplicity, this example does not reflect the effect of the impairment requirements in paragraphs 73–93~~Section 5.5~~ of PBE IPSAS 41~~IFRS 9~~.

On ~~31~~ 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 (= FC1,070 × 2.50). The amortised cost is FC1,086 (= LC2,715). The cumulative gain or loss to be accumulated in other comprehensive revenue and expense~~income~~ is the difference between the fair value and the amortised cost on ~~31~~ December 31, 20X3, i.e., negative LC40 (= LC2,675 – LC2,715). Thus, the amount recognised in other comprehensive revenue and expense~~income~~ equals the change in the difference during 20X3 of LC78 (= LC40 + LC38).

Interest received on the bond on ~~31~~ December 31, 20X3 is FC59 (= LC148). Interest revenue determined in accordance with the effective interest method is FC104 (= FC1,041 × 10%). 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~~22~~ of PBE IPSAS 4~~IAS 21~~). Thus, recognised interest revenue is LC234 (= FC104 × 2.25) including accretion of the initial discount of LC101 (= [FC104 – FC59] × 2.25). Accordingly, the exchange difference on the bond that is recognised in surplus or deficit~~profit or loss~~ is LC532 (= LC2,715 – LC2,082 – LC101). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.50 – 2.25]).

Dr	Bond		LC555	
Dr	Cash		LC148	
Dr	Fair value change in other comprehensive revenue and expense~~income~~		LC78	
	Cr	Interest revenue		LC234
	Cr	Exchange gain		LC547

E.2~~3~~.2~~3~~ PBE IPSAS 41~~IFRS 9~~ and PBE IPSAS 4~~IAS 21~~—Exchange Differences Arising on Translation of Foreign Entities: Other Comprehensive Revenue and Expense ~~income~~ or Surplus~~profit~~ or Deficit~~loss~~?

Paragraphs 37~~32~~ and 57~~48~~ of PBE IPSAS 4~~IAS 21~~ state that all exchange differences resulting from translating the financial statements of a foreign operation should be recognised in other comprehensive revenue and expense~~income~~ 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~~profit or loss~~ and financial assets that are measured at fair value through other comprehensive revenue and expense~~income~~ in accordance with PBE IPSAS 41~~IFRS 9~~.

PBE IPSAS 41~~IFRS 9~~ requires that changes in fair value of financial assets measured at fair value through surplus or deficit~~profit or loss~~ should be recognised in surplus or deficit~~profit or loss~~ and changes in fair value of financial assets measured at fair value through other comprehensive revenue and expense~~income~~ should be recognised in other comprehensive revenue and expense~~income~~.

If the foreign operation is a controlled entity~~subsidiary~~ whose financial statements are consolidated with those of its controlling entity~~parent~~, in the consolidated financial statements how are PBE IPSAS 41~~IFRS 9~~ and paragraph 44~~39~~ of PBE IPSAS 4~~IAS 21~~ applied?

PBE IPSAS 41~~IFRS 9~~ applies in the accounting for financial instruments in the financial statements of a foreign operation and PBE IPSAS 4~~IAS 21~~ 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~~subsidiary~~ (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~~profit or loss~~ in accordance with PBE IPSAS 41~~IFRS 9~~.

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 (= LCY100 × 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 recognises the trading asset at LCY110 in its statement of financial position and recognises a fair value gain of LCY10 in its surplus or deficit~~profit or loss~~. 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 (= LCY110 × 3.00) in the currency of Country X. Therefore, Entity A recognises the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of comprehensive revenue and expense~~income~~ of B 'at the exchange rates at the dates of the transactions' (paragraph 44~~39~~(b) of PBE IPSAS 4~~IAS 21~~). 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~~22~~ of PBE IPSAS 4~~IAS 21~~). Therefore, while the fair value of the trading asset has increased by LCX130 (= LCX330 – LCX200), Entity A recognises only LCX25 (= LCY10 × 2.5) of this increase in consolidated surplus or deficit~~profit or loss~~ to comply with paragraph 44~~39~~(b) of PBE IPSAS 41~~IAS 21~~. The resulting exchange difference, i.e., the remaining increase in the fair value of the debt instrument (LCX130 – LCX25 = LCX105), is accumulated in other comprehensive revenue and expense~~income~~ until the disposal of the net investment in the foreign operation in accordance with paragraph 57~~48~~ of PBE IPSAS 4~~IAS 21~~.

E.2.3~~3.4~~ PBE IPSAS 41~~IFRS 9~~ and PBE IPSAS 4~~IAS 21~~—Interaction Between PBE IPSAS 41~~IFRS 9~~ and PBE IPSAS 4~~IAS 21~~

PBE IPSAS 41~~IFRS 9~~ includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in surplus or deficit~~profit or loss~~. PBE IPSAS 4~~IAS 21~~ includes rules about the reporting of foreign currency items and the recognition of exchange differences in surplus or deficit~~profit or loss~~. In what order are PBE IPSAS 4~~IAS 21~~ and PBE IPSAS 41~~IFRS 9~~ applied?

Statement of Financial Position

Generally, the measurement of a financial asset or financial liability at fair value or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with PBE IPSAS 41~~IFRS 9~~. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with PBE IPSAS 4~~IAS 21~~ (paragraph AG224~~B5.7.2~~ of PBE IPSAS 41~~IFRS 9~~). For example, if a monetary financial asset (such as a debt instrument) is measured at amortised cost in accordance with PBE IPSAS 41~~IFRS 9~~, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (paragraph 27~~23~~ of PBE IPSAS 4~~IAS 21~~). That applies regardless of whether a monetary item is measured at amortised cost or fair value in the foreign currency (paragraph 28~~24~~ of PBE IPSAS 4~~IAS 21~~). 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~~23~~(c) of PBE IPSAS 4~~IAS 21~~).

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 PBE IPSAS 41~~IFRS 9~~ (or PBE IPSAS 29~~IAS 39~~ if an entity chooses as its accounting policy to continue to apply the hedge accounting requirements in PBE IPSAS 29~~IAS 39~~), the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under PBE IPSAS 4~~IAS 21~~ (paragraph 137~~6.5.8~~ of PBE IPSAS 41~~IFRS 9~~ or paragraph 99~~89~~ of PBE IPSAS 29~~IAS 39~~), i.e., the foreign currency amount is recognised 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~~23~~(b) of PBE IPSAS 4~~IAS 21~~).

Surplus or Deficit~~Profit or loss~~

The recognition of a change in the carrying amount of a financial asset or financial liability in surplus or deficit~~profit or loss~~ 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 recognising 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~~3.3~~).

Any exchange difference arising on recognising *a monetary item* at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in surplus or deficit~~profit or loss~~ in accordance with PBE IPSAS 4~~IAS 21~~ (paragraph AG224~~B5.7.2~~ of PBE IPSAS 41~~IFRS 9~~, paragraphs 32~~28~~ and 37~~32~~ of PBE IPSAS 41~~IAS 21~~), 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 apply (paragraph 140~~6.5.11~~ of PBE IPSAS 41~~IFRS 9~~ or paragraph 106~~95~~ of PBE IPSAS 29~~IAS 39~~). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised 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 recognised in surplus or deficit~~profit or loss~~ in accordance with PBE IPSAS 41~~IFRS 9~~. For example, although an entity recognises gains and losses on financial assets measured at fair value through other comprehensive revenue and expense~~income~~ in other comprehensive revenue and expense~~income~~ (paragraphs 111~~5.7.10~~ and AG225~~B5.7.2A~~ of PBE IPSAS 41~~IFRS 9~~), the entity nevertheless recognises the changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit~~profit or loss~~ (paragraph 27~~23~~(a) of PBE IPSAS 4~~IAS 21~~).

Any changes in the carrying amount of a *non-monetary item* are recognised in surplus or deficit~~profit or loss~~ or in other comprehensive revenue and expense~~income~~ in accordance with PBE IPSAS 41~~IFRS 9~~. For example, for an investment in an equity instrument that is presented in accordance with paragraph 106~~5.7.5~~ of PBE IPSAS 41~~IFRS 9~~, the entire change in the carrying amount, including the effect of changes in foreign currency rates, is presented in other comprehensive revenue and expense~~income~~ (paragraph AG226~~B5.7.3~~ of PBE IPSAS 41~~IFRS 9~~). If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges apply (paragraph 140~~6.5.11~~ of PBE IPSAS 41~~IFRS 9~~ or paragraph 106~~95~~ of PBE IPSAS 29~~IAS 39~~).

When some portion of the change in carrying amount is recognised in other comprehensive revenue and expense~~income~~ and some portion is recognised in surplus or deficit~~profit or loss~~, for example, if the amortised cost of a foreign currency bond measured at fair value through other comprehensive revenue and expense~~income~~ has increased in foreign currency (resulting in a gain in surplus or deficit~~profit or loss~~) but its fair value has decreased in foreign currency (resulting in a loss recognised in other comprehensive revenue and expense~~income~~), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in surplus or deficit~~profit or loss~~ or in other comprehensive revenue and expense~~income~~.

Note: Section E.2.4 is new. There is no equivalent implementation guidance in IFRS 9 or IPSAS 29/PBE IPSAS 29.

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?

Entities have a wide range of valuation techniques available when determining the fair value of an unquoted equity instrument. PBE IPSAS 41 does not prescribe the use of a specific valuation technique, but instead encourages the use of professional judgement and the consideration of all the facts and circumstances surrounding the section of an appropriate measurement technique. Figure 1 illustrates various valuations 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	• Transaction price paid for an identical or similar instrument of an investee (see illustrative example 23) • Comparable company valuation multiples
Other approaches	• Discounted cash flow method (see illustrative example 24) • Dividend discount model • Constant growth model (see illustrative example 25) • Capitalisation model • Adjusted net asset method (see illustrative example 26)

The economic characteristics of unquoted equity instruments and the information that is reasonably available to an 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, an entity is likely to place more emphasis on the discounted cash flow method when, for example:

(a) The cash flows of an entity present unique characteristics such as periods of unequal rates of growth (for example, a period of high growth that stabilises later to more steady levels of growth).

(b) Alternatively, when measuring the fair value of unquoted equity instruments, an 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 an 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 an 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 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.

Note: Section E.2.5 is new. There is no equivalent implementation guidance in IFRS 9 or IPSAS 29/PBE IPSAS 29.

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 AG140 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 ~~G~~F Other

Note: Section F is based on Section G.2 of the implementation guidance that accompanies IFRS 9.

F.1 PBE IPSAS 41 and PBE IPSAS 2—Hedge Accounting: Cash Flow Statements

How should cash flows arising from hedging instruments be classified in cash flow statements?

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 PBE IPSAS 2 has not been updated to reflect PBE IPSAS 41, the classification of cash flows arising from hedging instruments in the cash flow statement should be consistent with the classification of these instruments as hedging instruments under PBE IPSAS 41.

Note: Section G is new. There is no equivalent implementation guidance in IFRS 9 or IPSAS 29/PBE IPSAS 29.

Section G Concessionary Loans and Non-Exchange Equity Transactions

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 PBE IPSAS 28 and paragraphs 42–58 of PBE 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 paragraphs AG144–AG155. 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 61–65.

G.2 Concessionary Loans and 'Solely Payments of Principal and Interest' Evaluation

Can a concessionary loan satisfy the SPPI condition?

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 (see paragraphs AG72–AG75).

A common feature of a concessionary loan is an interest concession. A concessionary loan with a contractual interest rate of nil does not preclude the instrument from satisfying the SPPI condition.

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.

G.4 Equity Instruments Arising from Non-Exchange Transactions

How might an equity instrument included in a non-exchange transaction be evidenced?

In assessing whether an equity instrument is included as part of a transaction that also includes a non-exchange component, an entity applies the definition of an equity instrument and the requirements in PBE IPSAS 28.

Indicators that may evidence the existence of an equity instrument may include:

(a) A formal designation of the transfer (or a class of such transfers) of equity instruments forming part of the investment's contributed net assets/equity, either before the investment occurs or at the time of the investment;

(b) A formal agreement, in relation to the equity instrument, establishing or increasing an existing financial interest in the net assets/equity of the investment that can be sold, transferred, or redeemed; or

(c) The receipt of equity instruments that can be sold, transferred, or redeemed.

G.5 Factors to consider in evaluating concessionary and originated credit-impaired loans

What factors should be considered when evaluating whether a loan is a concessionary loan or an originated credit-impaired loan?

Both concessionary loans and originated credit-impaired loans have lower estimated future cash flows than similar loans that do not have a concessionary or credit-impaired component.

The issuer of a debt instrument evaluates the substance of the financial instrument to determine whether the instrument is classified as a concessionary loan or an originated credit-impaired loan.

Features that indicate that the financial instrument is a concessionary loan include:

- The lender has an objective to incorporate a non-exchange component in the loan transaction. As such, the lender intends to give up a portion of the cash flows that would otherwise be available had the transaction been negotiated at market terms;
- The financial instrument is extended below-market terms, by way of an interest and/or a principal concession; and
- The characteristics of the loan agreement, i.e., the contractual terms that are negotiated off market, result in a decrease in the estimated future cash flows of the instrument when compared to a similar loan that does not have a concessionary or credit-impaired component.

Originated credit-impaired financial assets (see paragraphs 85–86) are generally extended at market terms at origination but have lower estimated cash flows in comparison to similar instruments, because the borrowing entity is not expected to be able to satisfy the contractual terms of the arrangement. The lender expects a portion of the contractual cash flows to be uncollectible, as opposed to intending to give up a portion of the cash flows which would otherwise be available at market terms. As such, originated credit-impaired loans present an opportunity for the lender to collect cash flows in excess of the estimated future cash flows, while with concessionary loans, the estimated future cash flows approximate the contractual cash flows, meaning no additional cash flows are available.

G.6 Concessionary loans that are originated credit-impaired

Can a concessionary loan be originated credit-impaired?

Yes. In some circumstances a concessionary loan may be granted that is also originated credit-impaired. A concessionary loan may be credit-impaired at origination because one or more events have had a detrimental impact on the estimated future cash flows of the financial asset.

For example, in order to support the operation of the national airline's domestic routes, the department of finance advances loans to the airline on an annual basis. The annual interest payments are based on a contract rate of 6 per cent. Assuming the market rate at the time the loan is advanced is 10 per cent, this represents a concession.

Historically, even with the concessionary terms, the department of finance has collected only 85 per cent of the loan's contractual cash flows. The department of finance expects this trend to continue with the current loan issue.

This example represents a concessionary originated credit-impaired loan as the loan has concessionary terms, but even with those terms, significant credit losses are expected to occur.

In evaluating whether the expected credit losses on the concessionary loan support the loan being originated credit-impaired or just represent normal credit losses, the entity considers whether one or more events has occurred that have had a detrimental impact on the estimated future cash flows of the loan.

Note: Section H is new. There is no equivalent implementation guidance in IFRS 9 or IPSAS 29/PBE IPSAS 29.

Section H Effective Interest Method

H.1 Requirement to Use the Effective Interest Method

When transaction costs and any premium or discount on issuance are insignificant, measuring the amortised 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 method yields immaterial differences as compared to applying the straight-line method, is the effective interest method required to be used?

Measuring the amortised cost of an instrument requires the use of the effective interest method. However, in practice there may be scenarios where applying the straight-line method yields materially the same result.

Paragraph 10 of PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors*, indicates "PBE Standards set out accounting policies that the NZASB has concluded result in financial statements of public benefit entities containing relevant and faithfully representative 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 amortised cost using the effective interest method, management need not apply the effective interest method as required by PBE IPSAS 41 *Financial Instruments*.

The following example illustrates why differences arise when measuring the gross amount of a debt instrument using the effective interest 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 per cent is paid annually until maturity in 5 years. The bond was issued at a discount of 3 per cent 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 (CU95,000 = CU100,000 – CU2,000 – CU100,000 x 3 per cent).

Straight-Line Method

Measuring the gross amount of the instrument using the straight-line method requires amortising the discount and transaction costs evenly until maturity.

Year	**(a)**	**(b = 100,000 × 10 per cent)**	**(c)**	**(d)**	**(e = a + b + c – d)**
	Gross carrying amount at the beginning of the year	**Interest expense**	**Amortisation 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
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 Method

Measuring the gross amount of the instrument using the effective interest 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 per cent.

Year	(a)	(b = a × 11.37 per cent)	(c)	(d = a + b – c)
	Gross carrying amount at the beginning of the year	Interest expense	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 interest method, the gross amount is compared at each measurement date as detailed in the table below.

Year	Straight-Line Method	Effective Interest 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
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 method will become smaller. As the costs increase, the difference will grow in size.

Furthermore, contemplating the effect on annual interest expense may yield further considerations when assessing whether applying the straight-line method or effective interest method is material.

Note: Section I is new. There is no equivalent implementation guidance in IFRS 9 or IPSAS 29/PBE IPSAS 29.

Section I Sovereign Debt Restructurings

I.1 Sovereign Debt Restructurings

Are sovereign debt restructurings covered by PBE IPSAS 41?

Yes. Sovereign debt restructurings involve the modification, and/or derecognition, of financial liabilities, which are addressed in PBE IPSAS 41. The requirements and guidance relevant to sovereign debt restructurings include:

(a) Paragraphs 57 and 64 establish the requirements for the initial, and subsequent, measurement of financial liabilities;

(b) Paragraphs 35–38 establish the derecognition requirements for financial liabilities;

(c) Paragraph AG46 provides application guidance for assessing the extent of modifications to financial liabilities; and

(d) Paragraphs AG118–AG127 provide application guidance for loans granted at concessionary terms.

HISTORY OF AMENDMENTS

Table of Pronouncements – PBE IPSAS 41 *Financial Instruments*

This table lists the pronouncements establishing and substantially amending PBE IPSAS 41.

Pronouncements	**Date approved**	**Early operative date**	**Effective date (annual reporting periods… on or after …)**
PBE IPSAS 41 *Financial Instruments*	[Date]	Early application permitted	[Proposed] 1 Jan 2022

EXPOSURE DRAFT

PUBLIC BENEFIT ENTITY INTERNATIONAL FINANCIAL REPORTING STANDARD 17 INSURANCE CONTRACTS (PBE IFRS 17)

Issued [Date]

This [draft][1] Standard was issued on [Date] by the New Zealand Accounting Standards Board of the External Reporting Board pursuant to section 12(a) of the Financial Reporting Act 2013.

This [draft] Standard is a disallowable instrument for the purposes of the Legislation Act 2012, and pursuant to section 27(1) of the Financial Reporting Act 2013 takes effect on [Date].

Reporting entities that are subject to this [draft] Standard are required to apply it in accordance with the effective date, which is set out in paragraphs 132.1 to 132.2.

In finalising this [draft] Standard, the New Zealand Accounting Standards Board has carried out appropriate consultation in accordance with section 22(1) of the Financial Reporting Act 2013.

This New Zealand Tier 1 and Tier 2 Public Benefit Entity Accounting Standard has been issued to align the requirements for insurance contracts for Tier 1 and Tier 2 public benefit entities with the requirements for Tier 1 and Tier 2 for-profit entities applying New Zealand Equivalent to International Financial Reporting Standard 17 *Insurance Contracts* (NZ IFRS 17).

This Standard, when applied, supersedes PBE IFRS 4 *Insurance Contracts*.

[1] References to "this Standard" throughout this Exposure Draft should be read as referring to "this draft Standard".

PBE IFRS 17 INSURANCE CONTRACTS

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PBE IFRS 17 INSURANCE CONTRACTS

CONTENTS

The following is available within New Zealand on the XRB website as additional material

IASB Basis for Conclusions

Public Benefit Entity International Financial Reporting Standard 17 *Insurance Contracts* (PBE IFRS 17) is set out in paragraphs 1–166~~32~~ and Appendices A–D. PBE IFRS 17 is based on International Financial Reporting Standard 17 *Insurance Contracts* issued by the International Accounting Standards Board and NZ IFRS 17 *Insurance Contracts*. All the paragraphs have equal authority. PBE IFRS 17 should be read in the context of its objective, the NZASB's Basis for Conclusions on PBE IFRS 17, the IASB's Basis for Conclusions on IFRS 17, the *Public Benefit Entities' Conceptual Framework* and Standard XRB A1 *Application of the Accounting Standards Framework*. PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. **PBE IFRS 17 *Insurance Contracts* establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts within the scope of the Standard. The objective of PBE IFRS 17 is to ensure that an entity provides relevant information that faithfully represents those contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.**

2. An entity shall consider its substantive rights and obligations, whether they arise from a contract, law or regulation, when applying PBE IFRS 17. A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Contractual terms include all terms in a contract, explicit or implied, but an entity shall disregard terms that have no commercial substance (i.e., no discernible effect on the economics of the contract). Implied terms in a contract include those imposed by law or regulation. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services).

Scope

2.1 **This Standard applies to Tier 1 and Tier 2 public benefit entities.**

3. An entity shall apply PBE IFRS 17 to:

   (a) Insurance contracts, including reinsurance contracts, it issues;

   (b) Reinsurance contracts it holds; ~~and~~

   (c) Investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts~~.~~; and

   (d) Schemes where:

      (i) The scheme is intended to be fully funded from contributions and levies (paragraphs AG1.1–AG1.4 provide additional guidance); and

      (ii) There is evidence that the entity manages the scheme in the same way as an issuer of insurance contracts, including assessing the financial performance and financial position of the scheme on a regular basis (paragraphs AG1.5–AG1.6 provide additional guidance).

4. All references in PBE IFRS 17 to insurance contracts also apply to:

   (a) Reinsurance contracts held, except:

      (i) For references to insurance contracts issued; and

      (ii) As described in paragraphs 60–70.

   (b) Investment contracts with discretionary participation features as set out in paragraph 3(c), except for the reference to insurance contracts in paragraph 3(c) and as described in paragraph 71.

5. All references in PBE IFRS 17 to insurance contracts issued also apply to insurance contracts acquired by the entity in a transfer of insurance contracts or a business combination other than reinsurance contracts held.

6. ~~Appendix A~~Paragraph 13.1 defines an insurance contract and paragraphs AG~~B~~2–AG~~B~~30 ~~of Appendix B~~ provide guidance on the definition of an insurance contract.

7. An entity shall not apply PBE IFRS 17 to:

   (a) Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see ~~IFRS 15 *Revenue from Contracts with Customers*~~ PBE IPSAS 9 *Revenue from Exchange Transactions* and PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*).

(b) Employers' assets and liabilities from employee benefit plans (see PBE IPSAS ~~1~~39 *Employee Benefits*~~ and IFRS 2 *Share-based Payment*~~) and retirement benefit obligations reported by defined benefit retirement plans (see the relevant international or national standard dealing with reporting by retirement benefit plans~~IAS 26 *Accounting and Reporting by Retirement Benefit Plans*~~).

(c) Contractual rights or contractual obligations contingent on the future use of, or the right to use, a non-financial item (for example, some licence fees, royalties, ~~variable and other~~ contingent lease payments and similar items: see ~~IFRS 15~~PBE IPSAS 9, PBE IPSAS 13 *Leases* and PBE IPSAS 31 ~~IAS 38~~ *Intangible Assets*~~ and IFRS 16 *Leases*~~).

(d) Residual value guarantees provided by a manufacturer, dealer or retailer and a lessee's residual value guarantees when they are embedded in a lease (see ~~IFRS 15 and IFRS 16~~PBE IPSAS 13).

(e) Financial guarantee contracts, unless the issuer has previously ~~asserted explicitly that it regards such contracts as insurance contracts and has used~~applied accounting applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts. The issuer shall choose to apply either PBE IFRS 17 or PBE IPSAS ~~3~~28 *Financial Instruments: Presentation*, ~~IFRS 7~~PBE IPSAS 30 *Financial Instruments: Disclosures* and ~~IFRS 9~~[proposed] PBE IPSAS 41 *Financial Instruments* to such financial guarantee contracts.[2] The issuer may make that choice contract by contract, but the choice for each contract is irrevocable.

(f) Contingent consideration payable or receivable in a business combination (see PBE IFRS 3 *Business Combinations*).[3]

(g) Insurance contracts in which the entity is the policyholder, unless those contracts are reinsurance contracts held (see paragraph 3(b)).

8. Some contracts meet the definition of an insurance contract but have as their primary purpose the provision of services for a fixed fee. An entity may choose to apply ~~IFRS 15~~PBE IPSAS 9 instead of PBE IFRS 17 to such contracts that it issues if, and only if, specified conditions are met. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:

(a) The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;

(b) The contract compensates the customer by providing services, rather than by making cash payments to the customer; and

(c) The insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

Combination of Insurance Contracts

9. A set or series of insurance contracts with the same or a related counterparty may achieve, or be designed to achieve, an overall commercial effect. In order to report the substance of such contracts, it may be necessary to treat the set or series of contracts as a whole. For example, if the rights or obligations in one contract do nothing other than entirely negate the rights or obligations in another contract entered into at the same time with the same counterparty, the combined effect is that no rights or obligations exist.

Separating Components from an Insurance Contract (paragraphs AG~~B~~31–~~B~~AG35)

10. An insurance contract may contain one or more components that would be within the scope of another Standard if they were separate contracts. For example, an insurance contract may include an investment component or a service component (or both). An entity shall apply paragraphs 11–13 to identify and account for the components of the contract.

11. An entity shall:

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[2] NZASB ED 2018-5 PBE IPSAS 41 *Financial Instruments* sets out proposals for a PBE Standard which would supersede most of the requirements in PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* and PBE IFRS 9 *Financial Instruments*.

[3] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 7(f) would refer to PBE IPSAS 40 *PBE Combinations* rather than to PBE IFRS 3.

(a) Apply ~~IFRS 9~~ [proposed] PBE IPSAS 41 to determine whether there is an embedded derivative to be separated and, if there is, how to account for that derivative.

(b) Separate from a host insurance contract an investment component if, and only if, that investment component is distinct (see paragraphs ~~B~~AG31–~~B~~AG32). The entity shall apply ~~IFRS 9~~[proposed] PBE IPSAS 41 to account for the separated investment component.

12. After applying paragraph 11 to separate any cash flows related to embedded derivatives and distinct investment components, an entity shall separate from the host insurance contract any promise to transfer distinct goods or non-insurance services to a policyholder. ~~, applying paragraph 7 of IFRS 15. The entity shall account for such promises applying IFRS 15. In applying paragraph 7 of IFRS 15 t~~To separate the promise, the entity shall apply paragraphs ~~B~~AG33–~~B~~AG35 of PBE IFRS 17 and, on initial recognition, shall:

(a) ~~Apply IFRS 15 to a~~Attribute the cash inflows between the insurance component and any promises to provide distinct goods or non-insurance services; and

(b) Attribute the cash outflows between the insurance component and any promised goods or non-insurance services accounted for ~~applying IFRS 15~~ so that:

(i) Cash outflows that relate directly to each component are attributed to that component; and

(ii) Any remaining cash outflows are attributed on a systematic and rational basis, reflecting the cash outflows the entity would expect to arise if that component were a separate contract.

13. After applying paragraphs 11–12, an entity shall apply PBE IFRS 17 to all remaining components of the host insurance contract. Hereafter, all references in PBE IFRS 17 to embedded derivatives refer to derivatives that have not been separated from the host insurance contract and all references to investment components refer to investment components that have not been separated from the host insurance contract (except those references in paragraphs ~~B~~AG31–~~B~~AG32).

Definitions

13.1 **The following terms are used in this Standard with the meanings specified:**

The contractual service margin is a component of the carrying amount of the asset or liability for a group of insurance contracts representing the unearned ~~profit~~ surplus the entity will recognise as it provides services under the insurance contracts in the group.

For insurance contracts without direct participation features, ~~T~~the coverage period is the period during which the entity provides coverage for insured events. This period includes the coverage that relates to all premiums within the boundary of the insurance contract. For insurance contracts with direct participation features, the period during which the entity provides coverage for insured events or investment-related services. This period includes the coverage for insured events or investment-related services that relates to all premiums within the boundary of the insurance contract.

Experience adjustment: A difference between:

(a) For premium receipts (and any related cash flows such as insurance acquisition cash flows and insurance premium taxes)—the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or

(b) For insurance service expenses (excluding insurance acquisition expenses)—the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.

Financial risk is the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency 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.

Fulfilment cash flows is an explicit, unbiased and probability-weighted estimate (~~ie~~i.e., expected value) of the present value of the future cash outflows minus the present value of the future cash

inflows that will arise as the entity fulfils insurance contracts, including a risk adjustment for non-financial risk.

A group of insurance contracts is a set of insurance contracts resulting from the division of a portfolio of insurance contracts into, at a minimum, contracts written within a period of no longer than one year and that, at initial recognition:

(a) Are onerous, if any;

(b) Have no significant possibility of becoming onerous subsequently, if any; or

(c) Do not fall into either (a) or (b), if any.

Insurance acquisition cash flows are cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

An insurance contract is a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

An insurance contract with direct participation features is an insurance contract for which, at inception:

(a) The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and

(c) The entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

An insurance contract without direct participation features is an insurance contract that is not an insurance contract with direct participation features.

Insurance risk is risk, other than financial risk, transferred from the holder of a contract to the issuer.

An insured event is an uncertain future event covered by an insurance contract that creates insurance risk.

Investment component: The amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur.

An investment contract with discretionary participation features is a financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

(a) That are expected to be a significant portion of the total contractual benefits;

(b) The timing or amount of which are contractually at the discretion of the issuer; and

(c) That are contractually based on:

(i) The returns on a specified pool of contracts or a specified type of contract;

(ii) Realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) The ~~profit or loss~~surplus or deficit of the entity or fund that issues the contract.

Liability for incurred claims: An entity's obligation to investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses.

Liability for remaining coverage: An entity's obligation to investigate and pay valid claims under existing insurance contracts for insured events that have not yet occurred (i.e., the obligation that relates to the unexpired portion of the coverage period).

Non-performance risk is the risk that an entity will not fulfil an obligation. Non-performance risk includes, but may not be limited to, the entity's own credit risk.

A policyholder is a party that has a right to compensation under an insurance contract if an insured event occurs.

Portfolio of insurance contracts: Insurance contracts subject to similar risks and managed together.

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by that other entity (underlying contracts).

Risk adjustment for non-financial risk: is the compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts.

Underlying items are items that determine some of the amounts payable to a policyholder. Underlying items can comprise any items; for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity.

Terms defined in other PBE Standards are used in this Standard with the same meaning as in those standards, and are reproduced in the *Glossary of Defined Terms* published separately.

Level of Aggregation of Insurance Contracts

14. **An entity shall identify portfolios of insurance contracts. A portfolio comprises contracts subject to similar risks and managed together. Contracts within a product line would be expected to have similar risks and hence would be expected to be in the same portfolio if they are managed together. Contracts in different product lines (for example single premium fixed annuities compared with regular term life assurance) would not be expected to have similar risks and hence would be expected to be in different portfolios.**

15. **Paragraphs 16–24 apply to insurance contracts issued. The requirements for the level of aggregation of reinsurance contracts held are set out in paragraph 61.**

16. **An entity shall divide a portfolio of insurance contracts issued into a minimum of:**

    (a) **A group of contracts that are onerous at initial recognition, if any;**

    (b) **A group of contracts that at initial recognition have no significant possibility of becoming onerous subsequently, if any; and**

    (c) **A group of the remaining contracts in the portfolio, if any.**

17. If an entity has reasonable and supportable information to conclude that a set of contracts will all be in the same group applying paragraph 16, it may measure the set of contracts to determine if the contracts are onerous (see paragraph 47) and assess the set of contracts to determine if the contracts have no significant possibility of becoming onerous subsequently (see paragraph 19). If the entity does not have reasonable and supportable information to conclude that a set of contracts will all be in the same group, it shall determine the group to which contracts belong by considering individual contracts.

18. For contracts issued to which an entity applies the premium allocation approach (see paragraphs 53–59), the entity shall assume no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. An entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous subsequently by assessing the likelihood of changes in applicable facts and circumstances.

19. For contracts issued to which an entity does not apply the premium allocation approach (see paragraphs 53–59), an entity shall assess whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(a) Based on the likelihood of changes in assumptions which, if they occurred, would result in the contracts becoming onerous.

(b) Using information about estimates provided by the entity's internal reporting. Hence, in assessing whether contracts that are not onerous at initial recognition have no significant possibility of becoming onerous:

(i) An entity shall not disregard information provided by its internal reporting about the effect of changes in assumptions on different contracts on the possibility of their becoming onerous; but

(ii) An entity is not required to gather additional information beyond that provided by the entity's internal reporting about the effect of changes in assumptions on different contracts.

20. If, applying paragraphs 14–19, contracts within a portfolio would fall into different groups only because law or regulation specifically constrains the entity's practical ability to set a different price or level of benefits for policyholders with different characteristics, the entity may include those contracts in the same group. The entity shall not apply this paragraph by analogy to other items.

21. An entity is permitted to subdivide the groups described in paragraph 16. For example, an entity may choose to divide the portfolios into:

(a) More groups that are not onerous at initial recognition—if the entity's internal reporting provides information that distinguishes:

(i) Different levels of profitability; or

(ii) Different possibilities of contracts becoming onerous after initial recognition; and

(b) More than one group of contracts that are onerous at initial recognition—if the entity's internal reporting provides information at a more detailed level about the extent to which the contracts are onerous.

22. **An entity shall not include contracts issued more than one year apart in the same group. To achieve this the entity shall, if necessary, further divide the groups described in paragraphs 16–21.**

23. A group of insurance contracts shall comprise a single contract if that is the result of applying paragraphs 14–22.

24. An entity shall apply the recognition and measurement requirements of PBE IFRS 17 to the groups of contracts ~~issued~~ determined by applying paragraphs 14–23. An entity shall establish the groups at initial recognition, and shall not reassess the composition of the groups subsequently, except as set out in paragraph 28. To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio, provided the entity is able to include the appropriate fulfilment cash flows in the measurement of the group, applying paragraphs 32(a), 40(a)(i) and 40(b), by allocating such estimates to groups of contracts.

Recognition

25. **An entity shall recognise a group of insurance contracts it issues from the earliest of the following:**

(a) **The beginning of the coverage period of the group of contracts;**

(b) **The date when the first payment from a policyholder in the group becomes due; and**

(c) **For a group of onerous contracts, when the group becomes onerous.**

26. If there is no contractual due date, the first payment from the policyholder is deemed to be due when it is received. An entity is required to determine whether any contracts form a group of onerous contracts applying paragraph 16 before the earlier of the dates set out in paragraphs 25(a) and 25(b) if facts and circumstances indicate there is such a group.

27. An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of ~~issued~~ insurance contracts issued or expected to be issued that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or ~~income~~ revenue applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance

acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).

28. In recognising a group of insurance contracts in a reporting period, an entity shall include only contracts that meet the criteria set out in paragraph 26(a)–(c) applied to each contract ~~issued by the end of the reporting period~~ and shall make estimates for the discount rates at the date of initial recognition (see paragraph AG~~B~~73) and the coverage units provided in the reporting period (see paragraph ~~B~~AG119). An entity may ~~issue~~ include more contracts in the group after the end of a reporting period, subject to paragraphs 14–22. An entity shall add the contracts to the group in the reporting period in which the contracts meet the criteria set out in paragraph 26(a)–(c) applied to each contract~~are issued~~. This may result in a change to the determination of the discount rates at the date of initial recognition applying paragraph ~~B~~AG73. An entity shall apply the revised rates from the start of the reporting period in which the new contracts are added to the group.

Measurement (paragraphs ~~B~~AG36–~~B~~AG119)

29. An entity shall apply paragraphs 30–52 to all groups of insurance contracts within the scope of PBE IFRS 17, with the following exceptions:

    (a) For groups of insurance contracts meeting either of the criteria specified in paragraph 53, an entity may simplify the measurement of the group using the premium allocation approach in paragraphs 55–59.

    (b) For groups of reinsurance contracts held, an entity shall apply paragraphs 32–46 as required by paragraphs 63–70. Paragraphs 45 (on insurance contracts with direct participation features) and 47–52 (on onerous contracts) do not apply to groups of reinsurance contracts held.

    (c) For groups of investment contracts with discretionary participation features, an entity shall apply paragraphs 32–52 as modified by paragraph 71.

30. When applying PBE IPSAS 4~~21~~ *The Effects of Changes in Foreign Exchange Rates* to a group of insurance contracts that generate cash flows in a foreign currency, an entity shall treat the group of contracts, including the contractual service margin, as a monetary item.

31. In the financial statements of an entity that issues insurance contracts, the fulfilment cash flows shall not reflect the non-performance risk of that entity~~ (non-performance risk is defined in IFRS 13 *Fair Value Measurement*)~~.

Measurement on Initial Recognition (paragraphs ~~B~~AG36–~~B~~AG95)

32. **On initial recognition, an entity shall measure a group of insurance contracts at the total of:**

    (a) **The fulfilment cash flows, which comprise:**

        (i) **Estimates of future cash flows (paragraphs 33–35);**

        (ii) **An adjustment to reflect the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows (paragraph 36); and**

        (iii) **A risk adjustment for non-financial risk (paragraph 37).**

    (b) **The contractual service margin, measured applying paragraphs 38–39.**

Estimates of Future Cash Flows (paragraphs ~~B~~AG36–~~B~~AG71)

33. **An entity shall include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group (see paragraph 34). Applying paragraph 24, an entity may estimate the future cash flows at a higher level of aggregation and then allocate the resulting fulfilment cash flows to individual groups of contracts. The estimates of future cash flows shall:**

    (a) **Incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows (see paragraphs ~~B~~AG37–~~B~~AG41). To do this, an entity shall estimate the expected value (i.e., the probability-weighted mean) of the full range of possible outcomes.**

(b) **Reflect the perspective of the entity, provided that the estimates of any relevant market variables are consistent with observable market prices for those variables (see paragraphs ~~B~~AG42–~~B~~AG53).**

(c) **Be current—the estimates shall reflect conditions existing at the measurement date, including assumptions at that date about the future (see paragraphs ~~B~~AG54–~~B~~AG60).**

(d) **Be explicit—the entity shall estimate the adjustment for non-financial risk separately from the other estimates (see paragraph ~~B~~AG90). The entity also shall estimate the cash flows separately from the adjustment for the time value of money and financial risk, unless the most appropriate measurement technique combines these estimates (see paragraph ~~B~~AG46).**

34. Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services (see paragraphs ~~B~~AG61–~~B~~AG71). A substantive obligation to provide services ends when:

(a) The entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or

(b) Both of the following criteria are satisfied:

(i) The entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio; and

(ii) The pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

35. An entity shall not recognise as a liability or as an asset any amounts relating to expected premiums or expected claims outside the boundary of the insurance contract. Such amounts relate to future insurance contracts.

Discount Rates (paragraphs ~~B~~AG72–~~B~~AG85)

36. **An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the financial risks are not included in the estimates of cash flows. The discount rates applied to the estimates of the future cash flows described in paragraph 33 shall:**

(a) **Reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts;**

(b) **Be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and**

(c) **Exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.**

Risk Adjustment for Non-Financial Risk (paragraphs ~~B~~AG86–~~B~~AG92)

37. **An entity shall adjust the estimate of the present value of the future cash flows to reflect the compensation that the entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk.**

Contractual Service Margin

38. **The contractual service margin is a component of the asset or liability for the group of insurance contracts that represents the unearned ~~profit~~ surplus the entity will recognise as it provides services in the future. An entity shall measure the contractual service margin on initial recognition of a**

group of insurance contracts at an amount that, unless paragraph 47 (on onerous contracts) applies, results in no ~~income~~ revenue or expenses arising from:

(a) **The initial recognition of an amount for the fulfilment cash flows, measured by applying paragraphs 32–37;**

(b) **The derecognition at the date of initial recognition of any asset or liability recognised for insurance acquisition cash flows applying paragraph 27; and**

(c) **Any cash flows arising from the contracts in the group at that date.**

39. For insurance contracts acquired in a transfer of insurance contracts or a business combination within the scope of PBE IFRS 3, an entity shall apply paragraph 38 in accordance with paragraphs ~~B~~AG93–~~B~~AG95.[4]

Subsequent Measurement

40. **The carrying amount of a group of insurance contracts at the end of each reporting period shall be the sum of:**

(a) **The liability for remaining coverage comprising:**

(i) **The fulfilment cash flows related to future service allocated to the group at that date, measured applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92;**

(ii) **The contractual service margin of the group at that date, measured applying paragraphs 43–46; and**

(b) **The liability for incurred claims, comprising the fulfilment cash flows related to past service allocated to the group at that date, measured applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92.**

41. **An entity shall recognise ~~income~~ revenue and expenses for the following changes in the carrying amount of the liability for remaining coverage:**

(a) **Insurance revenue—for the reduction in the liability for remaining coverage because of services provided in the period, measured applying paragraphs ~~B~~AG120–~~B~~AG124;**

(b) **Insurance service expenses—for losses on groups of onerous contracts, and reversals of such losses (see paragraphs 47–52); and**

(c) **Insurance finance ~~income~~ revenue or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.**

42. **An entity shall recognise ~~income~~ revenue and expenses for the following changes in the carrying amount of the liability for incurred claims:**

(a) **Insurance service expenses—for the increase in the liability because of claims and expenses incurred in the period, excluding any investment components;**

(b) **Insurance service expenses—for any subsequent changes in fulfilment cash flows relating to incurred claims and incurred expenses; and**

(c) **Insurance finance ~~income~~ revenue or expenses—for the effect of the time value of money and the effect of financial risk as specified in paragraph 87.**

Contractual Service Margin (paragraphs ~~B~~AG96—~~B~~AG119)

43. **The contractual service margin at the end of the reporting period represents the ~~profit~~ surplus in the group of insurance contracts that has not yet been recognised in ~~profit or loss~~surplus or deficit because it relates to the future service to be provided under the contracts in the group.**

[4] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, paragraph 39 would refer to PBE IPSAS 40 rather than to PBE IFRS 3.

44. For insurance contracts without direct participation features, the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

(a) The effect of any new contracts added to the group (see paragraph 28);

(b) Interest accreted on the carrying amount of the contractual service margin during the reporting period, measured at the discount rates specified in paragraph ~~B~~AG72(b);

(c) The changes in fulfilment cash flows relating to future service as specified in paragraphs ~~B~~AG96–~~B~~AG100, except to the extent that:

(i) Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48(a)); or

(ii) Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) The effect of any currency exchange differences on the contractual service margin; and

(e) The amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph ~~B~~AG119.

45. For insurance contracts with direct participation features (see paragraphs ~~B~~AG101–~~B~~AG118), the carrying amount of the contractual service margin of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for the amounts specified in subparagraphs (a)–(e) below. An entity is not required to identify these adjustments separately. Instead, a combined amount may be determined for some, or all, of the adjustments. The adjustments are:

(a) The effect of any new contracts added to the group (see paragraph 28);

(b) The entity's share of the change in the fair value of the underlying items (see paragraph AG~~B~~104(b)(i)), except to the extent that:

(i) Paragraph ~~B~~AG115 (on risk mitigation) applies;

(ii) The entity's share of a decrease in the fair value of the underlying items exceeds the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) The entity's share of an increase in the fair value of the underlying items reverses the amount in (ii).

(c) The changes in fulfilment cash flows relating to future service, as specified in paragraphs ~~B~~AG101–~~B~~AG118, except to the extent that:

(i) Paragraph ~~B~~AG115 (on risk mitigation) applies;

(ii) Such increases in the fulfilment cash flows exceed the carrying amount of the contractual service margin, giving rise to a loss (see paragraph 48); or

(iii) Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage applying paragraph 50(b).

(d) The effect of any currency exchange differences arising on the contractual service margin; and

(e) The amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period, applying paragraph ~~B~~AG119.

46. Some changes in the contractual service margin offset changes in the fulfilment cash flows for the liability for remaining coverage, resulting in no change in the total carrying amount of the liability for remaining coverage. To the extent that changes in the contractual service margin do not offset changes

in the fulfilment cash flows for the liability for remaining coverage, an entity shall recognise ~~income~~ revenue and expenses for the changes, applying paragraph 41.

Onerous Contracts

47. An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow. Applying paragraph 16(a), an entity shall group such contracts separately from contracts that are not onerous. To the extent that paragraph 17 applies, an entity may identify the group of onerous contracts by measuring a set of contracts rather than individual contracts. An entity shall recognise a loss in ~~profit or loss~~surplus or deficit for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

48. A group of insurance contracts becomes onerous (or more onerous) on subsequent measurement if the following amounts exceed the carrying amount of the contractual service margin:

(a) Unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service; and

(b) For a group of insurance contracts with direct participation features, the entity's share of a decrease in the fair value of the underlying items.

Applying paragraphs 44(c)(i), 45(b)(ii) and 45(c)(ii), an entity shall recognise a loss in ~~profit or loss~~surplus or deficit to the extent of that excess.

49. An entity shall establish (or increase) a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised applying paragraphs 47–48. The loss component determines the amounts that are presented in ~~profit or loss~~surplus or deficit as reversals of losses on onerous groups and are consequently excluded from the determination of insurance revenue.

50. After an entity has recognised a loss on an onerous group of insurance contracts, it shall allocate:

(a) The subsequent changes in fulfilment cash flows of the liability for remaining coverage specified in paragraph 51 on a systematic basis between:

(i) The loss component of the liability for remaining coverage; and

(ii) The liability for remaining coverage, excluding the loss component.

(b) Any subsequent decrease in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service and any subsequent increases in the entity's share in the fair value of the underlying items solely to the loss component until that component is reduced to zero. Applying paragraphs 44(c)(ii), 45(b)(iii) and 45(c)(iii), an entity shall adjust the contractual service margin only for the excess of the decrease over the amount allocated to the loss component.

51. The subsequent changes in the fulfilment cash flows of the liability for remaining coverage to be allocated applying paragraph 50(a) are:

(a) Estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses;

(b) Changes in the risk adjustment for non-financial risk recognised in ~~profit or loss~~surplus or deficit because of the release from risk; and

(c) Insurance finance ~~income~~revenue or expenses.

52. The systematic allocation required by paragraph 50(a) shall result in the total amounts allocated to the loss component in accordance with paragraphs 48–50 being equal to zero by the end of the coverage period of a group of contracts.

Premium Allocation Approach

53. An entity may simplify the measurement of a group of insurance contracts using the premium allocation approach set out in paragraphs 55–59 if, and only if, at the inception of the group:

(a) The entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the requirements in paragraphs 32–52; or

(b) The coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

54. The criterion in paragraph 53(a) is not met if at the inception of the group an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the liability for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a) The extent of future cash flows relating to any derivatives embedded in the contracts; and

(b) The length of the coverage period of the group of contracts.

55. Using the premium allocation approach, an entity shall measure the liability for remaining coverage as follows:

(a) On initial recognition, the carrying amount of the liability is:

(i) The premiums, if any, received at initial recognition;

(ii) Minus any insurance acquisition cash flows at that date, unless the entity chooses to recognise the payments as an expense applying paragraph 59(a); and

(iii) Plus or minus any amount arising from the derecognition at that date of the asset or liability recognised for insurance acquisition cash flows applying paragraph 27.

(b) At the end of each subsequent reporting period, the carrying amount of the liability is the carrying amount at the start of the reporting period:

(i) Plus the premiums received in the period;

(ii) Minus insurance acquisition cash flows; unless the entity chooses to recognise the payments as an expense applying paragraph 59(a);

(iii) Plus any amounts relating to the amortisation of insurance acquisition cash flows recognised as an expense in the reporting period; unless the entity chooses to recognise insurance acquisition cash flows as an expense applying paragraph 59(a);

(iv) Plus any adjustment to a financing component, applying paragraph 56;

(v) Minus the amount recognised as insurance revenue for coverage provided in that period (see paragraph ~~B~~AG126); and

(vi) Minus any investment component paid or transferred to the liability for incurred claims.

56. If insurance contracts in the group have a significant financing component, an entity shall adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk using the discount rates specified in paragraph 36, as determined on initial recognition. The entity is not required to adjust the carrying amount of the liability for remaining coverage to reflect the time value of money and the effect of financial risk if, at initial recognition, the entity expects that the time between providing each part of the coverage and the related premium due date is no more than a year.

57. If at any time during the coverage period, facts and circumstances indicate that a group of insurance contracts is onerous, an entity shall calculate the difference between:

(a) The carrying amount of the liability for remaining coverage determined applying paragraph 55; and

(b) The fulfilment cash flows that relate to remaining coverage of the group, applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92. However, if, in applying paragraph 59(b), the entity does not adjust the liability for incurred claims for the time value of money and the effect of financial risk, it shall not include in the fulfilment cash flows any such adjustment.

58. To the extent that the fulfilment cash flows described in paragraph 57(b) exceed the carrying amount described in paragraph 57(a), the entity shall recognise a loss in ~~profit or loss~~surplus or deficit and increase the liability for remaining coverage.

59. In applying the premium allocation approach, an entity:

(a) May choose to recognise any insurance acquisition cash flows as expenses when it incurs those costs, provided that the coverage period of each contract in the group at initial recognition is no more than one year.

(b) Shall measure the liability for incurred claims for the group of insurance contracts at the fulfilment cash flows relating to incurred claims, applying paragraphs 33–37 and ~~B~~AG36–~~B~~AG92. However, the entity is not required to adjust future cash flows for the time value of money and the effect of financial risk if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.

Reinsurance Contracts Held

60. The requirements in PBE IFRS 17 are modified for reinsurance contracts held, as set out in paragraphs 61–70.

61. An entity shall divide portfolios of reinsurance contracts held applying paragraphs 14–24, except that the references to onerous contracts in those paragraphs shall be replaced with a reference to contracts on which there is a net gain on initial recognition. For some reinsurance contracts held, applying paragraphs 14–24 will result in a group that comprises a single contract.

Recognition

62. Instead of applying paragraph 25, an entity shall recognise a group of reinsurance contracts held:

(a) If the reinsurance contracts held provide proportionate coverage—at the beginning of the coverage period of the group of reinsurance contracts held or at the initial recognition of any underlying contract, whichever is the later; and

(b) In all other cases—from the beginning of the coverage period of the group of reinsurance contracts held.

Measurement

63. In applying the measurement requirements of paragraphs 32–36 to reinsurance contracts held, to the extent that the underlying contracts are also measured applying those paragraphs, the entity shall use consistent assumptions to measure the estimates of the present value of the future cash flows for the group of reinsurance contracts held and the estimates of the present value of the future cash flows for the group(s) of underlying insurance contracts. In addition, the entity shall include in the estimates of the present value of the future cash flows for the group of reinsurance contracts held the effect of any risk of non-performance by the issuer of the reinsurance contract, including the effects of collateral and losses from disputes.

64. Instead of applying paragraph 37, an entity shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the group of reinsurance contracts to the issuer of those contracts.

65. The requirements of paragraph 38 that relate to determining the contractual service margin on initial recognition are modified to reflect the fact that for a group of reinsurance contracts held there is no unearned ~~profit~~ surplus but instead a net cost or net gain on purchasing the reinsurance. Hence, on initial recognition:

(a) The entity shall recognise any net cost or net gain on purchasing the group of reinsurance contracts held as a contractual service margin measured at an amount equal to the sum of the fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the group of reinsurance contracts held, and any cash flows arising at that date; unless

(b) The net cost of purchasing reinsurance coverage relates to events that occurred before the purchase of the group of reinsurance contracts, in which case, notwithstanding the requirements of paragraph ~~B~~AG5, the entity shall recognise such a cost immediately in ~~profit or loss~~surplus or deficit as an expense.

66. Instead of applying paragraph 44, an entity shall measure the contractual service margin at the end of the reporting period for a group of reinsurance contracts held as the carrying amount determined at the start of the reporting period, adjusted for:

(a) The effect of any new contracts added to the group (see paragraph 28);

(b) Interest accreted on the carrying amount of the contractual service margin, measured at the discount rates specified in paragraph ~~B~~AG72(b);

(c) Changes in the fulfilment cash flows to the extent that the change:

(i) Relates to future service; unless

(ii) The change results from a change in fulfilment cash flows allocated to a group of underlying insurance contracts that does not adjust the contractual service margin for the group of underlying insurance contracts.

(d) The effect of any currency exchange differences arising on the contractual service margin; and

(e) The amount recognised in ~~profit or loss~~surplus or deficit because of services received in the period, determined by the allocation of the contractual service margin remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period of the group of reinsurance contracts held, applying paragraph ~~B~~AG119.

67. Changes in the fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a reinsurance contract held do not relate to future service and shall not adjust the contractual service margin.

68. Reinsurance contracts held cannot be onerous. Accordingly, the requirements of paragraphs 47–52 do not apply.

Premium Allocation Approach for Reinsurance Contracts Held

69. An entity may use the premium allocation approach set out in paragraphs 55–56 and 59 (adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued, for example the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of a group of reinsurance contracts held, if at the inception of the group:

(a) The entity reasonably expects the resulting measurement would not differ materially from the result of applying the requirements in paragraphs 63–68; or

(b) The coverage period of each contract in the group of reinsurance contracts held (including coverage from all premiums within the contract boundary determined at that date applying paragraph 34) is one year or less.

70. An entity cannot meet the condition in paragraph 69(a) if, at the inception of the group, an entity expects significant variability in the fulfilment cash flows that would affect the measurement of the asset for remaining coverage during the period before a claim is incurred. Variability in the fulfilment cash flows increases with, for example:

(a) The extent of future cash flows relating to any derivatives embedded in the contracts; and

(b) The length of the coverage period of the group of reinsurance contracts held.

Investment Contracts with Discretionary Participation Features

71. An investment contract with discretionary participation features does not include a transfer of significant insurance risk. Consequently, the requirements in PBE IFRS 17 for insurance contracts are modified for investment contracts with discretionary participation features as follows:

(a) The date of initial recognition (see paragraph 25) is the date the entity becomes party to the contract.

(b) The contract boundary (see paragraph 34) is modified so that cash flows are within the contract boundary if they result from a substantive obligation of the entity to deliver cash at a present or future date. The entity has no substantive obligation to deliver cash if it has the practical ability to set a price for the promise to deliver the cash that fully reflects the amount of cash promised and related risks.

(c) The allocation of the contractual service margin (see paragraphs 44(e) and 45(e)) is modified so that the entity shall recognise the contractual service margin over the duration of the group of contracts in a systematic way that reflects the transfer of investment services under the contract.

Modification and Derecognition

Modification of an Insurance Contract

72. If the terms of an insurance contract are modified, for example by agreement between the parties to the contract or by a change in regulation, an entity shall derecognise the original contract and recognise the modified contract as a new contract, applying PBE IFRS 17 or other applicable Standards if, and only if, any of the conditions in (a)–(c) are satisfied. The exercise of a right included in the terms of a contract is not a modification. The conditions are that:

(a) If the modified terms had been included at contract inception:

(i) The modified contract would have been excluded from the scope of PBE IFRS 17, applying paragraphs 3–8;

(ii) An entity would have separated different components from the host insurance contract applying paragraphs 10–13, resulting in a different insurance contract to which PBE IFRS 17 would have applied;

(iii) The modified contract would have had a substantially different contract boundary applying paragraph 34; or

(iv) The modified contract would have been included in a different group of contracts applying paragraphs 14–24.

(b) The original contract met the definition of an insurance contract with direct participation features, but the modified contract no longer meets that definition, or vice versa; or

(c) The entity applied the premium allocation approach in paragraphs 53–59 or paragraphs 69–70 to the original contract, but the modifications mean that the contract no longer meets the eligibility criteria for that approach in paragraph 53 or paragraph 69.

73. If a contract modification meets none of the conditions in paragraph 72, the entity shall treat changes in cash flows caused by the modification as changes in estimates of fulfilment cash flows by applying paragraphs 40–52.

Derecognition

74. **An entity shall derecognise an insurance contract when, and only when:**

(a) **It is extinguished, i.e., when the obligation specified in the insurance contract expires or is discharged or cancelled; or**

(b) **Any of the conditions in paragraph 72 are met.**

75. When an insurance contract is extinguished, the entity is no longer at risk and is therefore no longer required to transfer any economic resources to satisfy the insurance contract. For example, when an entity buys reinsurance, it shall derecognise the underlying insurance contract(s) when, and only when, the underlying insurance contract(s) is or are extinguished.

76. An entity derecognises an insurance contract from within a group of contracts by applying the following requirements in PBE IFRS 17:

(a) The fulfilment cash flows allocated to the group are adjusted to eliminate the present value of the future cash flows and risk adjustment for non-financial risk relating to the rights and obligations that have been derecognised from the group, applying paragraphs 40(a)(i) and 40(b);

(b) The contractual service margin of the group is adjusted for the change in fulfilment cash flows described in (a), to the extent required by paragraphs 44(c) and 45(c), unless paragraph 77 applies; and

(c) The number of coverage units for expected remaining coverage is adjusted to reflect the coverage units derecognised from the group, and the amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit in the period is based on that adjusted number, applying paragraph ~~B~~AG119.

77. When an entity derecognises an insurance contract because it transfers the contract to a third party or derecognises an insurance contract and recognises a new contract applying paragraph 72, the entity shall instead of applying paragraph 76(b):

(a) Adjust the contractual service margin of the group from which the contract has been derecognised, to the extent required by paragraphs 44(c) and 45(c), for the difference between (i) and either (ii) for contracts transferred to a third party or (iii) for contracts derecognised applying paragraph 72:

(i) The change in the carrying amount of the group of insurance contracts resulting from the derecognition of the contract, applying paragraph 76(a).

(ii) The premium charged by the third party.

(iii) The premium the entity would have charged had it entered into a contract with equivalent terms as the new contract at the date of the contract modification, less any additional premium charged for the modification.

(b) Measure the new contract recognised applying paragraph 72 assuming that the entity received the premium described in (a)(iii) at the date of the modification.

Presentation in the Statement of Financial Position

78. **An entity shall present separately in the statement of financial position the carrying amount of groups of:**

(a) **Insurance contracts issued that are assets;**

(b) **Insurance contracts issued that are liabilities;**

(c) **Reinsurance contracts held that are assets; and**

(d) **Reinsurance contracts held that are liabilities.**

79. An entity shall include any assets or liabilities for insurance acquisition cash flows recognised applying paragraph 27 in the carrying amount of the related groups of insurance contracts issued, and any assets or liabilities for cash flows related to groups of reinsurance contracts held (see paragraph 65(a)) in the carrying amount of the groups of reinsurance contracts held.

Recognition and Presentation in the Statement~~(s) of Financial Performance~~ of Comprehensive Revenue and Expense (paragraphs ~~B~~AG120–~~B~~AG136)

80. **Applying paragraphs 41 and 42, an entity shall disaggregate the amounts recognised in the statement~~(s)~~ of ~~profit or loss and other~~ comprehensive ~~income~~ revenue and expense~~(hereafter referred to as the statement(s) of financial performance)~~ into:**

(a) **An insurance service result (paragraphs 83–86), comprising insurance revenue and insurance service expenses; and**

(b) **Insurance finance ~~income~~revenue or expenses (paragraphs 87–92).**

81. An entity is not required to disaggregate the change in the risk adjustment for non-financial risk between the insurance service result and insurance finance ~~income~~revenue or expenses. If an entity does not make such a disaggregation, it shall include the entire change in the risk adjustment for non-financial risk as part of the insurance service result.

82. **An entity shall present ~~income~~revenue or expenses from reinsurance contracts held separately from the expenses or ~~income~~revenue from insurance contracts issued.**

Insurance Service Result

83. **An entity shall present in ~~profit or loss~~surplus or deficit insurance revenue arising from the groups of insurance contracts issued. Insurance revenue shall depict the provision of coverage and other services arising from the group of insurance contracts at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. Paragraphs ~~B~~AG120–~~B~~AG127 specify how an entity measures insurance revenue.**

84. **An entity shall present in ~~profit or loss~~surplus or deficit insurance service expenses arising from a group of insurance contracts issued, comprising incurred claims (excluding repayments of investment components), other incurred insurance service expenses and other amounts as described in paragraph 103(b).**

85. **Insurance revenue and insurance service expenses presented in ~~profit or loss~~surplus or deficit shall exclude any investment components. An entity shall not present premium information in ~~profit or loss~~surplus or deficit if that information is inconsistent with paragraph 83.**

86. An entity may present the ~~income~~revenue or expenses from a group of reinsurance contracts held (see paragraphs 60–70), other than insurance finance ~~income~~revenue or expenses, as a single amount; or the entity may present separately the amounts recovered from the reinsurer and an allocation of the premiums paid that together give a net amount equal to that single amount. If an entity presents separately the amounts recovered from the reinsurer and an allocation of the premiums paid, it shall:

    (a) Treat reinsurance cash flows that are contingent on claims on the underlying contracts as part of the claims that are expected to be reimbursed under the reinsurance contract held;

    (b) Treat amounts from the reinsurer that it expects to receive that are not contingent on claims of the underlying contracts (for example, some types of ceding commissions) as a reduction in the premiums to be paid to the reinsurer; and

    (c) Not present the allocation of premiums paid as a reduction in revenue.

Insurance Finance ~~Income~~Revenue or Expenses (see paragraphs ~~B~~AG128–~~B~~AG136)

87. **Insurance finance ~~income~~revenue or expenses comprises the change in the carrying amount of the group of insurance contracts arising from:**

    (a) **The effect of the time value of money and changes in the time value of money; and**

    (b) **The effect of financial risk and changes in financial risk; but**

    (c) **Excluding any such changes for groups of insurance contracts with direct participation features that would adjust the contractual service margin but do not do so when applying paragraphs 45(b)(ii), 45(b)(iii), 45(c)(ii) or 45(c)(iii). These are included in insurance service expenses.**

88. **Unless paragraph 89 applies, an entity shall make an accounting policy choice between:**

    (a) **Including insurance finance ~~income~~revenue or expenses for the period in ~~profit or loss~~surplus or deficit; or**

    (b) **Disaggregating insurance finance ~~income~~revenue or expenses for the period to include in ~~profit or loss~~surplus or deficit an amount determined by a systematic allocation of the expected total insurance finance ~~income~~revenue or expenses over the duration of the group of contracts, applying paragraphs ~~B~~AG130–~~B~~AG133.**

89. **For insurance contracts with direct participation features, for which the entity holds the underlying items, an entity shall make an accounting policy choice between:**

    (a) **Including insurance finance ~~income~~revenue or expenses for the period in ~~profit or loss~~surplus or deficit; or**

    (b) **Disaggregating insurance finance ~~income~~revenue or expenses for the period to include in ~~profit or loss~~surplus or deficit an amount that eliminates accounting mismatches with ~~income~~revenue or expenses included in ~~profit or loss~~surplus or deficit on the underlying items held, applying paragraphs ~~B~~AG134–~~B~~AG136.**

90. **If an entity chooses the accounting policy set out in paragraph 88(b) or in paragraph 89(b), it shall include in other comprehensive ~~income~~ revenue and expense the difference between the insurance finance ~~income~~revenue or expenses measured on the basis set out in those paragraphs and the total insurance finance ~~income~~revenue or expenses for the period.**

91. **If an entity transfers a group of insurance contracts or derecognises an insurance contract applying paragraph 77:**

    (a) **It shall reclassify to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1 *Presentation of Financial ~~Statements~~Reports*) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive ~~income~~ revenue and expense because the entity chose the accounting policy set out in paragraph 88(b).**

    (b) **It shall not reclassify to ~~profit or loss~~surplus or deficit as a reclassification adjustment (see PBE IPSAS 1) any remaining amounts for the group (or contract) that were previously recognised in other comprehensive ~~income~~ revenue and expense because the entity chose the accounting policy set out in paragraph 89(b).**

92. Paragraph 30 requires an entity to treat an insurance contract as a monetary item under PBE IPSAS 4~~21~~ for the purpose of translating foreign exchange items into the entity's functional currency. An entity includes exchange differences on changes in the carrying amount of groups of insurance contracts in the statement of ~~profit or loss~~surplus or deficit, unless they relate to changes in the carrying amount of groups of insurance contracts included in other comprehensive ~~income~~ revenue and expense applying paragraph 90, in which case they shall be included in other comprehensive ~~income~~revenue and expense.

Disclosure

93. **The objective of the disclosure requirements is for an entity to disclose information in the notes that, together with the information provided in the statement of financial position, statement~~(s)~~ of ~~financial performance~~comprehensive revenue and expense and ~~statement of~~ cash flows statement, gives a basis for users of financial statements to assess the effect that contracts within the scope of PBE IFRS 17 have on the entity's financial position, financial performance and cash flows. To achieve that objective, an entity shall disclose qualitative and quantitative information about:**

    (a) **The amounts recognised in its financial statements for contracts within the scope of PBE IFRS 17 (see paragraphs 97–116);**

    (b) **The significant judgements, and changes in those judgements, made when applying PBE IFRS 17 (see paragraphs 117–120); and**

    (c) **The nature and extent of the risks from contracts within the scope of PBE IFRS 17 (see paragraphs 121–132).**

94. An entity shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. If the disclosures provided, applying paragraphs 97–132, are not enough to meet the objective in paragraph 93, an entity shall disclose additional information necessary to meet that objective.

95. An entity shall aggregate or disaggregate information so that useful information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics.

96. Paragraphs ~~29~~45–47~~31~~ of PBE IPSAS 1 set out requirements relating to materiality and aggregation of information. Examples of aggregation bases that might be appropriate for information disclosed about insurance contracts are:

    (a) Type of contract (for example, major product lines); or

    (b) Geographical area (for example, country or region).~~; or~~

    (c) [Not used]~~reportable segment, as defined in IFRS 8 *Operating Segments*.~~

Explanation of Recognised Amounts

97. Of the disclosures required by paragraphs 98–109, only those in paragraphs 98–100 and 102–105 apply to contracts to which the premium allocation approach has been applied. If an entity uses the premium allocation approach, it shall also disclose:

(a) Which of the criteria in paragraphs 53 and 69 it has satisfied;

(b) Whether it makes an adjustment for the time value of money and the effect of financial risk applying paragraphs 56 and 57(b); and

(c) The method it has chosen to recognise insurance acquisition cash flows applying paragraph 59(a).

98. An entity shall disclose reconciliations that show how the net carrying amounts of contracts within the scope of PBE IFRS 17 changed during the period because of cash flows and ~~income~~revenue and expenses recognised in the statement~~(s)~~ of ~~financial performance~~comprehensive revenue and expense. Separate reconciliations shall be disclosed for insurance contracts issued and reinsurance contracts held. An entity shall adapt the requirements of paragraphs 100–109 to reflect the features of reinsurance contracts held that differ from insurance contracts issued; for example, the generation of expenses or reduction in expenses rather than revenue.

99. An entity shall provide enough information in the reconciliations to enable users of financial statements to identify changes from cash flows and amounts that are recognised in the statement~~(s)~~ of comprehensive revenue and expense~~financial performance~~. To comply with this requirement, an entity shall:

(a) Disclose, in a table, the reconciliations set out in paragraphs 100–105; and

(b) For each reconciliation, present the net carrying amounts at the beginning and at the end of the period, disaggregated into a total for groups of contracts that are assets and a total for groups of contracts that are liabilities, that equal the amounts presented in the statement of financial position applying paragraph 78.

100. An entity shall disclose reconciliations from the opening to the closing balances separately for each of:

(a) The net liabilities (or assets) for the remaining coverage component, excluding any loss component.

(b) Any loss component (see paragraphs 47–52 and 57–58).

(c) The liabilities for incurred claims. For insurance contracts to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose separate reconciliations for:

(i) The estimates of the present value of the future cash flows; and

(ii) The risk adjustment for non-financial risk.

101. For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall also disclose reconciliations from the opening to the closing balances separately for each of:

(a) The estimates of the present value of the future cash flows;

(b) The risk adjustment for non-financial risk; and

(c) The contractual service margin.

102. The objective of the reconciliations in paragraphs 100–101 is to provide different types of information about the insurance service result.

103. An entity shall separately disclose in the reconciliations required in paragraph 100 each of the following amounts related to insurance services, if applicable:

(a) Insurance revenue.

(b) Insurance service expenses, showing separately:

(i) Incurred claims (excluding investment components) and other incurred insurance service expenses;

(ii) Amortisation of insurance acquisition cash flows;

(iii) Changes that relate to past service, i.e., changes in fulfilment cash flows relating to the liability for incurred claims; and

(iv) Changes that relate to future service, i.e., losses on onerous groups of contracts and reversals of such losses.

(c) Investment components excluded from insurance revenue and insurance service expenses.

104. An entity shall separately disclose in the reconciliations required in paragraph 101 each of the following amounts related to insurance services, if applicable:

(a) Changes that relate to future service, applying paragraphs ~~B~~AG96–~~B~~AG118, showing separately:

(i) Changes in estimates that adjust the contractual service margin;

(ii) Changes in estimates that do not adjust the contractual service margin, i.e., losses on groups of onerous contracts and reversals of such losses; and

(iii) The effects of contracts initially recognised in the period.

(b) Changes that relate to current service, i.e.,:

(i) The amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit to reflect the transfer of services;

(ii) The change in the risk adjustment for non-financial risk that does not relate to future service or past service; and

(iii) Experience adjustments (see paragraphs ~~B96(a), B~~AG97(c) and ~~B~~AG113(a)), excluding amounts relating to the risk adjustment included in (ii).

(c) Changes that relate to past service, i.e., changes in fulfilment cash flows relating to incurred claims (see paragraphs ~~B~~AG97(b) and ~~B~~AG113(a)).

105. To complete the reconciliations in paragraphs 100–101, an entity shall also disclose separately each of the following amounts not related to insurance services provided in the period, if applicable:

(a) Cash flows in the period, including:

(i) Premiums received for insurance contracts issued (or paid for reinsurance contracts held);

(ii) Insurance acquisition cash flows; and

(iii) Incurred claims paid and other insurance service expenses paid for insurance contracts issued (or recovered under reinsurance contracts held), excluding insurance acquisition cash flows.

(b) The effect of changes in the risk of non-performance by the issuer of reinsurance contracts held;

(c) Insurance finance ~~income~~revenue or expenses; and

(d) Any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts.

106. For insurance contracts issued other than those to which the premium allocation approach described in paragraphs 53–59 has been applied, an entity shall disclose an analysis of the insurance revenue recognised in the period comprising:

(a) The amounts relating to the changes in the liability for remaining coverage as specified in paragraph ~~B~~AG124, separately disclosing:

(i) The insurance service expenses incurred during the period as specified in paragraph ~~B~~AG124(a);

(ii) The change in the risk adjustment for non-financial risk, as specified in paragraph ~~B~~AG124(b); and

(iii) The amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit because of the transfer of services in the period, as specified in paragraph ~~B~~AG124(c).

(b) The allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flows.

107. For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose the effect on the statement of financial position separately for insurance contracts issued and reinsurance contracts held that are initially recognised in the period, showing their effect at initial recognition on:

(a) The estimates of the present value of future cash outflows, showing separately the amount of the insurance acquisition cash flows;

(b) The estimates of the present value of future cash inflows;

(c) The risk adjustment for non-financial risk; and

(d) The contractual service margin.

108. In the disclosures required by paragraph 107, an entity shall separately disclose amounts resulting from:

(a) Contracts acquired from other entities in transfers of insurance contracts or business combinations; and

(b) Groups of contracts that are onerous.

109. For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose an explanation of when it expects to recognise the contractual service margin remaining at the end of the reporting period in ~~profit or loss~~surplus or deficit, either quantitatively, in appropriate time bands, or by providing qualitative information. Such information shall be provided separately for insurance contracts issued and reinsurance contracts held.

Insurance Finance ~~Income~~Revenue or Expenses

110. An entity shall disclose and explain the total amount of insurance finance ~~income~~revenue or expenses in the reporting period. In particular, an entity shall explain the relationship between insurance finance ~~income~~revenue or expenses and the investment return on its assets, to enable users of its financial statements to evaluate the sources of finance ~~income~~revenue or expenses recognised in ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense.

111. For contracts with direct participation features, the entity shall describe the composition of the underlying items and disclose their fair value.

112. For contracts with direct participation features, if an entity chooses not to adjust the contractual service margin for some changes in the fulfilment cash flows, applying paragraph ~~B~~AG115, it shall disclose the effect of that choice on the adjustment to the contractual service margin in the current period.

113. For contracts with direct participation features, if an entity changes the basis of disaggregation of insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense, applying paragraph ~~B~~AG135, it shall disclose, in the period when the change in approach occurred:

(a) The reason why the entity was required to change the basis of disaggregation;

(b) The amount of any adjustment for each financial statement line item affected; and

(c) The carrying amount of the group of insurance contracts to which the change applied at the date of the change.

Transition Amounts

114. An entity shall provide disclosures that enable users of financial statements to identify the effect of groups of insurance contracts measured at the transition date applying the modified retrospective approach (see paragraphs ~~C~~132.6–~~C~~132.19) or the fair value approach (see paragraphs ~~C~~132.20–~~C~~132.24) on the contractual service margin and insurance revenue in subsequent periods. Hence an entity shall disclose

the reconciliation of the contractual service margin applying paragraph 101(c), and the amount of insurance revenue applying paragraph 103(a), separately for:

(a) Insurance contracts that existed at the transition date to which the entity has applied the modified retrospective approach;

(b) Insurance contracts that existed at the transition date to which the entity has applied the fair value approach; and

(c) All other insurance contracts.

115. For all periods in which disclosures are made applying paragraphs 114(a) or 114(b), to enable users of financial statements to understand the nature and significance of the methods used and judgements applied in determining the transition amounts, an entity shall explain how it determined the measurement of insurance contracts at the transition date.

116. An entity that chooses to disaggregate insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~ revenue and expense applies paragraphs ~~C~~132.18(b), ~~C~~132.19(b), ~~C~~132.24(b) and ~~C~~132.24(c) to determine the cumulative difference between the insurance finance ~~income~~revenue or expenses that would have been recognised in ~~profit or loss~~surplus or deficit and the total insurance finance ~~income~~revenue or expenses at the transition date for the groups of insurance contracts to which the disaggregation applies. For all periods in which amounts determined applying these paragraphs exist, the entity shall disclose a reconciliation from the opening to the closing balance of the cumulative amounts included in other comprehensive ~~income~~ revenue and expense for financial assets measured at fair value through other comprehensive revenue and expense~~income~~ related to the groups of insurance contracts. The reconciliation shall include, for example, gains or losses recognised in other comprehensive ~~income~~ revenue and expense in the period and gains or losses previously recognised in other comprehensive ~~income~~ revenue and expense in previous periods reclassified in the period to ~~profit or loss~~surplus or deficit.

Significant Judgements in Applying PBE IFRS 17

117. An entity shall disclose the significant judgements and changes in judgements made in applying PBE IFRS 17. Specifically, an entity shall disclose the inputs, assumptions and estimation techniques used, including:

(a) The methods used to measure insurance contracts within the scope of PBE IFRS 17 and the processes for estimating the inputs to those methods. Unless impracticable, an entity shall also provide quantitative information about those inputs.

(b) Any changes in the methods and processes for estimating inputs used to measure contracts, the reason for each change, and the type of contracts affected.

(c) To the extent not covered in (a), the approach used:

(i) To distinguish changes in estimates of future cash flows arising from the exercise of discretion from other changes in estimates of future cash flows for contracts without direct participation features (see paragraph ~~B~~AG98);

(ii) To determine the risk adjustment for non-financial risk, including whether changes in the risk adjustment for non-financial risk are disaggregated into an insurance service component and an insurance finance component or are presented in full in the insurance service result;

(iii) To determine discount rates; and

(iv) To determine investment components.

118. If, applying paragraph 88(b) or paragraph 89(b), an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses into amounts presented in ~~profit or loss~~surplus or deficit and amounts presented in other comprehensive ~~income~~revenue and expense, the entity shall disclose an explanation of the methods used to determine the insurance finance ~~income~~revenue or expenses recognised in ~~profit or loss~~surplus or deficit.

119. An entity shall disclose the confidence level used to determine the risk adjustment for non-financial risk. If the entity uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk, it shall disclose the technique used and the confidence level corresponding to the results of that technique.

120. An entity shall disclose the yield curve (or range of yield curves) used to discount cash flows that do not vary based on the returns on underlying items, applying paragraph 36. When an entity provides this disclosure in aggregate for a number of groups of insurance contracts, it shall provide such disclosures in the form of weighted averages, or relatively narrow ranges.

Nature and Extent of Risks that arise from Contracts within the Scope of PBE IFRS 17

121. An entity shall disclose information that enables users of its financial statements to evaluate the nature, amount, timing and uncertainty of future cash flows that arise from contracts within the scope of PBE IFRS 17. Paragraphs 122–132 contain requirements for disclosures that would normally be necessary to meet this requirement.

122. These disclosures focus on the insurance and financial risks that arise from insurance contracts and how they have been managed. Financial risks typically include, but are not limited to, credit risk, liquidity risk and market risk.

123. If the information disclosed about an entity's exposure to risk at the end of the reporting period is not representative of its exposure to risk during the period, the entity shall disclose that fact, the reason why the period-end exposure is not representative, and further information that is representative of its risk exposure during the period.

124. For each type of risk arising from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) The exposures to risks and how they arise;

(b) The entity's objectives, policies and processes for managing the risks and the methods used to measure the risks; and

(c) Any changes in (a) or (b) from the previous period.

125. For each type of risk arising from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) Summary quantitative information about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to the entity's key management personnel.

(b) The disclosures required by paragraphs 127–132, to the extent not provided applying (a) of this paragraph.

126. An entity shall disclose information about the effect of the regulatory frameworks in which it operates; for example, minimum capital requirements or required interest-rate guarantees. If an entity applies paragraph 20 in determining the groups of insurance contracts to which it applies the recognition and measurement requirements of PBE IFRS 17, it shall disclose that fact.

All Types of Risk—Concentrations of Risk

127. An entity shall disclose information about concentrations of risk arising from contracts within the scope of PBE IFRS 17, including a description of how the entity determines the concentrations, and a description of the shared characteristic that identifies each concentration (for example, the type of insured event, industry, geographical area, or currency). Concentrations of financial risk might arise, for example, from interest-rate guarantees that come into effect at the same level for a large number of contracts. Concentrations of financial risk might also arise from concentrations of non-financial risk; for example, if an entity provides product liability protection to pharmaceutical companies and also holds investments in those companies.

Insurance and Market Risks—Sensitivity Analysis

128. An entity shall disclose information about sensitivities to changes in risk ~~exposures~~ variables arising from contracts within the scope of PBE IFRS 17. To comply with this requirement, an entity shall disclose:

(a) A sensitivity analysis that shows how ~~profit or loss~~surplus or deficit and equity would have been affected by changes in risk ~~exposures~~ variables that were reasonably possible at the end of the reporting period:

(i) For insurance risk—showing the effect for insurance contracts issued, before and after risk mitigation by reinsurance contracts held; and

(ii) For each type of market risk—in a way that explains the relationship between the sensitivities to changes in risk ~~exposures~~ variables arising from insurance contracts and those arising from financial assets held by the entity.

(b) The methods and assumptions used in preparing the sensitivity analysis; and

(c) Changes from the previous period in the methods and assumptions used in preparing the sensitivity analysis, and the reasons for such changes.

129. If an entity prepares a sensitivity analysis that shows how amounts different from those specified in paragraph 128(a) are affected by changes in risk ~~exposures~~ variables and uses that sensitivity analysis to manage risks arising from contracts within the scope of PBE IFRS 17, it may use that sensitivity analysis in place of the analysis specified in paragraph 128(a). The entity shall also disclose:

(a) An explanation of the method used in preparing such a sensitivity analysis and of the main parameters and assumptions underlying the information provided; and

(b) An explanation of the objective of the method used and of any limitations that may result in the information provided.

Insurance Risk—Claims Development

130. An entity shall disclose actual claims compared with previous estimates of the undiscounted amount of the claims (i.e., claims development). The disclosure about claims development shall start with the period when the earliest material claim(s) arose and for which there is still uncertainty about the amount and timing of the claims payments at the end of the reporting period; but the disclosure is not required to start more than 10 years before the end of the reporting period. The entity is not required to disclose information about the development of claims for which uncertainty about the amount and timing of the claims payments is typically resolved within one year. An entity shall reconcile the disclosure about claims development with the aggregate carrying amount of the groups of insurance contracts, which the entity discloses applying paragraph 100(c).

Credit Risk—Other Information

131. For credit risk that arises from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) The amount that best represents its maximum exposure to credit risk at the end of the reporting period, separately for insurance contracts issued and reinsurance contracts held; and

(b) Information about the credit quality of reinsurance contracts held that are assets.

Liquidity Risk—Other Information

132. For liquidity risk arising from contracts within the scope of PBE IFRS 17, an entity shall disclose:

(a) A description of how it manages the liquidity risk.

(b) Separate maturity analyses for groups of insurance contracts issued that are liabilities and groups of reinsurance contracts held that are liabilities that show, as a minimum, net cash flows of the groups for each of the first five years after the reporting date and in aggregate beyond the first five years. An entity is not required to include in these analyses liabilities for remaining coverage measured applying paragraphs 55–59. The analyses may take the form of:

(i) An analysis, by estimated timing, of the remaining contractual undiscounted net cash flows; or

(ii) An analysis, by estimated timing, of the estimates of the present value of the future cash flows.

(c) The amounts that are payable on demand, explaining the relationship between such amounts and the carrying amount of the related groups of contracts, if not disclosed applying (b) of this paragraph.

Effective Date and Transition

Effective Date

~~C~~132.1 **An entity shall apply PBE IFRS 17 for annual ~~reporting~~ financial statements covering periods beginning on or after [Date]~~1 January 2021~~. If an entity applies PBE IFRS 17 earlier, it shall disclose that fact. Early application is permitted for entities that apply ~~IFRS 9~~[proposed] PBE IPSAS 41 *Financial Instruments* ~~and IFRS 15 *Revenue from Contracts with Customers*~~ on or before the date of initial application of PBE IFRS 17.**

~~C~~132.2 For the purposes of the transition requirements in paragraphs ~~C~~132.1 and ~~C~~132.3–~~C~~132.33:

(a) The date of initial application is the beginning of the annual reporting period in which an entity first applies PBE IFRS 17; and

(b) The transition date is the beginning of the annual reporting period immediately preceding the date of initial application.

Transition

~~C~~132.3 An entity shall apply PBE IFRS 17 retrospectively unless impracticable, except that:

(a) An entity is not required to present the quantitative information required by paragraph ~~28~~33(f) of PBE IPSAS 3~~8~~ *Accounting Policies, Changes in Accounting Estimates and Errors*; and

(b) An entity shall not apply the option in paragraph ~~B~~AG115 for periods before the date of initial application of PBE IFRS 17.

~~C~~132.4 To apply PBE IFRS 17 retrospectively, an entity shall at the transition date:

(a) Identify, recognise and measure each group of insurance contracts as if PBE IFRS 17 had always applied;

(b) Derecognise any existing balances that would not exist had PBE IFRS 17 always applied; and

(c) Recognise any resulting net difference in equity.

~~C~~132.5 If, and only if, it is impracticable for an entity to apply paragraph ~~C~~132.3 for a group of insurance contracts, an entity shall apply the following approaches instead of applying paragraph ~~C~~132.4(a):

(a) The modified retrospective approach in paragraphs ~~C~~132.6–~~C~~132.19, subject to paragraph ~~C~~132.6(a); or

(b) The fair value approach in paragraphs ~~C~~132.20–~~C~~132.24.

Modified Retrospective Approach

~~C~~132.6 The objective of the modified retrospective approach is to achieve the closest outcome to retrospective application possible using reasonable and supportable information available without undue cost or effort. Accordingly, in applying this approach, an entity shall:

(a) Use reasonable and supportable information. If the entity cannot obtain reasonable and supportable information necessary to apply the modified retrospective approach, it shall apply the fair value approach.

(b) Maximise the use of information that would have been used to apply a fully retrospective approach, but need only use information available without undue cost or effort.

~~C~~132.7 Paragraphs ~~C~~132.9–~~C~~132.19 set out permitted modifications to retrospective application in the following areas:

(a) Assessments of insurance contracts or groups of insurance contracts that would have been made at the date of inception or initial recognition;

(b) Amounts related to the contractual service margin or loss component for insurance contracts without direct participation features;

(c) Amounts related to the contractual service margin or loss component for insurance contracts with direct participation features; and

(d) Insurance finance ~~income~~revenue or expenses.

~~C~~132.8 To achieve the objective of the modified retrospective approach, an entity is permitted to use each modification in paragraphs ~~C~~132.9–~~C~~132.19 only to the extent that an entity does not have reasonable and supportable information to apply a retrospective approach.

Assessments at Inception or Initial Recognition

~~C~~132.9 To the extent permitted by paragraph ~~C~~132.8, an entity shall determine the following matters using information available at the transition date:

(a) How to identify groups of insurance contracts, applying paragraphs 14–24;

(b) Whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs ~~B~~AG101–~~B~~AG109; and

(c) How to identify discretionary cash flows for insurance contracts without direct participation features, applying paragraphs ~~B~~AG98–~~B~~AG100.

~~C~~132.10 To the extent permitted by paragraph ~~C~~132.8, an entity shall not apply paragraph 22 to divide groups into those that do not include contracts issued more than one year apart.

Determining the Contractual Service Margin or Loss Component for Groups of Insurance Contracts without Direct Participation Features

~~C~~132.11 To the extent permitted by paragraph ~~C~~132.8, for contracts without direct participation features, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage (see paragraphs 49–52) at the transition date by applying paragraphs ~~C~~132.12–~~C~~132.16.

~~C~~132.12 To the extent permitted by paragraph ~~C~~132.8, an entity shall estimate the future cash flows at the date of initial recognition of a group of insurance contracts as the amount of the future cash flows at the transition date (or earlier date, if the future cash flows at that earlier date can be determined retrospectively, applying paragraph ~~C~~132.4(a)), adjusted by the cash flows that are known to have occurred between the date of initial recognition of a group of insurance contracts and the transition date (or earlier date). The cash flows that are known to have occurred include cash flows resulting from contracts that ceased to exist before the transition date.

~~C~~132.13 To the extent permitted by paragraph ~~C~~132.8, an entity shall determine the discount rates that applied at the date of initial recognition of a group of insurance contracts (or subsequently):

(a) Using an observable yield curve that, for at least three years immediately before the transition date, approximates the yield curve estimated applying paragraphs 36 and ~~B~~AG72–~~B~~AG85, if such an observable yield curve exists.

(b) If the observable yield curve in paragraph (a) does not exist, estimate the discount rates that applied at the date of initial recognition (or subsequently) by determining an average spread between an observable yield curve and the yield curve estimated applying paragraphs 36 and ~~B~~AG72–~~B~~AG85, and applying that spread to that observable yield curve. That spread shall be an average over at least three years immediately before the transition date.

~~C~~132.14 To the extent permitted by paragraph ~~C~~132.8, an entity shall determine the risk adjustment for non-financial risk at the date of initial recognition of a group of insurance contracts (or subsequently) by adjusting the risk adjustment for non-financial risk at the transition date by the expected release of risk before the transition date. The expected release of risk shall be determined by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.

~~C~~132.15 If applying paragraphs ~~C~~132.12–~~C~~13214 results in a contractual service margin at the date of initial recognition, to determine the contractual service margin at the date of transition an entity shall:

(a) If the entity applies paragraph ~~C~~132.13 to estimate the discount rates that apply on initial recognition, use those rates to accrete interest on the contractual service margin; and

(b) To the extent permitted by paragraph ~~C~~132.8, determine the amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit because of the transfer of services before the transition date, by comparing the remaining coverage units at that date with the coverage units provided under the group of contracts before the transition date (see paragraph ~~B~~AG119).

~~C~~132.16 If applying paragraphs ~~C~~132.12–~~C~~132.14 results in a loss component of the liability for remaining coverage at the date of initial recognition, an entity shall determine any amounts allocated to the loss component before the transition date applying paragraphs ~~C~~132.12–~~C~~132.14 and using a systematic basis of allocation.

Determining the Contractual Service Margin or Loss Component for Groups of Insurance Contracts with Direct Participation Features

~~C~~132.17 To the extent permitted by paragraph ~~C~~132.8, for contracts with direct participation features an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as:

(a) The total fair value of the underlying items at that date; minus

(b) The fulfilment cash flows at that date; plus or minus

(c) An adjustment for:

(i) Amounts charged by the entity to the policyholders (including amounts deducted from the underlying items) before that date.

(ii) Amounts paid before that date that would not have varied based on the underlying items.

(iii) The change in the risk adjustment for non-financial risk caused by the release from risk before that date. The entity shall estimate this amount by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.

(d) If (a)–(c) result in a contractual service margin—minus the amount of the contractual service margin that relates to services provided before that date. The total of (a)–(c) is a proxy for the total contractual service margin for all services to be provided under the group of contracts, i.e., before any amounts that would have been recognised in ~~profit or loss~~surplus or deficit for services provided. The entity shall estimate the amounts that would have been recognised in ~~profit or loss~~surplus or deficit for services provided by comparing the remaining coverage units at the transition date with the coverage units provided under the group of contracts before the transition date; or

(e) If (a)–(c) result in a loss component—adjust the loss component to nil and increase the liability for remaining coverage excluding the loss component by the same amount.

Insurance Finance ~~Income~~Revenue or Expenses

~~C~~132.18 For groups of insurance contracts that, applying paragraph ~~C~~132.10, include contracts issued more than one year apart:

(a) An entity is permitted to determine the discount rates at the date of initial recognition of a group specified in paragraphs ~~B~~AG72(b)–~~B~~AG72(e)(ii) and the discount rates at the date of the incurred claim specified in paragraph ~~B~~AG72(e)(iii) at the transition date instead of at the date of initial recognition or incurred claim.

(b) If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between amounts included in ~~profit or loss~~surplus or deficit and amounts included in other comprehensive ~~income~~ revenue and expense applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance ~~income~~revenue or expenses recognised in other comprehensive ~~income~~ revenue and expense at the transition date to apply paragraph 91(a) in future periods. The entity is permitted to determine that cumulative ~~difference~~ amount either by applying paragraph ~~C~~132.19(b) or:

(i) As nil, unless (ii) applies; and

(ii) For insurance contracts with direct participation features to which paragraph ~~B~~AG134 applies, as equal to the cumulative amount recognised in other comprehensive ~~income~~ revenue and expense on the underlying items.

~~C~~132.19 For groups of insurance contracts that do not include contracts issued more than one year apart:

(a) If an entity applies paragraph ~~C~~132.13 to estimate the discount rates that applied at initial recognition (or subsequently), it shall also determine the discount rates specified in paragraphs ~~B~~AG72(b)–~~B~~AG72(e) applying paragraph ~~C~~132.13; and

(b) If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between amounts included in ~~profit or loss~~surplus or deficit and amounts included in other comprehensive ~~income~~revenue and expense, applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance ~~income~~revenue or expenses recognised in other comprehensive ~~income~~ revenue and expense at the transition date to apply paragraph 91(a) in future periods. The entity shall determine that cumulative ~~difference~~amount:

(i) For insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph ~~B~~AG131—if the entity applies paragraph ~~C~~132.13 to estimate the discount rates at initial recognition—using the discount rates that applied at the date of initial recognition, also applying paragraph ~~C~~132.13;

(ii) For insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph ~~B~~AG132—on the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that apply on the transition date, i.e., as nil;

(iii) For insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph ~~B~~AG133—if the entity applies paragraph ~~C~~132.13 to estimate the discount rates at initial recognition (or subsequently)—using the discount rates that applied at the date of the incurred claim, also applying paragraph ~~C~~132.13; and

(iv) For insurance contracts with direct participation features to which paragraph ~~B~~AG134 applies—as equal to the cumulative amount recognised in other comprehensive ~~income~~ revenue and expense on the underlying items.

Fair Value Approach

~~C~~132.20 To apply the fair value approach, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date. ~~In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 *Fair Value Measurement* (relating to demand features).~~

~~C~~132.21 In applying the fair value approach, an entity may apply paragraph ~~C~~132.22 to determine:

(a) How to identify groups of insurance contracts, applying paragraphs 14–24;

(b) Whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs ~~B~~AG101–~~B~~AG109; and

(c) How to identify discretionary cash flows for insurance contracts without direct participation features, applying paragraphs ~~B~~AG98–~~B~~AG100.

~~C~~132.22 An entity may choose to determine the matters in paragraph ~~C~~132.21 using:

(a) Reasonable and supportable information for what the entity would have determined given the terms of the contract and the market conditions at the date of inception or initial recognition, as appropriate; or

(b) Reasonable and supportable information available at the transition date.

~~C~~132.23 In applying the fair value approach, an entity is not required to apply paragraph 22, and may include in a group contracts issued more than one year apart. An entity shall only divide groups into those including only contracts issued within a year (or less) if it has reasonable and supportable information to make the division. Whether or not an entity applies paragraph 22, it is permitted to determine the discount rates at the date of initial recognition of a group specified in paragraphs ~~B~~AG72(b)~~–B~~AG72(e)(ii) and the discount rates at the date of the incurred claim specified in paragraph ~~B~~AG72(e)(iii) at the transition date instead of at the date of initial recognition or incurred claim.

~~C~~132.24 In applying the fair value approach, if an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense, it is permitted to determine the cumulative amount of insurance finance ~~income~~revenue or expenses recognised in other comprehensive ~~income~~ revenue and expense at the transition date:

(a) Retrospectively—but only if it has reasonable and supportable information to do so; or

(b) As nil—unless (c) applies; and

(c) For insurance contracts with direct participation features to which paragraph ~~B~~AG134 applies—as equal to the cumulative amount recognised in other comprehensive ~~income~~ revenue and expense from the underlying items.

Comparative Information

~~C~~132.25 Notwithstanding the reference to the annual reporting period immediately preceding the date of initial application in paragraph ~~C~~132.2(b), an entity may also present adjusted comparative information applying PBE IFRS 17 for any earlier periods presented, but is not required to do so. If an entity does present adjusted comparative information for any earlier periods, the reference to 'the beginning of the annual reporting period immediately preceding the date of initial application' in paragraph ~~C~~132.2(b) shall be read as 'the beginning of the earliest adjusted comparative period presented'.

~~C~~132.26 An entity is not required to provide the disclosures specified in paragraphs 93–132 for any period presented before the beginning of the annual reporting period immediately preceding the date of initial application.

~~C~~132.27 If an entity presents unadjusted comparative information and disclosures for any earlier periods, it shall clearly identify the information that has not been adjusted, disclose that it has been prepared on a different basis, and explain that basis.

~~C~~132.28 An entity need not disclose previously unpublished information about claims development that occurred earlier than five years before the end of the annual reporting period in which it first applies PBE IFRS 17. However, if an entity does not disclose that information, it shall disclose that fact.

Redesignation of Financial Assets

~~C~~132.29 At the date of initial application of PBE IFRS 17, an entity that had applied ~~IFRS 9~~[proposed] PBE IPSAS 41 to annual reporting periods before the initial application of PBE IFRS 17:

(a) May reassess whether an eligible financial asset meets the condition in paragraph 40~~.1.2(a)~~ or paragraph 41~~.1.2A(a)~~ of [proposed] PBE IPSAS 41~~IFRS 9~~. A financial asset is eligible only if the financial asset is not held in respect of an activity that is unconnected with contracts within the scope of PBE IFRS 17. Examples of financial assets that would not be eligible for reassessment are financial assets held in respect of banking activities or financial assets held in funds relating to investment contracts that are outside the scope of PBE IFRS 17.

(b) Shall revoke its previous designation of a financial asset as measured at fair value through ~~profit or loss~~surplus or deficit if the condition in paragraph 44~~.1.5~~ of [proposed] PBE IPSAS 41~~IFRS 9~~ is no longer met because of the application of PBE IFRS 17.

(c) May designate a financial asset as measured at fair value through ~~profit or loss~~surplus or deficit if the condition in paragraph 44~~.1.5~~ of [proposed] PBE IPSAS 41~~IFRS 9~~ is met.

(d) May designate an investment in an equity instrument as at fair value through other comprehensive ~~income~~ revenue and expense applying paragraph 106~~5.7.5~~ of [proposed] PBE IPSAS 41~~IFRS 9~~.

(e) May revoke its previous designation of an investment in an equity instrument as at fair value through other comprehensive revenue and expense~~income~~ applying paragraph 106~~5.7.5~~ of [proposed] PBE IPSAS 41~~IFRS 9~~.

~~C~~132.30 An entity shall apply paragraph ~~C~~132.29 on the basis of the facts and circumstances that exist at the date of initial application of PBE IFRS 17. An entity shall apply those designations and classifications retrospectively. In doing so, the entity shall apply the relevant transition requirements in ~~IFRS 9~~[proposed] PBE IPSAS 41. The date of initial application for that purpose shall be deemed to be the date of initial application of PBE IFRS 17.

~~C~~132.31 An entity that applies paragraph ~~C~~132.29 is not required to restate prior periods to reflect such changes in designations or classifications. The entity may restate prior periods only if it is possible without the use of hindsight. If an entity restates prior periods, the restated financial statements must reflect all the requirements of ~~IFRS 9~~[proposed] PBE IPSAS 41 for those affected financial assets. If an entity does not restate prior periods, the entity shall recognise, in the opening ~~retained earnings~~accumulated comprehensive revenue and expense (or other component of equity, as appropriate) at the date of initial application, any difference between:

(a) The previous carrying amount of those financial assets; and

(b) The carrying amount of those financial assets at the date of initial application.

~~C~~132.32 When an entity applies paragraph ~~C~~132.29, it shall disclose in that annual reporting period for those financial assets by class:

(a) If paragraph ~~C~~132.29(a) applies—its basis for determining eligible financial assets;

(b) If any of paragraphs ~~C~~132.29(a)–~~C~~132.29(e) apply:

(i) The measurement category and carrying amount of the affected financial assets determined immediately before the date of initial application of PBE IFRS 17; and

(ii) The new measurement category and carrying amount of the affected financial assets determined after applying paragraph ~~C~~132.29.

(c) If paragraph ~~C~~132.29(b) applies—the carrying amount of financial assets in the statement of financial position that were previously designated as measured at fair value through ~~profit or loss~~surplus or deficit applying paragraph 4~~4.1.5~~ of [proposed] PBE IPSAS 41~~IFRS 9~~ that are no longer so designated.

~~C~~132.33 When an entity applies paragraph ~~C~~132.29, the entity shall disclose in that annual reporting period qualitative information that would enable users of financial statements to understand:

(a) How it applied paragraph ~~C~~132.29 to financial assets the classification of which has changed on initially applying PBE IFRS 17;

(b) The reasons for any designation or de-designation of financial assets as measured at fair value through ~~profit or loss~~surplus or deficit applying paragraph 4~~4.1.5~~ of [proposed] PBE IPSAS 41~~IFRS 9~~; and

(c) Why the entity came to any different conclusions in the new assessment applying paragraphs 40~~.1.2~~(a) or 41~~.1.2A~~(a) of [proposed] PBE IPSAS 41~~IFRS 9~~.

Withdrawal and Replacement of PBE IFRS 4

~~C~~132.34 PBE IFRS 17 supersedes PBE IFRS 4 *Insurance Contracts*.

Appendix A

Defined terms

[Not used]

Appendix B

Application Guidance

This Appendix is an integral part of PBE IFRS 17 Insurance Contracts

~~B~~AG1. This appendix provides guidance on the following:

(a) Determining whether a scheme is intended to be fully funded from contributions and levies (see paragraphs AG1.1–AG1.4);

(b) Determining whether an entity is managing a scheme in the same way as an insurer (see paragraphs AG1.5–AG1.6);

(c) Definition of an insurance contract (see paragraphs ~~B~~AG2~~–B~~AG30);

(~~b~~d) Separation of components from an insurance contract (see paragraphs ~~B~~AG31~~–B~~AG35);

(~~c~~e) Measurement (see paragraphs ~~B~~AG36~~–B~~AG119);

(~~d~~f) Insurance revenue (see paragraphs ~~B~~AG120~~–B~~AG127);

(~~e~~g) Insurance finance ~~income~~revenue or expenses (see paragraphs ~~B~~AG128~~–B~~AG136); and

(~~f~~g) Interim financial statements (see paragraph ~~B~~AG137).

Determining Whether a Scheme is Intended to be Fully Funded from Contributions and Levies (paragraph 3(d)(i))

AG1.1 A ~~social benefit~~ scheme is intended to be fully funded from contributions and levies when:

(a) The legislation or other arrangement governing the ~~social benefit~~ scheme provides for the scheme to be funded by contributions or levies paid by or on behalf of either the potential beneficiaries or those whose activities create or exacerbate the ~~social~~ risks which are mitigated by the ~~social benefit~~ scheme, together with investment returns arising from the contributions or levies; and

(b) One or more of the following indicators (individually or in combination) is satisfied:

(i) Contribution rates or levy rates are reviewed (and, where appropriate, adjusted in line with the scheme's funding policy), either on a regular basis or when specified criteria are met, with the aim of ensuring that the revenue from contributions and levies will be sufficient to fully fund the ~~social benefit~~ scheme; and/or

(ii) ~~Social b~~Benefit levels are reviewed (and, where appropriate, adjusted in line with the scheme's funding policy), either on a regular basis or when specified criteria are met, with the aim of ensuring that the levels of ~~social~~ benefits provided will not exceed the level of funding available from contributions or levies.

In subparagraphs (i) and (ii) above, reviews are undertaken on a regular basis when they are performed at a frequency appropriate for the specific scheme. While annual reviews are common, less frequent—or more frequent—reviews will be appropriate for some schemes.

AG1.2 In some circumstances, a public sector entity may be required to make contributions to a ~~social benefit~~ scheme on behalf of those individuals and/or households who could not afford to do so. Such contributions may be made by the entity administering the scheme or some other entity. For example, a public sector entity may be required to make contributions to a ~~retirement pension~~ scheme for those individuals who are unemployed. Where the contributions relate to specified individuals and/or households ~~(which in some cases will require the contributions to be credited against the individuals' contribution accounts)~~, the contributions made by the public sector entity are to be considered as contributions for the purposes of determining whether a ~~social benefit~~ scheme is intended to be fully funded in accordance with paragraph 3~~2~~(~~a~~d)(i). Where a public sector entity makes contributions to fund the deficit on a ~~social benefit~~ scheme, the contributions are not related to specified individuals and/or households, and are not considered as contributions for the purposes of determining whether a ~~social benefit~~ scheme is intended to be fully funded in accordance with paragraph 3~~2~~(~~a~~d)(i).

AG1.3. In assessing whether a ~~social benefit~~ scheme is intended to be fully funded from contributions and levies, an entity considers substance over form. For example, where a ~~social benefit~~ scheme is in deficit for a period and receives a loan from government to offset that deficit, the scheme is still intended to be fully funded from contributions and levies where the public sector entity operating the ~~social benefits~~ scheme reviews, and where necessary adjusts, the contribution rates and/or benefits payable such that the deficit is addressed and the loan is repaid. ~~The requirement to consider substance over form applies equally to assessing whether the other criteria for applying the insurance approach have been satisfied.~~

AG1.4 The reference in paragraph AG1.1~~2~~(a) to "those whose activities create or exacerbate the ~~social~~ risks which are mitigated by the ~~social benefit~~ scheme" is intended to cover those ~~social benefit~~ schemes such as accident insurance schemes that:

(a) Are funded by levies on, for example, motorists or employers in particular industries; and

(b) Provide coverage against ~~social~~ risks to the wider population.

Determining Whether an Entity is Managing a Scheme in the same way as an Insurer (paragraph 3(d)(ii))

AG1.5 An entity is managing a scheme in the same way as an insurer would manage an insurance portfolio when the ~~social benefit~~ scheme has commercial substance, and has, with the exception of its legislative rather than contractual origins, the look and feel of an insurance contract. The ~~social benefit~~ scheme should confer the rights and obligations on parties similar to that of an insurance contract.

AG1.6 In determining whether it is managing a scheme in the same way as an insurer would manage an insurance portfolio, an entity considers the following indicators:

(a) Does the entity consider itself bound by the scheme in a similar manner to an insurer being bound by an insurance contract? For example, there may be evidence that the entity considers that it can amend the terms of the scheme for existing participants in a manner that an insurer could not (such as where the entity can make retrospective changes to the scheme). In such cases, the entity will not be bound in a similar manner to an insurer, and the ~~social benefit~~ scheme will not have commercial substance or look and feel like an insurance contract. An entity will be bound by the scheme in a similar manner to an insurer where its ability to amend the scheme for existing participants is limited to:

(i) Circumstances prescribed by the legislation that establishes the scheme (equivalent to a contractual term permitting changes in specific circumstances); or

(ii) When a government is setting new contribution or levy rates (where a trade-off between the contributions and prospective benefits is part of the process of determining an appropriate rate).

(b) Are assets relating to the ~~social benefit~~ scheme held in a separate fund, or otherwise earmarked, and restricted to being used to provide ~~social~~ benefits to participants? If an entity does not separately identify amounts relating to ~~social~~ benefits, this will provide evidence that the entity considers the contributions as a form of taxation. The ~~social benefit~~ scheme will not have commercial substance or look and feel like an insurance contract. There will also be practical difficulties with applying the measurement requirements of PBE IFRS 17 ~~the relevant international or national accounting standard dealing with insurance contracts~~ if the assets associated with a ~~social benefit~~ scheme are not separately identified.

(c) Does the legislation that establishes the ~~social~~ benefit give enforceable rights to participants in the event that the ~~social~~ risk occurs? Insurance contracts give such rights to policyholders. If the ~~social benefit~~ scheme does not also include such rights, then any ~~social~~ benefits provided by the entity will have a discretionary nature. The ~~social benefit~~ scheme will not have commercial substance or look and feel like an insurance contract. For rights to be enforceable, a participant would need to have the right to challenge–in a court of law, via an arbitration or dispute resolution process or similar mechanism–decisions by the entity. The decisions that may be challenged include, but are not limited to, those regarding whether an event is covered by a scheme, the level of ~~social~~ benefits payable by a scheme, and the duration of any ~~social~~ benefits payable by a scheme.

(d) An entity assesses the financial performance and financial position of a ~~social benefit~~ scheme on a regular basis where it is required to report internally on the financial performance of the scheme, and, where necessary, to take action to address any under-performance by the scheme. The assessment is expected to involve the use of actuarial reviews, mathematical modelling, or similar techniques to provide information for internal decision-making on the different possible outcomes that might occur.

(e) Is there a separate entity established by the government, which is expected to act like an insurer in relation to a ~~social benefit~~ scheme? The existence of such an entity provides evidence that the entity is managing a scheme in the same way as an insurer would manage an insurance portfolio. However, it is not a requirement for applying PBE IFRS 17 ~~the insurance approach~~ that a separate entity has been established. PBE IFRS 17 ~~Relevant international and national accounting standards dealing with insurance contracts~~ appliies~~y~~ to insurance contracts, not just to insurance companies.

Definition of an Insurance Contract (~~Appendix a~~paragraph 13.1)

~~B~~AG2. This section provides guidance on the definition of an insurance contract as specified in ~~Appendix A~~paragraph 13.1. It addresses the following:

(a) Uncertain future event (see paragraphs ~~B~~AG3–~~B~~AG5);

(b) Payments in kind (see paragraph ~~B~~AG6);

(c) The distinction between insurance risk and other risks (see paragraphs ~~B~~AG7–~~B~~AG16);

(d) Significant insurance risk (see paragraphs ~~B~~AG17–~~B~~AG23);

(e) Changes in the level of insurance risk (see paragraphs ~~B~~AG24–~~B~~AG25); and

(f) Examples of insurance contracts (see paragraphs ~~B~~AG26–~~B~~AG30).

Uncertain Future Event

~~B~~AG3. Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:

(a) The probability of an insured event occurring;

(b) When the insured event will occur; or

(c) How much the entity will need to pay if the insured event occurs.

~~B~~AG4. In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if that loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

~~B~~AG5. Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

Payments in Kind

~~B~~AG6. Some insurance contracts require or permit payments to be made in kind. In such cases, the entity provides goods or services to the policyholder to settle the entity's obligation to compensate the policyholder for insured events. An example is when the entity replaces a stolen article instead of reimbursing the policyholder for the amount of its loss. Another example is when an entity uses its own hospitals and medical staff to provide medical services covered by the insurance contract. Such contracts are insurance contracts, even though the claims are settled in kind. Fixed-fee service contracts that meet the conditions specified in paragraph 8 are also insurance contracts, but applying paragraph 8, an entity may choose to account for them applying either PBE IFRS 17 or PBE IPSAS 9~~IFRS 15~~ *Revenue from Exchange Transactions~~Contracts with Customers~~*.

The Distinction between Insurance Risk and Other Risks

~~B~~AG7. The definition of an insurance contract requires that one party accepts significant insurance risk from another party. PBE IFRS 17 defines insurance risk as 'risk, other than financial risk, transferred from the holder of a contract to the issuer'. A contract that exposes the issuer to financial risk without significant insurance risk is not an insurance contract.

~~B~~AG8. The definition of financial risk in ~~Appendix A~~paragraph 13.1 refers to financial and non-financial variables. Examples of non-financial variables not specific to a party to the contract include an index of earthquake losses in a particular region or temperatures in a particular city. Financial risk excludes risk from non-financial variables that are specific to a party to the contract, such as the occurrence or non-occurrence of a fire that damages or destroys an asset of that party. Furthermore, the risk of changes in the fair value of a non-financial asset is not a financial risk if the fair value reflects changes in the market prices for such assets (i.e., a financial variable) and the condition of a specific non-financial asset held by a party to a contract (i.e., a non-financial variable). For example, if a guarantee of the residual value of a specific car in which the policyholder has an insurable interest exposes the guarantor to the risk of changes in the car's physical condition, that risk is insurance risk, not financial risk.

~~B~~AG9. Some contracts expose the issuer to financial risk in addition to significant insurance risk. For example, many life insurance contracts guarantee a minimum rate of return to policyholders, creating financial risk, and at the same time promise death benefits that may significantly exceed the policyholder's account balance, creating insurance risk in the form of mortality risk. Such contracts are insurance contracts.

~~B~~AG10. Under some contracts, an insured event triggers the payment of an amount linked to a price index. Such contracts are insurance contracts, provided that the payment contingent on the insured event could be significant. For example, a life-contingent annuity linked to a cost-of-living index transfers insurance risk because the payment is triggered by an uncertain future event—the survival of the person who receives the annuity. The link to the price index is a derivative, but it also transfers insurance risk because the number of payments to which the index applies depends on the survival of the annuitant. If the resulting transfer of insurance risk is significant, the derivative meets the definition of an insurance contract, in which case it shall not be separated from the host contract (see paragraph 11(a)).

~~B~~AG11. Insurance risk is the risk the entity accepts from the policyholder. This means the entity must accept, from the policyholder, a risk to which the policyholder was already exposed. Any new risk created by the contract for the entity or the policyholder is not insurance risk.

~~B~~AG12. The definition of an insurance contract refers to an adverse effect on the policyholder. This definition does not limit the payment by the entity to an amount equal to the financial effect of the adverse event. For example, the definition includes 'new for old' coverage that pays the policyholder an amount that permits the replacement of a used and damaged asset with a new one. Similarly, the definition does not limit the payment under a life insurance contract to the financial loss suffered by the deceased's dependants, nor does it exclude contracts that specify the payment of predetermined amounts to quantify the loss caused by death or an accident.

~~B~~AG13. Some contracts require a payment if a specified uncertain future event occurs, but do not require an adverse effect on the policyholder as a precondition for the payment. This type of contract is not an insurance contract even if the holder uses it to mitigate an underlying risk exposure. For example, if the holder uses a derivative to hedge an underlying financial or non-financial variable correlated with the cash flows from an asset of the entity, the derivative is not an insurance contract because the payment is not conditional on whether the holder is adversely affected by a reduction in the cash flows from the asset. The definition of an insurance contract refers to an uncertain future event for which an adverse effect on the policyholder is a contractual precondition for payment. A contractual precondition does not require the entity to investigate whether the event actually caused an adverse effect, but it does permit the entity to deny the payment if it is not satisfied that the event did cause an adverse effect.

~~B~~AG14. Lapse or persistency risk (the risk that the policyholder will cancel the contract earlier or later than the issuer had expected when pricing the contract) is not insurance risk because the resulting variability in the payment to the policyholder is not contingent on an uncertain future event that adversely affects the policyholder. Similarly, expense risk (i.e., the risk of unexpected increases in the administrative costs associated with the servicing of a contract, rather than in the costs associated with insured events) is not insurance risk because an unexpected increase in such expenses does not adversely affect the policyholder.

~~B~~AG15. Consequently, a contract that exposes the entity to lapse risk, persistency risk or expense risk is not an insurance contract unless it also exposes the entity to significant insurance risk. However, if the entity mitigates its risk by using a second contract to transfer part of the non-insurance risk to another party, the second contract exposes the other party to insurance risk.

~~B~~AG16. An entity can accept significant insurance risk from the policyholder only if the entity is separate from the policyholder. In the case of a mutual entity, the mutual entity accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively because they hold the residual interest in the entity, the mutual entity is a separate entity that has accepted the risk.

Significant Insurance Risk

~~B~~AG17. A contract is an insurance contract only if it transfers significant insurance risk. Paragraphs ~~B~~AG7–~~B~~AG16 discuss insurance risk. Paragraphs ~~B~~AG18–~~B~~AG23 discuss the assessment of whether the insurance risk is significant.

~~B~~AG18. Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e., no discernible effect on the economics of the transaction). If an insured event could mean significant additional amounts would be payable in any scenario that has commercial substance, the condition in the previous sentence can be met even if the insured event is extremely unlikely, or even if the expected (i.e., probability-weighted) present value of the contingent cash flows is a small proportion of the expected present value of the remaining cash flows from the insurance contract.

~~B~~AG19. In addition, a contract transfers significant insurance risk only if there is a scenario that has commercial substance in which the issuer has a possibility of a loss on a present value basis. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers to the reinsurer substantially all the insurance risk relating to the reinsured portions of the underlying insurance contracts.

~~B~~AG20. The additional amounts described in paragraph ~~B~~AG18 are determined on a present-value basis. If an insurance contract requires payment when an event with uncertain timing occurs and if the payment is not adjusted for the time value of money, there may be scenarios in which the present value of the payment increases, even if its nominal value is fixed. An example is insurance that provides a fixed death benefit when the policyholder dies, with no expiry date for the cover (often referred to as whole-life insurance for a fixed amount). It is certain that the policyholder will die, but the date of death is uncertain. Payments may be made when an individual policyholder dies earlier than expected. Because those payments are not adjusted for the time value of money, significant insurance risk could exist even if there is no overall loss on the portfolio of contracts. Similarly, contractual terms that delay timely reimbursement to the policyholder can eliminate significant insurance risk. An entity shall use the discount rates required in paragraph 36 to determine the present value of the additional amounts.

~~B~~AG21. The additional amounts described in paragraph ~~B~~AG18 refer to the present value of amounts that exceed those that would be payable if no insured event had occurred (excluding scenarios that lack commercial substance). Those additional amounts include claims handling and assessment costs, but exclude:

(a) The loss of the ability to charge the policyholder for future service. For example, in an investment-linked life insurance contract, the death of the policyholder means that the entity can no longer perform investment management services and collect a fee for doing so. However, this economic loss for the entity does not result from insurance risk, just as a mutual fund manager does not take on insurance risk in relation to the possible death of a client. Consequently, the potential loss of future investment management fees is not relevant when assessing how much insurance risk is transferred by a contract.

(b) A waiver, on death, of charges that would be made on cancellation or surrender. Because the contract brought those charges into existence, their waiver does not compensate the policyholder for a pre-existing risk. Consequently, they are not relevant when assessing how much insurance risk is transferred by a contract.

(c) A payment conditional on an event that does not cause a significant loss to the holder of the contract. For example, consider a contract that requires the issuer to pay CU1 million[5] if an asset suffers physical damage that causes an insignificant economic loss of CU1 to the holder. In this contract, the holder transfers the insignificant risk of losing CU1 to the issuer. At the same time, the contract creates a non-insurance risk that the issuer will need to pay CU999,999 if the specified event occurs. Because there is no scenario in which an insured event causes a significant loss to the holder of the contract, the issuer does not accept significant insurance risk from the holder and this contract is not an insurance contract.

(d) Possible reinsurance recoveries. The entity accounts for these separately.

~~B~~AG22. An entity shall assess the significance of insurance risk contract by contract. Consequently, the insurance risk can be significant even if there is minimal probability of significant losses for a portfolio or group of contracts.

~~B~~AG23. It follows from paragraphs ~~B~~AG18–~~B~~AG22 that, if a contract pays a death benefit that exceeds the amount payable on survival, the contract is an insurance contract unless the additional death benefit is not significant (judged by reference to the contract itself rather than to an entire portfolio of contracts). As noted in paragraph ~~B~~AG21(b), the waiver on death of cancellation or surrender charges is not included in this assessment if that waiver does not compensate the policyholder for a pre-existing risk. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

Changes in the Level of Insurance Risk

~~B~~AG24. For some contracts, the transfer of insurance risk to the issuer occurs after a period of time. For example, consider a contract that provides a specified investment return and includes an option for the policyholder to use the proceeds of the investment on maturity to buy a life-contingent annuity at the same rates the entity charges other new annuitants at the time the policyholder exercises that option. Such a contract transfers insurance risk to the issuer only after the option is exercised, because the entity remains free to price the annuity on a basis that reflects the insurance risk that will be transferred to the entity at that time. Consequently, the cash flows that would occur on the exercise of the option fall outside the boundary of the contract, and before exercise there are no insurance cash flows within the boundary of the contract. However, if the contract specifies the annuity rates (or a basis other than market rates for setting the annuity rates), the contract transfers insurance risk to the issuer because the issuer is exposed to the risk that the annuity rates will be unfavourable to the issuer when the policyholder exercises the option. In that case, the cash flows that would occur when the option is exercised are within the boundary of the contract.

~~B~~AG25. A contract that meets the definition of an insurance contract remains an insurance contract until all rights and obligations are extinguished (i.e., discharged, cancelled or expired), unless the contract is derecognised applying paragraphs 74–77, because of a contract modification.

Examples of Insurance Contracts

~~B~~AG26. The following are examples of contracts that are insurance contracts if the transfer of insurance risk is significant:

(a) Insurance against theft or damage.

(b) Insurance against product liability, professional liability, civil liability or legal expenses.

(c) Life insurance and prepaid funeral plans (although death is certain, it is uncertain when death will occur or, for some types of life insurance, whether death will occur within the period covered by the insurance).

(d) Life-contingent annuities and pensions, i.e., contracts that provide compensation for the uncertain future event—the survival of the annuitant or pensioner—to provide the annuitant or pensioner with a level of income that would otherwise be adversely affected by his or her survival. (Employers' liabilities that arise from employee benefit plans and retirement benefit obligations

[5] CU denotes currency unit.

reported by defined benefit retirement plans are outside the scope of PBE IFRS 17, applying paragraph 7(b)).

(e) Insurance against disability and medical costs.

(f) Surety bonds, fidelity bonds, performance bonds and bid bonds, i.e., contracts that compensate the holder if another party fails to perform a contractual obligation; for example, an obligation to construct a building.

(g) Product warranties. Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of PBE IFRS 17. However, product warranties issued directly by a manufacturer, dealer or retailer are outside the scope of PBE IFRS 17 applying paragraph 7(a), and are instead within the scope of ~~IFRS 15 or IAS 37~~ PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*.

(h) Title insurance (insurance against the discovery of defects in the title to land or buildings that were not apparent when the insurance contract was issued). In this case, the insured event is the discovery of a defect in the title, not the defect itself.

(i) Travel insurance (compensation in cash or in kind to policyholders for losses suffered in advance of, or during, travel).

(j) Catastrophe bonds that provide for reduced payments of principal, interest or both, if a specified event adversely affects the issuer of the bond (unless the specified event does not create significant insurance risk; for example, if the event is a change in an interest rate or a foreign exchange rate).

(k) Insurance swaps and other contracts that require a payment depending on changes in climatic, geological or other physical variables that are specific to a party to the contract.

~~B~~AG27. The following are examples of items that are not insurance contracts:

(a) Investment contracts that have the legal form of an insurance contract but do not transfer significant insurance risk to the issuer. For example, life insurance contracts in which the entity bears no significant mortality or morbidity risk are not insurance contracts; such contracts are financial instruments or service contracts—see paragraph ~~B~~AG28. Investment contracts with discretionary participation features do not meet the definition of an insurance contract; however, they are within the scope of PBE IFRS 17 provided they are issued by an entity that also issues insurance contracts, applying paragraph 3(c).

(b) Contracts that have the legal form of insurance, but return all significant insurance risk to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder to the issuer as a direct result of insured losses. For example, some financial reinsurance contracts or some group contracts return all significant insurance risk to the policyholders; such contracts are normally financial instruments or service contracts (see paragraph ~~B~~AG28).

(c) Self-insurance (i.e., retaining a risk that could have been covered by insurance). In such situations, there is no insurance contract because there is no agreement with another party. Thus, if an entity issues an insurance contract to its parent, subsidiary or fellow subsidiary, there is no insurance contract in the consolidated financial statements because there is no contract with another party. However, for the individual or separate financial statements of the issuer or holder, there is an insurance contract.

(d) Contracts (such as gambling contracts) that require a payment if a specified uncertain future event occurs, but do not require, as a contractual precondition for payment, the event to adversely affect the policyholder. However, this does not exclude from the definition of an insurance contract contracts that specify a predetermined payout to quantify the loss caused by a specified event such as a death or an accident (see paragraph ~~B~~AG12).

(e) Derivatives that expose a party to financial risk but not insurance risk, because the derivatives require that party to make (or give them the right to receive) payment solely based on the changes in one or more of a specified interest rate, a financial instrument price, a commodity price, a foreign exchange rate, an index of prices or rates, a credit rating or a credit index or any other variable, provided that, in the case of a non-financial variable, the variable is not specific to a party to the contract.

(f) Credit-related guarantees that require payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due; such contracts are accounted for applying ~~IFRS 9~~[proposed] PBE IPSAS 41 *Financial Instruments* (see paragraph ~~B~~AG29).

(g) Contracts that require a payment that depends on a climatic, geological or any other physical variable not specific to a party to the contract (commonly described as weather derivatives).

(h) Contracts that provide for reduced payments of principal, interest or both, that depend on a climatic, geological or any other physical variable, the effect of which is not specific to a party to the contract (commonly referred to as catastrophe bonds).

~~B~~AG28. An entity shall apply other applicable Standards, such as ~~IFRS 9~~[proposed] PBE IPSAS 41 and ~~IFRS 15~~PBE IPSAS 9, to the contracts described in paragraph ~~B~~AG27.

~~B~~AG29. The credit-related guarantees and credit insurance contracts discussed in paragraph ~~B~~AG27(f) can have various legal forms, such as that of a guarantee, some types of letters of credit, a credit default contract or an insurance contract. Those contracts are insurance contracts if they require the issuer to make specified payments to reimburse the holder for a loss that the holder incurs because a specified debtor fails to make payment when due to the policyholder applying the original or modified terms of a debt instrument. However, such insurance contracts are excluded from the scope of PBE IFRS 17 unless the issuer has previously asserted explicitly that it regards the contracts as insurance contracts and has used accounting applicable to insurance contracts (see paragraph 7(e)).

~~B~~AG30. Credit-related guarantees and credit insurance contracts that require payment, even if the policyholder has not incurred a loss on the failure of the debtor to make payments when due, are outside the scope of PBE IFRS 17 because they do not transfer significant insurance risk. Such contracts include those that require payment:

(a) Regardless of whether the counterparty holds the underlying debt instrument; or

(b) On a change in the credit rating or the credit index, rather than on the failure of a specified debtor to make payments when due.

Separating Components from an Insurance Contract (paragraphs 10–13)

Investment Components (paragraph 11(b))

~~B~~AG31. Paragraph 11(b) requires an entity to separate a distinct investment component from the host insurance contract. An investment component is distinct if, and only if, both the following conditions are met:

(a) The investment component and the insurance component are not highly interrelated.

(b) A contract with equivalent terms is sold, or could be sold, separately in the same market or the same jurisdiction, either by entities that issue insurance contracts or by other parties. The entity shall take into account all information reasonably available in making this determination. The entity is not required to undertake an exhaustive search to identify whether an investment component is sold separately.

~~B~~AG32. An investment component and an insurance component are highly interrelated if, and only if:

(a) The entity is unable to measure one component without considering the other. Thus, if the value of one component varies according to the value of the other, an entity shall apply PBE IFRS 17 to account for the combined investment and insurance component; or

(b) The policyholder is unable to benefit from one component unless the other is also present. Thus, if the lapse or maturity of one component in a contract causes the lapse or maturity of the other, the entity shall apply PBE IFRS 17 to account for the combined investment component and insurance component.

Promises to Transfer Distinct Goods or Non-Insurance Services (paragraph 12)

~~B~~AG33. Paragraph 12 requires an entity to separate from an insurance contract a promise to transfer distinct goods or non-insurance services to a policyholder. For the purpose of separation, an entity shall not consider activities that an entity must undertake to fulfil a contract unless the entity transfers a good or service to the policyholder as those activities occur. For example, an entity may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the tasks are performed.

~~B~~AG34. A good or non-insurance service promised to a policyholder is distinct if the policyholder can benefit from the good or service either on its own or together with other resources readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the entity or by another entity), or resources that the policyholder has already got (from the entity or from other transactions or events).

~~B~~AG35. A good or non-insurance service that is promised to the policyholder is not distinct if:

(a) The cash flows and risks associated with the good or service are highly interrelated with the cash flows and risks associated with the insurance components in the contract; and

(b) The entity provides a significant service in integrating the good or non-insurance service with the insurance components.

Measurement (paragraphs 29–71)

Estimates of Future Cash Flows (paragraphs 33–35)

~~B~~AG36. This section addresses:

(a) Unbiased use of all reasonable and supportable information available without undue cost or effort (see paragraphs ~~B~~AG37–~~B~~AG41);

(b) Market variables and non-market variables (see paragraphs ~~B~~AG42–~~B~~AG53);

(c) Using current estimates (see paragraphs ~~B~~AG54–~~B~~AG60); and

(d) Cash flows within the contract boundary (see paragraphs ~~B~~AG61–~~B~~AG71).

Unbiased use of all Reasonable and Supportable Information Available without Undue Cost or Effort (paragraph 33(a))

~~B~~AG37. The objective of estimating future cash flows is to determine the expected value, or probability-weighted mean, of the full range of possible outcomes, considering all reasonable and supportable information available at the reporting date without undue cost or effort. Reasonable and supportable information available at the reporting date without undue cost or effort includes information about past events and current conditions, and forecasts of future conditions (see paragraph ~~B~~AG41). Information available from an entity's own information systems is considered to be available without undue cost or effort.

~~B~~AG38. The starting point for an estimate of the cash flows is a range of scenarios that reflects the full range of possible outcomes. Each scenario specifies the amount and timing of the cash flows for a particular outcome, and the estimated probability of that outcome. The cash flows from each scenario are discounted and weighted by the estimated probability of that outcome to derive an expected present value. Consequently, the objective is not to develop a most likely outcome, or a more-likely-than-not outcome, for future cash flows.

~~B~~AG39. When considering the full range of possible outcomes, the objective is to incorporate all reasonable and supportable information available without undue cost or effort in an unbiased way, rather than to identify every possible scenario. In practice, developing explicit scenarios is unnecessary if the resulting estimate is consistent with the measurement objective of considering all reasonable and supportable information available without undue cost or effort when determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small number of parameters, it will be sufficient to estimate the smaller number of parameters. Similarly, in some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for many detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and may respond in a non-linear fashion to changes in economic conditions. This may happen if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, more sophisticated stochastic modelling is likely to be necessary to satisfy the measurement objective.

~~B~~AG40. The scenarios developed shall include unbiased estimates of the probability of catastrophic losses under existing contracts. Those scenarios exclude possible claims under possible future contracts.

~~B~~AG41. An entity shall estimate the probabilities and amounts of future payments under existing contracts on the basis of information obtained including:

(a) Information about claims already reported by policyholders.

(b) Other information about the known or estimated characteristics of the insurance contracts.

(c) Historical data about the entity's own experience, supplemented when necessary with historical data from other sources. Historical data is adjusted to reflect current conditions, for example, if:

(i) The characteristics of the insured population differ (or will differ, for example, because of adverse selection) from those of the population that has been used as a basis for the historical data;

(ii) There are indications that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows that arise from the existing insurance contracts; or

(iii) There have been changes in items such as underwriting procedures and claims management procedures that may affect the relevance of historical data to the insurance contracts.

(d) Current price information, if available, for reinsurance contracts and other financial instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of insurance contracts. This information shall be adjusted to reflect the differences between the cash flows that arise from those reinsurance contracts or other financial instruments, and the cash flows that would arise as the entity fulfils the underlying contracts with the policyholder.

Market Variables and Non-Market Variables

~~B~~AG42. PBE IFRS 17 identifies two types of variables:

(a) Market variables—variables that can be observed in, or derived directly from, markets (for example, prices of publicly traded securities and interest rates); and

(b) Non-market variables—all other variables (for example, the frequency and severity of insurance claims and mortality).

~~B~~AG43. Market variables will generally give rise to financial risk (for example, observable interest rates) and non-market variables will generally give rise to non-financial risk (for example, mortality rates). However, this will not always be the case. For example, there may be assumptions that relate to financial risks for which variables cannot be observed in, or derived directly from, markets (for example, interest rates that cannot be observed in, or derived directly from, markets).

Market Variables (paragraph 33(b))

~~B~~AG44. Estimates of market variables shall be consistent with observable market prices at the measurement date. An entity shall maximise the use of observable inputs and shall not substitute its own estimates for observable market data. ~~except as described in paragraph 79 of IFRS 13 *Fair Value Measurement*. Consistent with IFRS 13, i~~If variables need to be derived (for example, because no observable market variables exist) they shall be as consistent as possible with observable market variables.

~~B~~AG45. Market prices blend a range of views about possible future outcomes and also reflect the risk preferences of market participants. Consequently, they are not a single-point forecast of the future outcome. If the actual outcome differs from the previous market price, this does not mean that the market price was 'wrong'.

~~B~~AG46. An important application of market variables is the notion of a replicating asset or a replicating portfolio of assets. A replicating asset is one whose cash flows *exactly* match, in all scenarios, the contractual cash flows of a group of insurance contracts in amount, timing and uncertainty. In some cases, a replicating asset may exist for some of the cash flows that arise from a group of insurance contracts. The fair value of that asset reflects both the expected present value of the cash flows from the asset and the risk associated with those cash flows. If a replicating portfolio of assets exists for some of the cash flows that arise from a group of insurance contracts, the entity can use the fair value of those assets to measure the relevant fulfilment cash flows instead of explicitly estimating the cash flows and discount rate.

~~B~~AG47. PBE IFRS 17 does not require an entity to use a replicating portfolio technique. However, if a replicating asset or portfolio does exist for some of the cash flows that arise from insurance contracts and an entity chooses to use a different technique, the entity shall satisfy itself that a replicating portfolio technique would be unlikely to lead to a materially different measurement of those cash flows.

~~B~~AG48. Techniques other than a replicating portfolio technique, such as stochastic modelling techniques, may be more robust or easier to implement if there are significant interdependencies between cash flows that vary based on returns on assets and other cash flows. Judgement is required to determine the technique that best meets the objective of consistency with observable market variables in specific circumstances. In particular, the technique used must result in the measurement of any options and guarantees included in the insurance contracts being consistent with observable market prices (if any) for such options and guarantees.

Non-Market Variables

~~B~~AG49. Estimates of non-market variables shall reflect all reasonable and supportable evidence available without undue cost or effort, both external and internal.

~~B~~AG50. Non-market external data (for example, national mortality statistics) may have more or less relevance than internal data (for example, internally developed mortality statistics), depending on the circumstances. For example, an entity that issues life insurance contracts shall not rely solely on national mortality statistics, but shall consider all other reasonable and supportable internal and external sources of information available without undue cost or effort when developing unbiased estimates of probabilities for mortality scenarios for its insurance contracts. In developing those probabilities, an entity shall give more weight to the more persuasive information. For example:

(a) Internal mortality statistics may be more persuasive than national mortality data if national data is derived from a large population that is not representative of the insured population. This might be because, for example, the demographic characteristics of the insured population could significantly differ from those of the national population, meaning that an entity would need to place more weight on the internal data and less weight on the national statistics.

(b) Conversely, if the internal statistics are derived from a small population with characteristics that are believed to be close to those of the national population, and the national statistics are current, an entity shall place more weight on the national statistics.

~~B~~AG51. Estimated probabilities for non-market variables shall not contradict observable market variables. For example, estimated probabilities for future inflation rate scenarios shall be as consistent as possible with probabilities implied by market interest rates.

~~B~~AG52. In some cases, an entity may conclude that market variables vary independently of non-market variables. If so, the entity shall consider scenarios that reflect the range of outcomes for the non-market variables, with each scenario using the same observed value of the market variable.

~~B~~AG53. In other cases, market variables and non-market variables may be correlated. For example, there may be evidence that lapse rates (a non-market variable) are correlated with interest rates (a market variable). Similarly, there may be evidence that claim levels for house or car insurance are correlated with economic cycles and therefore with interest rates and expense amounts. The entity shall ensure that the probabilities for the scenarios and the risk adjustments for the non-financial risk that relates to the market variables are consistent with the observed market prices that depend on those market variables.

Using Current Estimates (paragraph 33(c))

~~B~~AG54. In estimating each cash flow scenario and its probability, an entity shall use all reasonable and supportable information available without undue cost or effort. An entity shall review the estimates that it made at the end of the previous reporting period and update them. In doing so, an entity shall consider whether:

(a) The updated estimates faithfully represent the conditions at the end of the reporting period.

(b) The changes in estimates faithfully represent the changes in conditions during the period. For example, suppose that estimates were at one end of a reasonable range at the beginning of the period. If the conditions have not changed, shifting the estimates to the other end of the range at the end of the period would not faithfully represent what has happened during the period. If an entity's most recent estimates are different from its previous estimates, but conditions have not changed, it shall assess whether the new probabilities assigned to each scenario are justified. In updating its estimates of those probabilities, the entity shall consider both the evidence that supported its previous estimates and all newly available evidence, giving more weight to the more persuasive evidence.

~~B~~AG55. The probability assigned to each scenario shall reflect the conditions at the end of the reporting period. Consequently, applying PBE IPSAS 14~~0~~ *Events after the Reporting ~~Period~~Date*, an event occurring after the end of the reporting period that resolves an uncertainty that existed at the end of the reporting period does not provide evidence of the conditions that existed at that date. For example, there may be a 20 per cent probability at the end of the reporting period that a major storm will strike during the remaining six months of an insurance contract. After the end of the reporting period but before the financial statements are authorised for issue, a major storm strikes. The fulfilment cash flows under that contract shall not reflect the storm that, with hindsight, is known to have occurred. Instead, the cash flows included in the measurement include the 20 per-cent probability apparent at the end of the reporting period (with disclosure applying PBE IPSAS 14~~0~~ that a non-adjusting event occurred after the end of the reporting period).

~~B~~AG56. Current estimates of expected cash flows are not necessarily identical to the most recent actual experience. For example, suppose that mortality experience in the reporting period was 20 per-cent worse than the previous mortality experience and previous expectations of mortality experience. Several factors could have caused the sudden change in experience, including:

(a) Lasting changes in mortality;

(b) Changes in the characteristics of the insured population (for example, changes in underwriting or distribution, or selective lapses by policyholders in unusually good health);

(c) Random fluctuations; or

(d) Identifiable non-recurring causes.

~~B~~AG57. An entity shall investigate the reasons for the change in experience and develop new estimates of cash flows and probabilities in the light of the most recent experience, the earlier experience and other information. The result for the example in paragraph ~~B~~AG56 would typically be that the expected present value of death benefits changes, but not by as much as 20 per-cent. In the example in paragraph ~~B~~AG56, if mortality rates continue to be significantly higher than the previous estimates for reasons that are expected to continue, the estimated probability assigned to the high-mortality scenarios will increase.

~~B~~AG58. Estimates of non-market variables shall include information about the current level of insured events and information about trends. For example, mortality rates have consistently declined over long periods in many countries. The determination of the fulfilment cash flows reflects the probabilities that would be assigned to each possible trend scenario, taking account of all reasonable and supportable information available without undue cost or effort.

~~B~~AG59. Similarly, if cash flows allocated to a group of insurance contracts are sensitive to inflation, the determination of the fulfilment cash flows shall reflect current estimates of possible future inflation rates. Because inflation rates are likely to be correlated with interest rates, the measurement of fulfilment cash flows shall reflect the probabilities for each inflation scenario in a way that is consistent with the probabilities implied by the market interest rates used in estimating the discount rate (see paragraph ~~B~~AG51).

~~B~~AG60. When estimating the cash flows, an entity shall take into account current expectations of future events that might affect those cash flows. The entity shall develop cash flow scenarios that reflect those future events, as well as unbiased estimates of the probability of each scenario. However, an entity shall not take into account current expectations of future changes in legislation that would change or discharge the present obligation or create new obligations under the existing insurance contract until the change in legislation is substantively enacted.

Cash Flows within the Contract Boundary (paragraph 34)

~~B~~AG61. Estimates of cash flows in a scenario shall include all cash flows within the boundary of an existing contract and no other cash flows. An entity shall apply paragraph 2 in determining the boundary of an existing contract.

~~B~~AG62. Many insurance contracts have features that enable policyholders to take actions that change the amount, timing, nature or uncertainty of the amounts they will receive. Such features include renewal options, surrender options, conversion options and options to stop paying premiums while still receiving benefits under the contracts. The measurement of a group of insurance contracts shall reflect, on an expected value basis, the entity's current estimates of how the policyholders in the group will exercise the options available, and the risk adjustment for non-financial risk shall reflect the entity's current estimates of how the actual behaviour of the policyholders may differ from the expected behaviour. This requirement to determine the expected value applies regardless of the number of contracts in a group; for example it applies even if the group comprises a single contract. Thus, the measurement of a group of insurance contracts shall not assume a 100 per~~-~~cent probability that policyholders will:

(a) Surrender their contracts, if there is some probability that some of the policyholders will not; or

(b) Continue their contracts, if there is some probability that some of the policyholders will not.

~~B~~AG63. When an issuer of an insurance contract is required by the contract to renew or otherwise continue the contract, it shall apply paragraph 34 to assess whether premiums and related cash flows that arise from the renewed contract are within the boundary of the original contract.

~~B~~AG64. Paragraph 34 refers to an entity's practical ability to set a price at a future date (a renewal date) that fully reflects the risks in the contract from that date. An entity has that practical ability in the absence of constraints that prevent the entity from setting the same price it would for a new contract with the same characteristics as the existing contract issued on that date, or if it can amend the benefits to be consistent with the price it will charge. Similarly, an entity has that practical ability to set a price when it can reprice an existing contract so that the price reflects overall changes in the risks in a portfolio of insurance contracts, even if the price set for each individual policyholder does not reflect the change in risk for that specific policyholder. When assessing whether the entity has the practical ability to set a price that fully reflects the risks in the contract or portfolio, it shall consider all the risks that it would consider when underwriting equivalent contracts on the renewal date for the remaining coverage. In determining the estimates of future cash flows at the end of a reporting period, an entity shall reassess the boundary of an insurance contract to include the effect of changes in circumstances on the entity's substantive rights and obligations.

~~B~~AG65. Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

(a) Premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.

(b) Payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (i.e., reported claims), incurred claims for events that have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34).

(c) Payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.

(d) Payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).

(e) An allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.

(f) Claim handling costs (i.e., the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).

(g) Costs the entity will incur in providing contractual benefits paid in kind.

(h) Policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.

(i) Transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.

(j) Payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.

(k) Potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.

(l) An allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.

(m) Any other costs specifically chargeable to the policyholder under the terms of the contract.

~~B~~AG66. The following cash flows shall not be included when estimating the cash flows that will arise as the entity fulfils an existing insurance contract:

(a) Investment returns. Investments are recognised, measured and presented separately.

(b) Cash flows (payments or receipts) that arise under reinsurance contracts held. Reinsurance contracts held are recognised, measured and presented separately.

(c) Cash flows that may arise from future insurance contracts, i.e., cash flows outside the boundary of existing contracts (see paragraphs 34–35).

(d) Cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs. Such costs are recognised in ~~profit or loss~~surplus or deficit when incurred.

(e) Cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract. Such costs are recognised in ~~profit or loss~~surplus or deficit when incurred.

(f) Income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity. Such payments and receipts are recognised, measured and presented separately applying PBE IAS 12 *Income Taxes*.

(g) Cash flows between different components of the reporting entity, such as policyholder funds and shareholder funds, if those cash flows do not change the amount that will be paid to the policyholders.

(h) Cash flows arising from components separated from the insurance contract and accounted for using other applicable PBE Standards (see paragraphs 10–13).

Contracts with Cash Flows that Affect or are Affected by Cash Flows to Policyholders of Other Contracts

~~B~~AG67. Some insurance contracts affect the cash flows to policyholders of other contracts by requiring:

(a) The policyholder to share with policyholders of other contracts the returns on the same specified pool of underlying items; and

(b) Either:

  (i) The policyholder to bear a reduction in their share of the returns on the underlying items because of payments to policyholders of other contracts that share in that pool, including payments arising under guarantees made to policyholders of those other contracts; or

(ii) Policyholders of other contracts to bear a reduction in their share of returns on the underlying items because of payments to the policyholder, including payments arising from guarantees made to the policyholder.

~~B~~AG68. Sometimes, such contracts will affect the cash flows to policyholders of contracts in other groups. The fulfilment cash flows of each group reflect the extent to which the contracts in the group cause the entity to be affected by expected cash flows, whether to policyholders in that group or to policyholders in another group. Hence the fulfilment cash flows for a group:

(a) Include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and

(b) Exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

~~B~~AG69. For example, to the extent that payments to policyholders in one group are reduced from a share in the returns on underlying items of CU350 to CU250 because of payments of a guaranteed amount to policyholders in another group, the fulfilment cash flows of the first group would include the payments of CU100 (i.e., would be CU350) and the fulfilment cash flows of the second group would exclude CU100 of the guaranteed amount.

~~B~~AG70. Different practical approaches can be used to determine the fulfilment cash flows of groups of contracts that affect or are affected by cash flows to policyholders of contracts in other groups. In some cases, an entity might be able to identify the change in the underlying items and resulting change in the cash flows only at a higher level of aggregation than the groups. In such cases, the entity shall allocate the effect of the change in the underlying items to each group on a systematic and rational basis.

~~B~~AG71. After all the coverage has been provided to the contracts in a group, the fulfilment cash flows may still include payments expected to be made to current policyholders in other groups or future policyholders. An entity is not required to continue to allocate such fulfilment cash flows to specific groups but can instead recognise and measure a liability for such fulfilment cash flows arising from all groups.

Discount Rates (paragraph 36)

~~B~~AG72. An entity shall use the following discount rates in applying PBE IFRS 17:

(a) To measure the fulfilment cash flows—current discount rates applying paragraph 36;

(b) To determine the interest to accrete on the contractual service margin applying paragraph 44(b) for insurance contracts without direct participation features—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;

(c) To measure the changes to the contractual service margin applying paragraph ~~B~~AG96(a)–~~B~~AG96(c) for insurance contracts without direct participation features—discount rates applying paragraph 36 determined on initial recognition;

(d) For groups of contracts applying the premium allocation approach that have a significant financing component, to adjust the carrying amount of the liability for remaining coverage applying paragraph 56—discount rates applying paragraph 36 determined on initial recognition;

(e) If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~ revenue and expense (see paragraph 88), to determine the amount of the insurance finance ~~income~~revenue or expenses included in ~~profit or loss~~surplus or deficit:

(i) For groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to policyholders, applying paragraph ~~B~~AG131—discount rates determined at the date of initial recognition of a group of contracts, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items;

(ii) For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to policyholders, applying paragraph ~~B~~AG132(a)(i)—discount rates that allocate the remaining revised expected finance ~~income~~revenue or expenses over the remaining duration of the group of contracts at a constant rate; and

(iii) For groups of contracts applying the premium allocation approach applying paragraphs 59(b) and ~~B~~AG133—discount rates determined at the date of the incurred claim, applying paragraph 36 to nominal cash flows that do not vary based on the returns on any underlying items.

~~B~~AG73. To determine the discount rates at the date of initial recognition of a group of contracts described in paragraphs ~~B~~AG72(b)–~~B~~AG72(e), an entity may use weighted-average discount rates over the period that contracts in the group are issued, which applying paragraph 22 cannot exceed one year.

~~B~~AG74. Estimates of discount rates shall be consistent with other estimates used to measure insurance contracts to avoid double counting or omissions; for example:

(a) Cash flows that do not vary based on the returns on any underlying items shall be discounted at rates that do not reflect any such variability;

(b) Cash flows that vary based on the returns on any financial underlying items shall be:

(i) Discounted using rates that reflect that variability; or

(ii) Adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made.

(c) Nominal cash flows (i.e., those that include the effect of inflation) shall be discounted at rates that include the effect of inflation; and

(d) Real cash flows (i.e., those that exclude the effect of inflation) shall be discounted at rates that exclude the effect of inflation.

~~B~~AG75. Paragraph ~~B~~AG74(b) requires cash flows that vary based on the returns on underlying items to be discounted using rates that reflect that variability, or to be adjusted for the effect of that variability and discounted at a rate that reflects the adjustment made. The variability is a relevant factor regardless of whether it arises because of contractual terms or because the entity exercises discretion, and regardless of whether the entity holds the underlying items.

~~B~~AG76. Cash flows that vary with returns on underlying items with variable returns, but that are subject to a guarantee of a minimum return, do not vary solely based on the returns on the underlying items, even when the guaranteed amount is lower than the expected return on the underlying items. Hence, an entity shall adjust the rate that reflects the variability of the returns on the underlying items for the effect of the guarantee, even when the guaranteed amount is lower than the expected return on the underlying items.

~~B~~AG77. PBE IFRS 17 does not require an entity to divide estimated cash flows into those that vary based on the returns on underlying items and those that do not. If an entity does not divide the estimated cash flows in this way, the entity shall apply discount rates appropriate for the estimated cash flows as a whole; for example, using stochastic modelling techniques or risk-neutral measurement techniques.

~~B~~AG78. Discount rates shall include only relevant factors, i.e., factors that arise from the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. Such discount rates may not be directly observable in the market. Hence, when observable market rates for an instrument with the same characteristics are not available, or observable market rates for similar instruments are available but do not separately identify the factors that distinguish the instrument from the insurance contracts, an entity shall estimate the appropriate rates. PBE IFRS 17 does not require a particular estimation technique for determining discount rates. In applying an estimation technique, an entity shall:

(a) Maximise the use of observable inputs (see paragraph ~~B~~AG44) and reflect all reasonable and supportable information on non-market variables available without undue cost or effort, both external and internal (see paragraph ~~B~~AG49). In particular, the discount rates used shall not contradict any available and relevant market data, and any non-market variables used shall not contradict observable market variables.

(b) Reflect current market conditions from the perspective of a market participant.

(c) Exercise judgement to assess the degree of similarity between the features of the insurance contracts being measured and the features of the instrument for which observable market prices are available and adjust those prices to reflect the differences between them.

~~B~~AG79. For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment shall reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts.

~~B~~AG80. Hence, for cash flows of insurance contracts that do not vary based on the returns on underlying items, an entity may determine discount rates by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts (a bottom-up approach).

~~B~~AG81. Alternatively, an entity may determine the appropriate discount rates for insurance contracts based on a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets (a top-down approach). An entity shall adjust that yield curve to eliminate any factors that are not relevant to the insurance contracts, but is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio.

~~B~~AG82. In estimating the yield curve described in paragraph ~~B~~AG81:

(a) If there are observable market prices in active markets for assets in the reference portfolio, an entity shall use those prices ~~(consistent with paragraph 69 of IFRS 13)~~.

(b) If a market is not active, an entity shall adjust observable market prices for similar assets to make them comparable to market prices for the assets being measured ~~(consistent with paragraph 83 of IFRS 13)~~.

(c) If there is no market for assets in the reference portfolio, an entity shall apply an estimation technique. For such assets ~~(consistent with paragraph 89 of IFRS 13)~~ an entity shall:

(i) Develop unobservable inputs using the best information available in the circumstances. Such inputs might include the entity's own data and, in the context of PBE IFRS 17, the entity might place more weight on long-term estimates than on short-term fluctuations; and

(ii) Adjust those data to reflect all information about market participant assumptions that is reasonably available.

~~B~~AG83. In adjusting the yield curve, an entity shall adjust market rates observed in recent transactions in instruments with similar characteristics for movements in market factors since the transaction date, and shall adjust observed market rates to reflect the degree of dissimilarity between the instrument being measured and the instrument for which transaction prices are observable. For cash flows of insurance contracts that do not vary based on the returns on the assets in the reference portfolio, such adjustments include:

(a) Adjusting for differences between the amount, timing and uncertainty of the cash flows of the assets in the portfolio and the amount, timing and uncertainty of the cash flows of the insurance contracts; and

(b) Excluding market risk premiums for credit risk, which are relevant only to the assets included in the reference portfolio.

~~B~~AG84. In principle, for cash flows of insurance contracts that do not vary based on the returns of the assets in the reference portfolio, there should be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows. However, in practice the top-down approach and the bottom-up approach may result in different yield curves, even in the same currency. This is because of the inherent limitations in estimating the adjustments made under each approach, and the possible lack of an adjustment for different liquidity characteristics in the top-down approach. An entity is not required to reconcile the discount rate determined under its chosen approach with the discount rate that would have been determined under the other approach.

~~B~~AG85. PBE IFRS 17 does not specify restrictions on the reference portfolio of assets used in applying paragraph ~~B~~AG81. However, fewer adjustments would be required to eliminate factors that are not relevant to the insurance contracts when the reference portfolio of assets has similar characteristics. For example, if the cash flows from the insurance contracts do not vary based on the returns on underlying items, fewer adjustments would be required if an entity used debt instruments as a starting point rather than equity instruments. For debt instruments, the objective would be to eliminate from the total bond yield the effect of credit risk and other factors that are not relevant to the insurance contracts. One way to estimate the effect of credit risk is to use the market price of a credit derivative as a reference point.

Risk Adjustment for Non-Financial Risk (paragraph 37)

~~B~~AG86. The risk adjustment for non-financial risk relates to risk arising from insurance contracts other than financial risk. Financial risk is included in the estimates of the future cash flows or the discount rate used to adjust the cash flows. The risks covered by the risk adjustment for non-financial risk are insurance risk and other non-financial risks such as lapse risk and expense risk (see paragraph ~~B~~AG14).

~~B~~AG87. The risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make the entity indifferent between:

(a) Fulfilling a liability that has a range of possible outcomes arising from non-financial risk; and

(b) Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts.

For example, the risk adjustment for non-financial risk would measure the compensation the entity would require to make it indifferent between fulfilling a liability that—because of non-financial risk—has a 50 per~~-~~cent probability of being CU90 and a 50 per~~-~~cent probability of being CU110, and fulfilling a liability that is fixed at CU100. As a result, the risk adjustment for non-financial risk conveys information to users of financial statements about the amount charged by the entity for the uncertainty arising from non-financial risk about the amount and timing of cash flows.

~~B~~AG88. Because the risk adjustment for non-financial risk reflects the compensation the entity would require for bearing the non-financial risk arising from the uncertain amount and timing of the cash flows, the risk adjustment for non-financial risk also reflects:

(a) The degree of diversification benefit the entity includes when determining the compensation it requires for bearing that risk; and

(b) Both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion.

~~B~~AG89. The purpose of the risk adjustment for non-financial risk is to measure the effect of uncertainty in the cash flows that arise from insurance contracts, other than uncertainty arising from financial risk. Consequently, the risk adjustment for non-financial risk shall reflect all non-financial risks associated with the insurance contracts. It shall not reflect the risks that do not arise from the insurance contracts, such as general operational risk.

~~B~~AG90. The risk adjustment for non-financial risk shall be included in the measurement in an explicit way. The risk adjustment for non-financial risk is conceptually separate from the estimates of future cash flows and the discount rates that adjust those cash flows. The entity shall not double-count the risk adjustment for non-financial risk by, for example, also including the risk adjustment for non-financial risk implicitly when determining the estimates of future cash flows or the discount rates. The discount rates that are disclosed to comply with paragraph 120 shall not include any implicit adjustments for non-financial risk.

~~B~~AG91. PBE IFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. However, to reflect the compensation the entity would require for bearing the non-financial risk, the risk adjustment for non-financial risk shall have the following characteristics:

(a) Risks with low frequency and high severity will result in higher risk adjustments for non-financial risk than risks with high frequency and low severity;

(b) For similar risks, contracts with a longer duration will result in higher risk adjustments for non-financial risk than contracts with a shorter duration;

(c) Risks with a wider probability distribution will result in higher risk adjustments for non-financial risk than risks with a narrower distribution;

(d) The less that is known about the current estimate and its trend, the higher will be the risk adjustment for non-financial risk; and

(e) To the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and vice versa.

~~B~~AG92. An entity shall apply judgement when determining an appropriate estimation technique for the risk adjustment for non-financial risk. When applying that judgement, an entity shall also consider whether the technique provides concise and informative disclosure so that users of financial statements can benchmark the entity's performance against the performance of other entities. Paragraph 119 requires an entity that uses a technique other than the confidence level technique for determining the risk adjustment for non-financial risk to disclose the technique used and the confidence level corresponding to the results of that technique.

Initial Recognition of Transfers of Insurance Contracts and Business Combinations within the Scope of PBE IFRS 3 (paragraph 39)[6]

~~B~~AG93. When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination within the scope of PBE IFRS 3, the entity shall apply paragraphs 14–24 to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.

~~B~~AG94. An entity shall use the consideration received or paid for the contracts as a proxy for the premiums received. The consideration received or paid for the contracts excludes the consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination within the scope of PBE IFRS 3, the consideration received or paid is the fair value of the contracts at that date. ~~In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 (relating to demand features).~~

~~B~~AG95. Unless the premium allocation approach for the liability for remaining coverage in paragraphs 55–59 applies, on initial recognition the contractual service margin is calculated applying paragraph 38 for acquired insurance contracts issued and paragraph 65 for acquired reinsurance contracts held using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition. If acquired insurance contracts issued are onerous, applying paragraph 47, the entity shall recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination within the scope of PBE IFRS 3 or as a loss in ~~profit or loss~~surplus or deficit for contracts acquired in a transfer. The entity shall establish a loss component of the liability for remaining coverage for that excess, and apply paragraphs 49–52 to allocate subsequent changes in fulfilment cash flows to that loss component.

Changes in the Carrying Amount of the Contractual Service Margin for Insurance Contracts without Direct Participation Features (paragraph 44)

~~B~~AG96. For insurance contracts without direct participation features, paragraph 44(c) requires an adjustment to the contractual service margin of a group of insurance contracts for changes in fulfilment cash flows that relate to future service. These changes comprise:

(a) Experience adjustments arising from premiums received in the period that relate to future service, and related cash flows such as insurance acquisition cash flows and premium-based taxes, measured at the discount rates specified in paragraph ~~B~~AG72(c);

(b) Changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those described in paragraph ~~B~~AG97(a), measured at the discount rates specified in paragraph ~~B~~AG72(c);

[6] NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3. If that Standard is finalised before this Standard, this heading and paragraphs AG93–AG95 would refer to PBE IPSAS 40 rather than to PBE IFRS 3.

(c) Differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period, measured at the discount rates specified in paragraph ~~B~~AG72(c); and

(d) Changes in the risk adjustment for non-financial risk that relate to future service.

~~B~~AG97. An entity shall not adjust the contractual service margin for a group of insurance contracts without direct participation features for the following changes in fulfilment cash flows because they do not relate to future service:

(a) The effect of the time value of money and changes in the time value of money and the effect of financial risk and changes in financial risk (being the effect, if any, on estimated future cash flows and the effect of a change in discount rate);

(b) Changes in estimates of fulfilment cash flows in the liability for incurred claims; and

(c) Experience adjustments, except those described in paragraph ~~B~~AG96(a).

~~B~~AG98. The terms of some insurance contracts without direct participation features give an entity discretion over the cash flows to be paid to policyholders. A change in the discretionary cash flows is regarded as relating to future service, and accordingly adjusts the contractual service margin. To determine how to identify a change in discretionary cash flows, an entity shall specify at inception of the contract the basis on which it expects to determine its commitment under the contract; for example, based on a fixed interest rate, or on returns that vary based on specified asset returns.

~~B~~AG99. An entity shall use that specification to distinguish between the effect of changes in assumptions that relate to financial risk on that commitment (which do not adjust the contractual service margin) and the effect of discretionary changes to that commitment (which adjust the contractual service margin).

~~B~~AG100. If an entity cannot specify at inception of the contract what it regards as its commitment under the contract and what it regards as discretionary, it shall regard its commitment to be the return implicit in the estimate of the fulfilment cash flows at inception of the contract, updated to reflect current assumptions that relate to financial risk.

Changes in the Carrying Amount of the Contractual Service Margin for Insurance Contracts with Direct Participation Features (paragraph 45)

~~B~~AG101. Insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items. Hence, they are defined as insurance contracts for which:

(a) The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items (see paragraphs ~~B~~AG105–~~B~~AG106);

(b) The entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items (see paragraph ~~B~~AG107); and

(c) The entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items (see paragraph ~~B~~AG107).

~~B~~AG102. An entity shall assess whether the conditions in paragraph ~~B~~AG101 are met using its expectations at inception of the contract and shall not reassess the conditions afterwards, unless the contract is modified, applying paragraph 72.

~~B~~AG103. To the extent that insurance contracts in a group affect the cash flows to policyholders of contracts in other groups (see paragraphs ~~B~~AG67–~~B~~AG71), an entity shall assess whether the conditions in paragraph ~~B~~AG101 are met by considering the cash flows that the entity expects to pay the policyholders determined applying paragraphs ~~B~~AG68–~~B~~AG70.

~~B~~AG104. The conditions in paragraph ~~B~~AG101 ensure that insurance contracts with direct participation features are contracts under which the entity's obligation to the policyholder is the net of:

(a) The obligation to pay the policyholder an amount equal to the fair value of the underlying items; and

(b) A variable fee (see paragraphs ~~B~~AG110–~~B~~AG118) that the entity will deduct from (a) in exchange for the future service provided by the insurance contract, comprising:

(i) The entity's share of the fair value of the underlying items; less

(ii) Fulfilment cash flows that do not vary based on the returns on underlying items.

~~B~~AG105. A share referred to in paragraph ~~B~~AG101(a) does not preclude the existence of the entity's discretion to vary the amounts paid to the policyholder. However, the link to the underlying items must be enforceable (see paragraph 2).

~~B~~AG106. The pool of underlying items referred to in paragraph ~~B~~AG101(a) can comprise any items, for example a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity, as long as they are clearly identified by the contract. An entity need not hold the identified pool of underlying items. However, a clearly identified pool of underlying items does not exist when:

(a) An entity can change the underlying items that determine the amount of the entity's obligation with retrospective effect; or

(b) There are no underlying items identified, even if the policyholder could be provided with a return that generally reflects the entity's overall performance and expectations, or the performance and expectations of a subset of assets the entity holds. An example of such a return is a crediting rate or dividend payment set at the end of the period to which it relates. In this case, the obligation to the policyholder reflects the crediting rate or dividend amounts the entity has set, and does not reflect identified underlying items.

~~B~~AG107. Paragraph ~~B~~AG101(b) requires that the entity expects a substantial share of the fair value returns on the underlying items will be paid to the policyholder and paragraph ~~B~~AG101(c) requires that the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items. An entity shall:

(a) Interpret the term 'substantial' in both paragraphs in the context of the objective of insurance contracts with direct participation features being contracts under which the entity provides investment-related services and is compensated for the services by a fee that is determined by reference to the underlying items; and

(b) Assess the variability in the amounts in paragraphs ~~B~~AG101(b) and ~~B~~AG101(c):

(i) Over the duration of the group of insurance contracts; and

(ii) On a present value probability-weighted average basis, not a best or worst outcome basis (see paragraphs ~~B~~AG37–~~B~~AG38).

~~B~~AG108. For example, if the entity expects to pay a substantial share of the fair value returns on underlying items, subject to a guarantee of a minimum return, there will be scenarios in which:

(a) The cash flows that the entity expects to pay to the policyholder vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items do not exceed the fair value return on the underlying items; and

(b) The cash flows that the entity expects to pay to the policyholder do not vary with the changes in the fair value of the underlying items because the guaranteed return and other cash flows that do not vary based on the returns on underlying items exceed the fair value return on the underlying items.

The entity's assessment of the variability in paragraph ~~B~~AG101(c) for this example will reflect a present value probability-weighted average of all these scenarios.

~~B~~AG109. Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of PBE IFRS 17.

~~B~~AG110. For insurance contracts with direct participation features, the contractual service margin is adjusted to reflect the variable nature of the fee. Hence, changes in the amounts set out in paragraph ~~B~~AG104 are treated as set out in paragraphs ~~B~~AG111–~~B~~AG114.

~~B~~AG111. Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items (paragraph ~~B~~AG104(a)) do not relate to future service and do not adjust the contractual service margin.

~~B~~AG112. Changes in the entity's share of the fair value of the underlying items (paragraph ~~B~~AG104(b)(i)) relate to future service and adjust the contractual service margin, applying paragraph 45(b).

~~B~~AG113. Changes in the fulfilment cash flows that do not vary based on the returns on underlying items (paragraph ~~B~~AG104(b)(ii)) comprise:

(a) Changes in ~~estimates of~~ the fulfilment cash flows other than those specified in (b). An entity shall apply paragraphs ~~B~~AG96~~–B~~AG97, consistent with insurance contracts without direct participation features, to determine to what extent they relate to future service and, applying paragraph 45(c), adjust the contractual service margin. All the adjustments are measured using current discount rates.

(b) The change in the effect of the time value of money and financial risks not arising from the underlying items; for example, the effect of financial guarantees. These relate to future service and, applying paragraph 45(c), adjust the contractual service margin, except to the extent that paragraph ~~B~~AG115 applies.

~~B~~AG114. An entity is not required to identify the adjustments to the contractual service margin required by paragraphs ~~B~~AG112 and ~~B~~AG113 separately. Instead, a combined amount may be determined for some or all of the adjustments.

Risk Mitigation

~~B~~AG115. To the extent that an entity meets the conditions in paragraph ~~B~~AG116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items (see paragraph ~~B~~AG112) or the fulfilment cash flows set out in paragraph ~~B~~AG113(b).

~~B~~AG116. To apply paragraph ~~B~~AG115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:

(a) The entity uses a derivative to mitigate the financial risk arising from the insurance contracts.

(b) An economic offset exists between the insurance contracts and the derivative, i.e., the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.

(c) Credit risk does not dominate the economic offset.

~~B~~AG117. The entity shall determine the fulfilment cash flows in a group to which paragraph ~~B~~AG115 applies in a consistent manner in each reporting period.

~~B~~AG118. If any of the conditions in paragraph ~~B~~AG116 ceases to be met, an entity shall:

(a) Cease to apply paragraph ~~B~~AG115 from that date; and

(b) Not make any adjustment for changes previously recognised in ~~profit or loss~~surplus or deficit.

Recognition of the Contractual Service Margin in ~~Profit or Loss~~Surplus or Deficit

~~B~~AG119. An amount of the contractual service margin for a group of insurance contracts is recognised in ~~profit or loss~~surplus or deficit in each period to reflect the services provided under the group of insurance contracts in that period (see paragraphs 44(e), 45(e) and 66(e)). The amount is determined by:

(a) Identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage ~~duration~~period~~duration~~.

(b) Allocating the contractual service margin at the end of the period (before recognising any amounts in ~~profit or loss~~surplus or deficit to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.

(c) Recognising in ~~profit or loss~~surplus or deficit the amount allocated to coverage units provided in the period.

Insurance Revenue (paragraphs 83 and 85)

~~B~~AG120. The total insurance revenue for a group of insurance contracts is the consideration for the contracts, i.e., the amount of premiums paid to the entity:

(a) Adjusted for a financing effect; and

(b) Excluding any investment components.

~~B~~AG121. Paragraph 83 requires the amount of insurance revenue recognised in a period to depict the transfer of promised services at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those services. The total consideration for a group of contracts covers the following amounts:

(a) Amounts related to the provision of services, comprising:

(i) Insurance service expenses, excluding any amounts relating to the risk adjustment included in (ii) and allocated to the loss component of the liability for remaining coverage;

(ii) The risk adjustment for non-financial risk, excluding any amounts allocated to the loss component of the liability for remaining coverage; and

(iii) The contractual service margin.

(b) Amounts related to insurance acquisition cash flows.

~~B~~AG122. Insurance revenue for a period relating to the amounts described in paragraph ~~B~~AG121(a) is determined as set out in paragraphs ~~B~~AG123–~~B~~AG124. Insurance revenue for a period relating to the amounts described in paragraph ~~B~~AG121(b) is determined as set out in paragraph ~~B~~AG125.

~~B~~AG123. ~~Applying IFRS 15, when an entity provides services, it derecognises the performance obligation for those services and recognises revenue. Consistently, applying IFRS 17, w~~When an entity provides services in a period, it reduces the liability for remaining coverage for the services provided and recognises insurance revenue. The reduction in the liability for remaining coverage that gives rise to insurance revenue excludes changes in the liability that do not relate to services expected to be covered by the consideration received by the entity. Those changes are:

(a) Changes that do not relate to services provided in the period, for example:

(i) Changes resulting from cash inflows from premiums received;

(ii) Changes that relate to investment components in the period;

(iii) Changes that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) (see paragraph ~~B~~AG65(i));

(iv) Insurance finance ~~income~~revenue or expenses;

(v) Insurance acquisition cash flows (see paragraph ~~B~~AG125); and

(vi) Derecognition of liabilities transferred to a third party.

(b) Changes that relate to services, but for which the entity does not expect consideration, i.e., increases and decreases in the loss component of the liability for remaining coverage (see paragraphs 47–52).

~~B~~AG124. Consequently, insurance revenue for the period can also be analysed as the total of the changes in the liability for remaining coverage in the period that relates to services for which the entity expects to receive consideration. Those changes are:

(a) Insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding:

(i) Amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(a);

(ii) Repayments of investment components;

(iii) Amounts that relate to transaction-based taxes collected on behalf of third parties (such as premium taxes, value added taxes and goods and services taxes) (see paragraph ~~B~~AG65(i)); ~~and~~

(iv) Insurance acquisition expenses (see paragraph ~~B~~AG125); and~~.~~

(v) The amount related to the risk adjustment (see (b)).

(b) The change in the risk adjustment for non-financial risk, excluding:

(i) Changes included in insurance finance ~~income~~revenue or expenses applying paragraph 87;

(ii) Changes that adjust the contractual service margin because they relate to future service applying paragraphs 44(c) and 45(c); and

(iii) Amounts allocated to the loss component of the liability for remaining coverage applying paragraph 51(b).

(c) The amount of the contractual service margin recognised in ~~profit or loss~~surplus or deficit in the period, applying paragraphs 44(e) and 45(e).

~~B~~AG125. An entity shall determine insurance revenue related to insurance acquisition cash flows by allocating the portion of the premiums that relate to recovering those cash flows to each reporting period in a systematic way on the basis of the passage of time. An entity shall recognise the same amount as insurance service expenses.

~~B~~AG126. When an entity applies the premium allocation approach in paragraphs 55–58, insurance revenue for the period is the amount of expected premium receipts (excluding any investment component and adjusted to reflect the time value of money and the effect of financial risk, if applicable, applying paragraph 56) allocated to the period. The entity shall allocate the expected premium receipts to each period of coverage:

(a) On the basis of the passage of time; but

(b) If the expected pattern of release of risk during the coverage period differs significantly from the passage of time, then on the basis of the expected timing of incurred insurance service expenses.

~~B~~AG127. An entity shall change the basis of allocation between paragraphs ~~B~~AG126(a) and ~~B~~AG126(b) as necessary if facts and circumstances change.

Insurance Finance ~~Income~~Revenue or Expenses (paragraphs 87–92)

~~B~~AG128. Paragraph 87 requires an entity to include in insurance finance ~~income~~revenue or expenses the effect of changes in assumptions that relate to financial risk. For the purposes of PBE IFRS 17:

(a) Assumptions about inflation based on an index of prices or rates or on prices of assets with inflation-linked returns are assumptions that relate to financial risk; and

(b) Assumptions about inflation based on an entity's expectation of specific price changes are not assumptions that relate to financial risk.

~~B~~AG129. Paragraphs 88–89 require an entity to make an accounting policy choice as to whether to disaggregate insurance finance ~~income~~revenue or expenses for the period between ~~profit or loss~~surplus or deficit and other comprehensive ~~income~~revenue and expense. An entity shall apply its choice of accounting policy to portfolios of insurance contracts. In assessing the appropriate accounting policy for a portfolio of insurance contracts, applying paragraph 1~~6~~3 of ~~IAS 8~~ PBE IPSAS 3 *Accounting Policies,* *Changes in Accounting Estimates and Errors*, the entity shall consider for each portfolio the assets that the entity holds and how it accounts for those assets.

~~B~~AG130. If paragraph 88(b) applies, an entity shall include in ~~profit or loss~~surplus or deficit an amount determined by a systematic allocation of the expected total finance ~~income~~revenue or expenses over the duration of the group of insurance contracts. In this context, a systematic allocation is an allocation of the total expected finance ~~income~~revenue or expenses of a group of insurance contracts over the duration of the group that:

(a) Is based on characteristics of the contracts, without reference to factors that do not affect the cash flows expected to arise under the contracts. For example, the allocation of the finance ~~income~~revenue or expenses shall not be based on expected recognised returns on assets if those expected recognised returns do not affect the cash flows of the contracts in the group.

(b) Results in the amounts recognised in other comprehensive ~~income~~ revenue and expense over the duration of the group of contracts totalling zero. The cumulative amount recognised in other comprehensive ~~income~~ revenue and expense at any date is the difference between the carrying amount of the group of contracts and the amount that the group would be measured at when applying the systematic allocation.

~~B~~AG131. For groups of insurance contracts for which changes in assumptions that relate to financial risk do not have a substantial effect on the amounts paid to the policyholder, the systematic allocation is determined using the discount rates specified in paragraph ~~B~~AG72(e)(i).

~~B~~AG132. For groups of insurance contracts for which changes in assumptions that relate to financial risk have a substantial effect on the amounts paid to the policyholders:

(a) A systematic allocation for the finance ~~income~~revenue or expenses arising from the estimates of future cash flows can be determined in one of the following ways:

  (i) Using a rate that allocates the remaining revised expected finance ~~income~~revenue or expenses over the remaining duration of the group of contracts at a constant rate; or

  (ii) For contracts that use a crediting rate to determine amounts due to the policyholders—using an allocation that is based on the amounts credited in the period and expected to be credited in future periods.

(b) A systematic allocation for the finance ~~income~~revenue or expenses arising from the risk adjustment for non-financial risk, if separately disaggregated from other changes in the risk adjustment for non-financial risk applying paragraph 81, is determined using an allocation consistent with that used for the allocation for the finance ~~income~~revenue or expenses arising from the future cash flows.

(c) A systematic allocation for the finance ~~income~~revenue or expenses arising from the contractual service margin is determined:

  (i) For insurance contracts that do not have direct participation features, using the discount rates specified in paragraph ~~B~~AG72(b); and

  (ii) For insurance contracts with direct participation features, using an allocation consistent with that used for the allocation for the finance ~~income~~revenue or expenses arising from the future cash flows.

~~B~~AG133. In applying the premium allocation approach to insurance contracts described in paragraphs 53–59, an entity may be required, or may choose, to discount the liability for incurred claims. In such cases, it may choose to disaggregate the insurance finance ~~income~~revenue or expenses applying paragraph 88(b). If the entity makes this choice, it shall determine the insurance finance ~~income~~revenue or expenses in ~~profit or loss~~surplus or deficit using the discount rate specified in paragraph ~~B~~AG72(e)(iii).

~~B~~AG134. Paragraph 89 applies if an entity, either by choice or because it is required to, holds the underlying items for insurance contracts with direct participation features. If an entity chooses to disaggregate insurance finance ~~income~~revenue or expenses applying paragraph 89(b), it shall include in ~~profit or loss~~surplus or deficit expenses or ~~income~~revenue that exactly match the ~~income~~revenue or expenses included in ~~profit or loss~~surplus or deficit for the underlying items, resulting in the net of the two separately presented items being nil.

~~B~~AG135. An entity may qualify for the accounting policy choice in paragraph 89 in some periods but not in others because of a change in whether it holds the underlying items. If such a change occurs, the accounting policy choice available to the entity changes from that set out in paragraph 88 to that set out in paragraph 89, or vice versa. Hence, an entity might change its accounting policy between that set out in paragraph 88(b) and that set out in paragraph 89(b). In making such a change an entity shall:

(a) Include the accumulated amount previously included in other comprehensive ~~income~~ revenue and expense by the date of the change as a reclassification adjustment in ~~profit or loss~~surplus or deficit in the period of change and in future periods, as follows:

   (i) If the entity had previously applied paragraph 88(b)—the entity shall include in ~~profit or loss~~surplus or deficit the accumulated amount included in other comprehensive ~~income~~ revenue and expense before the change as if the entity were continuing the approach in paragraph 88(b) based on the assumptions that applied immediately before the change; and

   (ii) If the entity had previously applied paragraph 89(b)—the entity shall include in ~~profit or loss~~surplus or deficit the accumulated amount included in other comprehensive ~~income~~ revenue and expense before the change as if the entity were continuing the approach in paragraph 89(b) based on the assumptions that applied immediately before the change.

(b) Not restate prior period comparative information.

~~B~~AG136. When applying paragraph ~~B~~AG135(a), an entity shall not recalculate the accumulated amount previously included in other comprehensive ~~income~~ revenue and expense as if the new disaggregation had always applied; and the assumptions used for the reclassification in future periods shall not be updated after the date of the change.

Interim Financial Statements

~~B~~AG137 Notwithstanding the requirement in PBE IAS 34 *Interim Financial Reporting* that the frequency of an entity's reporting shall not affect the measurement of its annual results, an entity shall not change the treatment of accounting estimates made in previous interim financial statements when applying PBE IFRS 17 in subsequent interim financial statements or in the annual reporting period.

Appendix C

Effective Date and Transition

[Not used]

Appendix D
Amendments to other Standards

The amendments in this Appendix reflect the text of the relevant standards, including amendments set out in:

(a) PBE FRS 48 *Service Performance Reporting*, issued November 2017 and effective from 1 January 2021;

(b) *2018 Omnibus Amendments to PBE Standards,* issued October 2018. The relevant amendments reflected in this Appendix are effective from 1 January 2019; and

(c) ED 2018-5 PBE IPSAS 41 *Financial Instruments* which is expected to be finalised and issued at the same time as PBE IFRS 17.

The amendments do not reflect the proposals in ED 2018-4 PBE IPSAS 40 *PBE Combinations*, issued in September 2018 and open for comment until 31 January 2019. However, this Appendix identifies the amendments that would be required to PBE IPSAS 40, if PBE IPSAS 40 were to be issued before PBE IFRS 17.

Except where otherwise stated, an entity shall apply the amendments in this Appendix when it applies PBE IFRS 17 issued in [date].

PBE IPSAS 1 *Presentation of Financial Reports*

Paragraphs 7, 88 and 99.1 are amended and paragraph 154.13 is added. New text is underlined and deleted text is struck through.

Definitions

7. **...**

Other comprehensive revenue and expense comprises items of revenue and expense (including reclassification adjustments) that are not recognised in surplus or deficit as required or permitted by other PBE Standards.

The components of other comprehensive revenue and expense include:

(a) …

(h) …;

(i) … ~~.~~; ~~and~~

(j) Insurance finance revenue and expenses from contracts issued within the scope of PBE IFRS 17 *Insurance Contracts* excluded from surplus or deficit when total insurance finance revenue or expenses is disaggregated to include in surplus or deficit an amount determined by a systematic allocation applying paragraph 88(b) of PBE IFRS 17, or by an amount that eliminates accounting mismatches with the finance revenue or expenses arising on the underlying items, applying paragraph 89(b) of PBE IFRS 17; and

(k) Finance revenue and expenses from reinsurance contracts held excluded from surplus or deficit when total reinsurance finance revenue or expenses is disaggregated to include in surplus or deficit an amount determined by a systematic allocation applying paragraph 88(b) of PBE IFRS 17.

...

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

88. **The face of the statement of financial position shall include line items that present the following amounts:**

(a) **...**

(da) **Groups of contracts within the scope of PBE IFRS 17 that are assets, disaggregated as required by paragraph 78 of PBE IFRS 17;**

(e) **…**

(ma) **Groups of contracts within the scope of PBE IFRS 17 that are liabilities, disaggregated as required by paragraph 78 of PBE IFRS 17;**

(n) **...**

Statement of Comprehensive Revenue and Expense

…

Surplus or Deficit for the Period

…

99.1 The surplus or deficit section or the statement of comprehensive revenue and expense 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) Insurance revenue (see PBE IFRS 17);

(aa) ...

(ab) Insurance service expenses from contracts issued within the scope of PBE IFRS 17 (see PBE IFRS 17);

(ac) Revenue or expenses from reinsurance contracts held (see PBE IFRS 17);

(b) ...

(bb) Insurance finance revenue or expenses from contracts issued within the scope of PBE IFRS 17 (see PBE IFRS 17);

(bc) Finance revenue or expenses from reinsurance contracts held (see PBE IFRS 17);

(c) ...

Effective Date

…

154.13 **PBE IFRS 17, issued in [date], amended paragraphs 7, 88 and 99.1. An entity shall apply those amendments when it applies PBE IFRS 17.**

PBE IPSAS 2 *Cash Flow Statements*

Paragraph 22 is amended and paragraph 63.4 is added. New text is underlined and deleted text is struck through.

Operating Activities

...

22. Cash flows from operating activities are primarily derived from the principal cash-generating activities of the entity. Examples of cash flows from operating activities are:

(a) …

(k) [Deleted by NZASB] ~~Cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;~~

(l) …

Effective Date

…

63.4 **PBE IFRS 17 *Insurance Contracts*, issued in [date], amended paragraph 22. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 9 *Revenue from Exchange Transactions*

Paragraph 10 is amended and paragraph 42.6 is added. New text is underlined and deleted text is struck through.

Scope

…

10. This Standard does not deal with revenues arising from:

    (a) …

    (d) Insurance contracts within the scope of ~~PBE IFRS 4~~PBE IFRS 17 *Insurance Contracts*. However, an entity may choose to apply this Standard to insurance contracts that have as their primary purpose the provision of services for a fixed fee in accordance with paragraph 8 of PBE IFRS 17;

    (e) …

Effective Date

…

42.6 **PBE IFRS 17 *Insurance Contracts*, issued in [date], amended paragraph 10. An entity shall apply that amendments when it applies PBE IFRS 17.**

PBE IPSAS 13 *Leases*

Paragraph 86.6 is added. New text is underlined.

Effective Date

…

86.6 **PBE IFRS 17, issued in [date], amended paragraph B7. An entity shall apply that amendment when it applies PBE IFRS 17.**

In Appendix B, paragraph B7 is amended. New text is underlined and deleted text is struck through.

Consensus

…

B7. Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under ~~this Standard~~ PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, ~~PBE IPSAS 29~~[proposed] PBE IPSAS 41 *Financial Instruments* or ~~PBE IFRS 4~~ PBE IFRS 17 *Insurance Contracts*, depending on the terms.

PBE IPSAS 16 *Investment Property*

Paragraphs 41.1–41.3 and 102.7 are added. New text is underlined.

Accounting Policy

…

41.1 **An entity may:**

(a) **choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and**

(b) **choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).**

41.2 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue insurance contracts with direct participation features, for which the underlying items include investment property. For the purposes of paragraphs 41.1–41.2 only, insurance contracts include investment contracts with discretionary participation features. Paragraph 41.1 does not permit an entity to measure property held by the fund (or property that is an underlying item) partly at cost and partly at fair value. (See PBE IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard.)

41.3 If an entity chooses different models for the two categories described in paragraph 41.1, sales of investment property between pools of assets measured using different models shall be recognised at fair value and the cumulative change in fair value shall be recognised in surplus or deficit. Accordingly, if an investment property is sold from a pool in which the fair value model is used into a pool in which the cost model is used, the property's fair value at the date of the sale becomes its deemed cost.

...

Effective Date

…

102.7 **PBE IFRS 17, issued in [date], added paragraphs 41.1–41.3. An entity shall apply those amendments when it applies PBE IFRS 17.**

In the Basis for Conclusions, paragraphs BC10–BC11 and the related heading are added. New text is underlined.

PBE IFRS 17 *Insurance Contracts*

BC10. IFRS 4 *Insurance Contracts* added paragraphs 32A–32C to IAS 40. Paragraph 32B was subsequently amended as a consequential amendment of IFRS 17 *Insurance Contracts*. The equivalent paragraphs were not included in PBE IPSAS 16 when the NZASB issued the suite of PBE Standards.

BC11. When developing PBE IFRS 17 *Insurance Contracts* the NZASB considered these paragraphs and believed that adding these paragraphs to PBE IPSAS 16 would maintain the cohesion of the suite of PBE Standards and align the requirements with NZ IFRS for entities that issue insurance contracts. Therefore, PBE IFRS 17 issued in [date], added paragraphs 41.1–41.3 to PBE IPSAS 16. These paragraphs contain the same requirements as paragraphs 32A–32C of IAS 40.

PBE IPSAS 17 *Property, Plant and Equipment*

Paragraphs 42.1, 42.2 and 108.12 are added. New text is underlined.

Measurement after Recognition

…

<u>42.1 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund. Similarly, some entities issue groups of insurance contracts with direct participation features and hold the underlying items. Some such funds or underlying items include owner-occupied property. The entity applies PBE IPSAS 17 to owner-occupied properties that are included in such a fund or are underlying items. Despite paragraph 42, the entity may elect to measure such properties using the fair value model in accordance with PBE IPSAS 16. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See PBE IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard).</u>

<u>42.2 An entity shall treat owner-occupied property measured using the investment property fair value model applying paragraph 42.1 as a separate class of property, plant and equipment.</u>

...

Effective Date

…

<u>108.12 **PBE IFRS 17, issued in [date], added paragraphs 42.1 and 42.2. An entity shall apply those amendments when it applies PBE IFRS 17.**</u>

PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*

Paragraph 1 is amended and paragraph 112.9 is added. New text is underlined and deleted text is struck through.

Scope

1. **An entity that prepares and presents financial statements shall apply this Standard in accounting for provisions, contingent liabilities, and contingent assets, except:**

   (a) ...

   (d) **Insurance contracts <u>and other contracts</u> within the scope of ~~PBE IFRS 4~~ <u>PBE IFRS 17</u> *Insurance Contracts*.**

   (e) ...

Effective Date

...

<u>112.9 **PBE IFRS 17, issued in [date], amended paragraph 1. An entity shall apply that amendment when it applies PBE IFRS 17.**</u>

PBE IPSAS 26 *Impairment of Cash-Generating Assets*

Paragraph 2 is amended and paragraph 127.10 is added. New text is underlined and deleted text is struck through.

Scope

2. **An entity that prepares and presents financial statements shall apply this Standard in accounting for the impairment of cash-generating assets, except for:**

   (a) **...**

   (k) **~~Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance~~ Contracts within the scope of ~~PBE IFRS 4~~ PBE IFRS 17 *Insurance Contracts* that are assets; and**

   (l) **…**

Effective Date

…

127.10 **PBE IFRS 17, issued in [date], amended paragraph 2. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 28 *Financial Instruments: Presentation*

Paragraphs 3 and 9 are amended and paragraphs 38.1 and 62.7 are added. New text is underlined and deleted text is struck through.

Scope (see also paragraphs AG3–AG9)

3. **An entity that prepares and presents financial statements shall apply this Standard to all types of financial instruments except:**

   …

   (c) **~~Obligations arising from i~~Insurance contracts as defined in PBE IFRS 17 *Insurance Contracts* and investment contracts with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to:**

   (i) **Derivatives that are embedded in ~~insurance~~ contracts within the scope of PBE IFRS 17, if [proposed] PBE IPSAS 41~~PBE IPSAS 29~~ requires the entity to account for them separately; and**

   (ii) **Investment components that are separated from contracts within the scope of PBE IFRS 17, if PBE IFRS 17 requires such separation. ~~Financial guarantee contracts, if the issuer applies PBE IPSAS 29 in recognising and measuring the contracts, but shall apply PBE IFRS 4 *Insurance Contracts* if the issuer elects to apply that standard in recognising and measuring them.~~**

   Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies [proposed] PBE IPSAS 41 in recognising and measuring the contracts, but shall apply PBE IFRS 17 if the issuer elects, in accordance with paragraph 7(e) of PBE IFRS 17, to apply PBE IFRS 17 in recognising 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) [Deleted by NZASB]**~~Financial instruments that are within the scope of PBE IFRS 4 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 PBE IPSAS 29).~~

(e) …

Definitions (see also paragraphs AG10–AG48)

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

…

An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. (See ~~Appendix B of~~ the Application Guidance in PBE IFRS 4~~~~17 for guidance on this definition.)

…

Treasury Shares (see also paragraph AG61)

…

38.1 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's treasury shares. Despite paragraph 38, an entity may elect not to deduct from equity a treasury share that is included in such a fund or is an underlying item when, and only when, an entity reacquires its own equity instrument for such purposes. Instead, the entity may elect to continue to account for that treasury share as equity and to account for the reacquired instrument as if the instrument were a financial asset and measure it at fair value through surplus or deficit in accordance with [proposed] PBE IPSAS 41. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See PBE IFRS 17 for terms used in this paragraph that are defined in that Standard.)

...

Effective Date

…

62.7 PBE IFRS 17, issued in [date], amended paragraphs 3, 9, AG9, AG15 and AG61, and added paragraph 38.1. An entity shall apply those amendments when it applies PBE IFRS 17.

In the Application Guidance, paragraphs AG9, AG15 and AG61 are amended. New text is underlined and deleted text is struck through.

Insurance Contracts

…

AG9. In accordance with paragraph 3(c), an entity treats financial guarantee contracts as financial instruments unless it elects to treat such contracts as insurance contracts in accordance with ~~PBE IFRS 4~~ PBE IFRS 17.

Definitions (paragraphs 9–12)

Financial Assets and Financial Liabilities

…

AG15. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of these contingent rights and obligations may be ~~insurance~~ contracts within the scope of PBE IFRS 17.

…

Treasury Shares (paragraphs38–39)

AG61. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired. Paragraph 38 requires an entity that reacquires its own equity instruments to deduct those equity instruments from net assets/equity (but see also paragraph 38.1). However, when an entity holds its own equity instruments on behalf of others, for example, a financial institution holding its own equity instruments on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's statement of financial position.

…

PBE IPSAS 30 *Financial Instruments: Disclosures*

Paragraphs 3, 11 and 35 are amended, paragraph 53.8 is added and paragraph 36 is deleted. New text is underlined and deleted text is struck through.

Scope

3. **This Standard shall be applied by all entities to all types of financial instruments, except:**

(a) **…**

(c) **~~Rights and obligations arising under i~~Insurance contracts. as defined in PBE IFRS 17 *Insurance Contracts* and investment contracts with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to:**

(i) **Derivatives that are embedded in ~~insurance~~ contracts within the scope of PBE IFRS 17, if ~~PBE IPSAS 29~~[proposed] PBE IPSAS 41 requires the entity to account for them separately; and**

(ii) **Investment components that are separated from contracts within the scope of PBE IFRS 17 if PBE IFRS 17 requires such separation. ~~An issuer of financial guarantee contracts if the issuer applies PBE IPSAS 29 in recognising and measuring the contracts, but shall apply PBE IFRS 4 *Insurance Contracts* if the issuer elects to apply that standard in recognising and measuring them.~~**

Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies [proposed] PBE IPSAS 41 in recognising and measuring the contracts, but shall apply PBE IFRS 17 if the issuer elects, in accordance with paragraph 7(e) of PBE IFRS 17, to apply PBE IFRS 17 in recognising 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) **…**

Categories of Financial Assets and Financial Liabilities

*11. The carrying amounts of each of the following categories, as specified in ~~PBE IPSAS 29~~[proposed] PBE IPSAS 41, shall be disclosed either in the statement of financial position or in the notes:

(a) financial assets measured at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition or subsequently in accordance with paragraph 152 of

~~PBE IFRS 9~~[proposed] PBE IPSAS 41; (ii) those measured as such in accordance with the election in paragraph 38.1 of [proposed] PBE IPSAS 41; (iii) those measured as such in accordance with the election in paragraph 38.1 of PBE IPSAS 28 and (~~ii~~iv) those mandatorily measured at fair value through surplus or deficit in accordance with ~~PBE IPSAS 29~~[proposed] PBE IPSAS 41.

(b) …

Fair Value

...

35. Disclosures of fair value are not required:

(a) …

(c) [Deleted by NZASB]~~For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.~~

36. [Deleted by NZASB]~~In the case described in paragraph 35(c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts 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 derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.~~

...

Effective Date and Transition

…

53.8 **PBE IFRS 17, issued in [date], amended paragraphs 3, 11 and 35 and deleted paragraph 36. An entity shall apply those amendments when it applies PBE IFRS 17.**

PBE IPSAS 31 *Intangible Assets*

Paragraph 3 is amended and paragraph 133.9 is added. New text is underlined and deleted text is struck through.

Scope

3. **This Standard shall be applied in accounting for intangible assets, except:**

(a) …

(i) **~~Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance c~~Contracts within the scope of ~~PBE IFRS 4~~PBE IFRS 17 *Insurance Contracts* ~~IFRS 4 sets out specific disclosure requirements for those deferred acquisition costs but not for those intangible assets. Therefore, the disclosure requirements in this Standard apply to those intangible assets~~; and**

(j) ...

Effective Date

…

133.9 **PBE IFRS 17, issued in [date], amended paragraph 3. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 32 *Service Concession Arrangements: Grantor*

Paragraph 37.6 is added. New text is underlined.

Effective Date

…

37.6 **PBE IFRS 17, issued in [date], amended paragraph AG52. An entity shall apply that amendment when it applies PBE IFRS 17**.

In the Application Guidance, paragraph AG52 is amended. New text is underlined and deleted text is struck through.

Other Liabilities, Commitments, Contingent Liabilities and Contingent Assets (see paragraph 29)

AG51. …

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 PBE IPSAS 28, ~~PBE IPSAS 29 and~~ PBE IPSAS 30 and [proposed] PBE IPSAS 41 *Financial Instruments* in accounting for the guarantee. Where the guarantee is an insurance contract, the grantor can elect to apply ~~PBE IFRS 4~~ PBE IFRS 17 *Insurance Contracts*. See PBE IPSAS 28, paragraphs AG3–AG9 for further guidance.

PBE IPSAS 36 *Investments in Associates and Joint Ventures*

Paragraph 24 is amended and paragraph 51.6 is added.[7] New text is underlined and deleted text is struck through.

Exemptions from Applying the Equity Method

…

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 organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through profit or loss in accordance with ~~PBE IPSAS 29~~[proposed] PBE IPSAS 41. An example of an investment-linked insurance fund is a fund held by an entity as the underlying items for a group of insurance contracts with direct participation features. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. An entity shall make this election separately for each associate or joint venture, at initial recognition of the associate or joint venture. (See PBE IFRS 17 *Insurance Contracts* for terms used in this paragraph that are defined in that Standard.) An investment entity will, by definition, have made this election for its investments.

...

[7] NZASB ED 2018-3 *2018 Omnibus Amendments to PBE Standards* proposed to amend paragraph 24.

Effective Date

…

51.6 **PBE IFRS 17, issued in [date], amended paragraph 24. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE IPSAS 39 *Employee Benefits*

The footnote to paragraph 8 (definition of a qualifying insurance policy) is amended and paragraph 177.2 is added. New text is underlined and deleted text is struck through.

A qualifying insurance policy is not necessarily an insurance contract, as defined in ~~PBE IFRS 4~~ PBE IFRS 17 *Insurance Contracts*.

...

Effective Date

…

177.2 **PBE IFRS 17, issued in [date], amended the footnote to paragraph 8. An entity shall apply that amendment when it applies PBE IFRS 17.**

[Proposed] PBE IPSAS 41 *Financial Instruments*

If PBE IPSAS 41 is issued at the same time as PBE IFRS 17, paragraphs 2(e) and 38.1 will read as outlined below.

Scope

2. **This Standard shall be applied by all entities to all types of financial instruments except:**

   (a) **...**

   (e) **Rights and obligations arising under (i) an insurance contract as defined in PBE IFRS 17 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, or (ii) an investment contract with discretionary participation features within the scope of PBE IFRS 17. However, this Standard applies to (i) a derivative that is embedded in a contract within the scope of PBE IFRS 17, if the derivative is not itself a contract within the scope of PBE IFRS 17; and (ii) an investment component that is separated from a contract within the scope of PBE IFRS 17, if PBE IFRS 17 requires such separation. Moreover, if an issuer of financial guarantee contracts has previously applied accounting that is applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, the issuer may elect to apply either this Standard or PBE IFRS 17 to such financial guarantee contracts (see paragraphs AG5–AG6). The issuer may make that election contract by contract, but the election for each contract is irrevocable.**

...

Derecognition of Financial Liabilities

…

38.1 Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's financial liability (for example, a corporate bond issued). Despite the other requirements in this Standard for the derecognition of financial liabilities, an entity may elect not to derecognise its financial liability that is included in such a fund or is an underlying item when, and only when, the entity repurchases its financial liability for such purposes. Instead, the entity may elect to continue to account for that instrument as a financial liability and to account for the repurchased instrument as if the instrument were a financial asset, and measure it at fair value through surplus or deficit in accordance with this Standard. That election is irrevocable and made on an instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (See PBE IFRS 17 for terms used in this paragraph that are defined in that Standard.)

...

If PBE IPSAS 41 is issued at the same time as PBE IFRS 17, paragraphs AG1, AG4, AG5 and AG92 will read as outlined below.

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 within the scope of PBE IFRS 17 *Insurance Contracts*, they are within the scope of this Standard.

…

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 under contracts within the scope of PBE IFRS 17.

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 PBE IFRS 17 (see paragraph 7(e) of PBE IFRS 17) if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously applied accounting that is applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, the issuer may elect to apply either this Standard or PBE IFRS 17 to such financial guarantee contracts. ...

(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 as defined in PBE IFRS 17. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) …

Designation eliminates or significantly reduces an accounting mismatch

…

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 contracts within the scope of PBE IFRS 17 (the measurement of which incorporates current information and financial assets that it considers to be related and that would otherwise be measured at either fair value through other comprehensive income or amortised cost.

(b) ...

PBE IFRS 3 *Business Combinations* (if PBE IPSAS 40 *PBE Combinations* is not issued and does not become effective before PBE IFRS 17)

Paragraphs 17, 20, 21 and 35 are amended, after paragraph 31, a heading and paragraph 31.1 are added and paragraph 64.9 is added. New text is underlined and deleted text is struck through.

Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination

…

17. This Standard provides ~~two~~<u>an</u> exception~~s~~ to the principle in paragraph 15:

    (a) Classification of a lease contract as either an operating lease or a finance lease in accordance with PBE IPSAS 13 *Leases*<u>.</u>~~; and~~

    (b) <u>[Deleted by NZASB]</u>~~classification of a contract as an insurance contract in accordance with PBE IFRS 4 *Insurance Contracts*.~~

    The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

…

Measurement Principle

…

20. Paragraphs B41–B45 provide guidance on measuring the fair value of particular identifiable assets and a non-controlling interest in an acquiree. Paragraphs 24~~–31~~<u>31.1</u> specify the types of identifiable assets and liabilities that include items for which this Standard provides limited exceptions to the measurement principle.

Exceptions to the Recognition or Measurement Principles

21. This Standard provides limited exceptions to its recognition and measurement principles. Paragraphs 22–~~31~~<u>31.1</u> specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs 22–~~31~~<u>31.1</u>, which will result in some items being:

…

<u>*Insurance Contracts*</u>

<u>31.1. The acquirer shall measure a group of contracts within the scope of PBE IFRS 17 *Insurance Contracts* acquired in a business combination as a liability or asset in accordance with paragraphs 39 and AG93–AG95 of PBE IFRS 17, at the acquisition date.</u>

…

Bargain Purchases

…

35. A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items discussed in paragraphs 22~~–31~~<u>31.1</u> may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

...

Effective Date and Transition

Effective Date

…

64.9 **PBE IFRS 17, issued in [date], amended paragraphs 17, 20, 21, 35 and B63, and after paragraph 31 added a heading and paragraph 31.1. An entity shall apply ~~those~~ the amendments to paragraph 17 to business combinations with an acquisition date after the date of initial application of PBE IFRS 17. An entity shall apply the other amendments when it applies PBE IFRS 17.**

In Appendix B, paragraph B63 is amended. New text is underlined and deleted text is struck through.

Other PBE Standards that Provide Guidance on Subsequent Measurement and Accounting (application of paragraph 54)

B63. Examples of other PBE Standards that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination include:

(a) …

(b) [Deleted by NZASB]~~PBE IFRS 4 *Insurance Contracts* provides guidance on the subsequent accounting for an insurance contract acquired in a business combination.~~

(c) …

Forthcoming PBE IPSAS 40 *PBE Combinations*

Note: NZASB ED 2018-4 PBE IPSAS 40 *PBE Combinations* sets out proposals for a PBE Standard which would supersede PBE IFRS 3 *Business Combinations*. The amendments that would be required to PBE IPSAS 40, if PBE IPSAS 40 were to be issued before PBE IFRS 17, are set out below.

Paragraphs 71, 74, 75 and 89 are amended, after paragraph 84.1, a heading and paragraph 84.2 are added and paragraph 126.2 is added. New text is underlined and deleted text is struck through.

Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in an Acquisition

…

71. This Standard provides ~~two~~an exception~~s~~ to the principle in paragraph 69:

(a) Classification of a lease arrangement as either an operating lease or a finance lease in accordance with PBE IPSAS 13 *Leases*; and

(b) [Deleted by NZASB]~~Classification of a contract as an insurance contract in accordance with PBE IFRS 4 *Insurance Contracts*.~~

The acquirer shall classify those binding arrangements on the basis of the terms and other factors at the inception of the binding arrangement (or, if the terms of the binding arrangement have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

…

Measurement Principle

…

74. Paragraphs 78–84.~~1~~2 specify the types of identifiable assets and liabilities that include items for which this Standard provides limited exceptions to the measurement principle.

Exceptions to the Recognition or Measurement Principles

75. This Standard provides limited exceptions to its recognition and measurement principles. Paragraphs 76–84.~~1~~2 specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs 76–84.~~1~~2, which will result in some items being:

…

Insurance Contracts

84.2. The acquirer shall measure a group of contracts within the scope of PBE IFRS 17 *Insurance Contracts* acquired in an acquired operation as a liability or asset in accordance with paragraphs 39 and AG93–AG95 of PBE IFRS 17, at the acquisition date.

…

Bargain Purchases

…

89. A bargain purchase might happen, for example, in an acquisition that is a forced sale in which the seller is acting under economic compulsion. However, the recognition or measurement exceptions for particular items discussed in paragraphs 76–84.~~1~~2 may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

…

Effective Date

…

126.2 **PBE IFRS 17, issued in [date], amended paragraphs 71, 74, 75, 89 and AG107, and after paragraph 84.1 added a heading and paragraph 84.2. An entity shall apply the amendments to paragraph 71 to business combinations with an acquisition date after the date of initial application of PBE IFRS 17. An entity shall apply the other amendments when it applies PBE IFRS 17.**

In Appendix A Application Guidance, paragraph AG107 is amended. New text is underlined and deleted text is struck through.

Subsequent Measurement and Accounting (see paragraph 112)

AG107. Examples of other PBE Standards that provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in an acquisition include:

(f) …

(g) [Deleted by NZASB]~~PBE IFRS 4 provides guidance on the subsequent accounting for an insurance contract acquired in an acquisition.~~

(h) …

PBE IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Paragraph 5 is amended and paragraph 44.10 is added. New text is underlined and deleted text is struck through.

Scope

…

5. The measurement provisions of this Standard [footnote omitted] do not apply to the following assets, which are covered by the Standards listed, either as individual assets or as part of a disposal group:

   (a) …

   (f) ~~Contractual rights under insurance contracts as defined in PBE IFRS 4~~Groups of contracts within the scope of PBE IFRS 17 *Insurance Contracts*.

   ...

Effective Date

…

44.10 **PBE IFRS 17, issued in [date], amended paragraph 5. An entity shall apply that amendment when it applies PBE IFRS 17.**

PBE FRS 47 *First-time Adoption of PBE Standards by Entities other than those Previously Applying NZ IFRS*

Paragraph 42.10 is added. New text is underlined.

Effective Date

…

42.10 **PBE IFRS 17 *Insurance Contracts*, issued in [date], amended paragraph A1 and after paragraph A9 added a heading and paragraph A10. An entity shall apply those amendments when it applies PBE IFRS 17.**

In Appendix A, paragraph A1 is amended. After paragraph A9, a heading and paragraph A10 are added. New text is underlined and deleted text is struck through.

A1. An entity shall apply the following exceptions:

   (a) …

   (f) Embedded derivatives (paragraph A9); and~~.~~

   (g) Insurance contracts (paragraph A10).

   …

Insurance Contracts

A10. An entity shall apply the transition provisions in paragraphs 132.1–132.24 and 132.28 of PBE IFRS 17 to contracts within the scope of PBE IFRS 17. The references in those paragraphs in PBE IFRS 17 to the transition date shall be read as the date of transition to PBE Standards.

XRB A1 *Application of the Accounting Standards Framework*

Appendix C is amended. New text is underlined.

APPENDIX C

TIER 1 PBE ACCOUNTING REQUIREMENTS AND TIER 2 PBE ACCOUNTING REQUIREMENTS TO BE APPLIED BY PUBLIC BENEFIT ENTITIES

This appendix forms an integral part of XRB A1 Application of the Accounting Standards Framework.

…

Accounting Standards

…

PBE IFRS 4	*Insurance Contracts* (superseded on adoption of PBE IFRS 17)
…	
PBE IFRS 9	*Financial Instruments* (superseded on adoption of PBE IPSAS 41)
PBE IFRS 17	*Insurance Contracts*
…	

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, PBE IFRS 17.

BC1. The IPSASB has not developed, and at the date of issuing PBE IFRS 17 *Insurance Contracts* has no plans of developing, an IPSAS for accounting for insurance contracts.

BC2. When the PBE Standards were developed, the New Zealand Accounting Standards Board (NZASB) included PBE IFRS 4 *Insurance Contracts*, which was based on NZ IFRS 4 *Insurance Contracts*. Although NZ IFRS 4 included the requirements of IFRS 4 *Insurance Contracts*, it also included appendices that carried forward the accounting for insurance contracts that was applicable in New Zealand before the adoption of IFRS® Standards.

BC3. In August 2017 the NZASB approved NZ IFRS 17 *Insurance Contracts*, which is identical to IFRS 17 *Insurance Contracts* except for a New Zealand-specific scope paragraph. On adoption, NZ IFRS 17 supersedes NZ IFRS 4.

BC4. The NZASB did not modify the requirements in NZ IFRS 17 for application by Tier 1 and Tier 2 public benefit entities except for the scope as outlined below. The NZASB considered that the requirements of NZ IFRS 17 were appropriate for application by public benefit entities. Where applicable, the language has been generalised for use by public benefit entities.

Scope

BC5. The NZASB is aware that the IPSASB is finalising proposals for an International Public Sector Accounting Standard (IPSAS) dealing with the accounting for social benefits.[8] IPSASB ED 63 *Social Benefits* proposed that entities with contributory social benefit schemes that met certain criteria could elect to apply the insurance approach to those schemes, and that the insurance approach should be based on IFRS 17 or national standards that have adopted substantially the same principles as IFRS 17. The IPSASB considered that for social benefits schemes that meet the criteria to apply the insurance approach, that approach was expected to provide information that best meets users' needs. [IPSASB BC125].

BC6. In its comment letter to the IPSASB on ED 63, the NZASB supported the criteria proposed by the IPSASB for a scheme to be able to apply the insurance approach.

BC7. The NZASB is, therefore, proposing to amend the scope of PBE IFRS 17 to capture schemes that are eligible to apply the insurance approach under the IPSASB's forthcoming IPSAS dealing with Social Benefits.

BC8. The types of schemes that are proposed to be included in the scope of PBE IFRS 17 are those:

(a) That are intended to be fully funded from contributions and levies; and

(b) Where there is evidence that the entity manages the scheme in the same way as an issuer of insurance contracts, including assessing the financial performance and financial position of the arrangement on a regular basis.

BC9. The NZASB is also proposing to add Application Guidance from ED 63 on determining:

(a) Whether a scheme is intended to be fully funded from contributions and levies; and

(b) Whether a scheme is being managed in the same way as an insurer would manage an insurance portfolio.

Other PBE-specific modifications considered

BC10. The NZASB considered the following issues in determining whether PBE-specific modifications are needed to the requirements of IFRS 17.

(a) Whether a risk adjustment for non-financial risk is appropriate for PBEs.

(b) Whether the contract boundary is clear for PBEs that are funded through levies, particularly when determining their eligibility to apply the premium allocation approach.

[8] The IPSASB is currently considering respondents' comments on ED 63 and plans to issue a final IPSAS at the end of 2018/early 2019.

(c) Whether the requirements of IFRS 17 to divide portfolios of insurance contracts into more granular groups of contracts and assess onerous contracts at that granular level are appropriate for PBEs.

(d) Whether the discount rate described in IFRS 17 is appropriate for PBEs, in particular the need for the discount rate to factor in liquidity.

BC11. The NZASB has not proposed any PBE-specific modifications to the requirements of IFRS 17 in relation to the issues outlined above for the following reasons.

(a) The requirements in PBE IFRS 17 are explicit in that the risk adjustment is determined from the perspective of the entity issuing the insurance contract. The risk adjustment under IFRS 17 for a PBE could be small, and even potentially immaterial, but it is unlikely to equal zero. Although PBEs with the ability to recover cost overruns by increasing premiums/levies in future periods might have a less risk averse approach to an equivalent entity which does not have such ability, such PBEs are still expected to have a risk adjustment for non-financial risk, albeit lower than that of an equivalent entity without such powers.

(b) Paragraph 34 of PBE IFRS 17 explains which cash flows are within the boundary of an insurance contract, and when a substantive obligation to provide services ends (that is, the contract boundary). Paragraph 34 requires the entity to have the practical ability to reassess:

(i) the risks of the particular policyholder and, as a result, set a level of benefits that fully reflects those risks; and

(ii) the risks of the portfolio of insurance contacts that contains the contract and, as a result, can set a price or level of benefits that fully reflects the risk of that portfolio.

(c) The NZASB considered the requirements in IFRS 17 for determining the boundary of an insurance contract for a PBE that is funded through levies rather than premiums. The NZASB is of the view that the requirements are sufficiently clear for such a PBE to determine the contract boundary.

(d) The NZASB considered the applicability of the requirements in IFRS 17 to public sector PBEs and is unaware of any situations in which a PBE would not be eligible to apply the PAA, and the application of the general model would not be appropriate.

(e) The NZASB notes that similar concerns regarding the level of granularity have been expressed by for-profit insurers and that this issue is, therefore, not specific to PBEs.

(f) Although concerns have been raised regarding the appropriateness for PBEs of applying a discount rate that includes an adjustment for liquidity and inconsistencies concerning discount rates in PBE Standards, the NZASB is of the view that it would be more appropriate to wait for the IPSASB to consider discount rates generally at a future date.

BC12. The Australian Accounting Standards Board (AASB) considered the suitability of the requirements of IFRS 17 for private not-for-profit entities when developing AASB 17 *Insurance Contracts*. AASB 17 was issued in July 2017 and is applicable to for-profit entities and not-for-profit private sector entities. No changes were made to the recognition and measurement requirements in IFRS 17 when AASB 17 was developed. The AASB sought feedback on the appropriateness of the requirements for public sector entities and is undertaking further work on some issues raised by respondents.

History of Amendments

PBE IFRS 17 *Insurance Contracts* was issued in [Date].

This table lists the pronouncements establishing and substantially amending PBE IFRS 17.

Pronouncements	**Date approved**	**Early operative date**	**Effective date (annual reporting periods… on or after …)**
PBE IFRS 17 *Insurance Contracts*	[Date]	Early application is permitted	[Date]

EXTERNAL REPORTING BOARD

Te Kāwai Ārahi Pūrongo Mōwaho

Policy Approach to Developing the Suite of PBE Standards

Originally Issued September 2013

Updated [month] 2018

Approved by the XRB Board for application by the New Zealand Accounting Standards Board from [Date]

External Reporting Board
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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) *New Zealand 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 to Developing the Suite of PBE Standards* (the PBE 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 PBE Policy Approach ~~paper~~therefore provides constituents with some certainty about the likely future direction of the suite of 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 suite of 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 *New Zealand 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 (NFP) PBEs~~entities~~, including public sector PBE groups and ~~not-for-profit~~NFP 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® Standard, 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;[1]

   (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 Standard, 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 PBE Policy Approach ~~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 Standard that the IASB has issued on a new topic in the suite of PBE Standards unless the IPSASB addresses the issue.

(c) In considering the impact on PBE Standards from 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~~ will consider the factors in the development principle in determining whether to initiate the development of a related change to ~~a development of~~the PBE Standards ahead of the IPSASB. Particular emphasis in this case needs to be placed on the IPSASB's likely response to the change and whether the IPSASB will address the change in an acceptable time frame.

[1] This policy refers to the work of the International Accounting Standards Board (IASB) and uses registered trademarks of the IFRS Foundation (for example, IFRS® Standards, IFRIC® Interpretations and IASB® papers).

(d) The NZASB will not incorporate minor amendments to NZ IFRS into the equivalent PBE Standard in advance of the IPSASB considering the change. However, the NZASB may issue an exposure draft that proposes the incorporation of these minor amendments into the equivalent PBE Standards at the same time as the IPSASB issues an exposure draft that proposes the incorporation of these minor amendments into IPSAS.

1. Introduction

1. The PBE Policy Approach~~is paper~~ addresses the NZASB's 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 Policy~~paper~~ include references to all PBEs: public sector PBEs and ~~not-for-profit~~NFP PBEs~~entities~~, and public sector PBE groups and ~~not-for-profit~~NFP PBE groups.

2. Triggers for possible changes to the PBE S~~s~~tandards 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 Standard or a change to an existing IFRS ~~-~~Standard (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. The PBE Policy Approach~~is paper~~ considers the implications of the *New Zealand 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 New Zealand *Accounting Standards Framework* (issued in April 2012 and updated in December 2015) is designed to better meet the needs of users of the financial statements of PBEs.[2] Accounting Standards for ~~In its decision to base the development of standards~~Tier1 and Tier 2 entities are based on IPSAS.~~, the XRB Board decided the following:~~

> 57. An explicit part of the multi-standards approach is the adoption of a set of accounting standards for PBEs other than one based on IFRS.
>
> 58. The only set of international accounting standards, other than IFRS, is IPSAS. IPSAS provides a better basis for PBE reporting for entities in Tier 1 and Tier 2 than does IFRS because it is developed for a wider set of users, notably service recipients as well as resource providers.
>
> 59. The XRB also considers that IPSAS is a credible set of standards. The historical concerns about IPSAS had been the lack of a conceptual framework and the lack of independent governance arrangements for IPSASB (at least compared to those applying to the IASB). These concerns have been addressed by both the IPSASB and the International Federation of Accountants (IFAC – the IPSASB's parent body). The IPSASB issued its conceptual framework General Purpose Financial Reporting by Public Sector Entities in late 2014 and an independent governance body for the IPSASB has been established for the first time in 2015.
>
> 60. However, the XRB continues to consider that it is premature to adopt "pure" IPSAS (in the way that NZ IFRS reflects "pure" IFRS). This is because, among other matters, the IPSAS is developed for public sector entities and the requirements are not always appropriate for not-for-profit entities or do not necessarily fit with the New Zealand regulatory environment. Moreover, IPSAS does not currently represent a complete set of standards. Therefore, a set of PBE Standards has been developed that uses IPSAS as their base. PBE Standards modify IPSAS for any recognition, measurement or disclosure matters considered inappropriate in New Zealand. Such modifications are only made where the IPSAS requirement in question has a material impact on the financial position or performance being reported, and that impact would adversely detract from the financial statements' usefulness to users.
>
> 61. Since the adoption of the initial Accounting Standards Framework, the XRB, in conjunction with its sub-Board, the New Zealand Accounting Standards Board (NZASB), has developed (and issued in September 2013) a *Policy Approach to Developing the Suite of PBE Standards* [footnote omitted]. The Policy Approach establishes an approach, based on a "development principle" and a series of "rebuttable presumptions", which are used by the NZASB to determine whether, and when, to make changes to PBE Standards.
>
> 62. PBE Standards include other relevant standards (including domestic standards) appropriate for New Zealand and/or to address topics not covered in IPSAS.
>
> 63. The PBE Standards are also modified to make them relevant, applicable and understandable to the not-for-profit sector preparers and users. Some modification is desirable to enhance their usefulness in the not-for-profit context.
>
> ~~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 inapprpriate 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.~~

[2] The New Zealand Accounting Standards Frameworks is~~are~~ available at https://www.xrb.govt.nz/reporting-requirements/accounting-standards-framework/

~~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.~~

(*New Zealand Accounting Standards Framework*, paragraphs 57–63~~149 – 151~~)

5. The PBE Policy Approach ~~is 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 *New Zealand 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. Paragraph 1.2 of ~~T~~the New Zealand Equivalent to the IASB *Conceptual Framework for Financial Reporting* (2018 *NZ Conceptual Framework*)~~IASB's emerging Conceptual Framework~~ identifies users of ~~IFRS~~financial statements as suppliers of resources to the entity, and notes that the decisions that they make are related to providing resources to the entity.[3]

10. In contrast, the IPSASB considers ~~that the objective of financial reporting is to serve~~ a wider group of users of financial reports, being resource providers and service recipients and their representatives. The IPSASB notes that information is needed for both accountability and decision-making purposes.[4]

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

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[3] ~~New Zealand Equivalent to the IASB *Conceptual Framework for Financial Reporting 2010*, paragraph 1.2OB2.~~

[4] IPSASB, *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*, January 2013, paragraphs 2.1–2.4.

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~~reports.

15. Benefits need to be considered in relation to the suite of PBE ~~s~~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 groups and users of PBE financial statements whose familiarity with financial statements arises from experience in the for-profit sector.[5] 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 *New Zealand 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 discussed further below in paragraph 29~~8~~). 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~~ NFP 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

[5] For the purposes of the PBE Policy Approach~~is 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.

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 ~~p~~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~~NFP PBEs~~entities~~ (including public sector and ~~not-for-profit~~NFP groups) through a complete and coherent suite of PBE Standards.

3. The Development Principle

19. In accordance with the *New Zealand 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 NFP~~not-for-profit~~ PBEs~~entities~~, including public sector PBE groups ~~and not-for-profit~~NFP PBE 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 Standard, 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~~NFP 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 Standard, the IPSASB's likely response to the change (e.g. whether the IPSASB is expected to develop~~ing~~ an IPSAS on the topic in an acceptable time frame).

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 the PBE Policy Approach~~his 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. Therefore, 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.

24. Depending on the circumstances, it may be appropriate to apply one of the following ~~,~~approaches when a new or amended IPSAS is issued: ~~: amend a recently issued or newly amended IPSAS in the process of adoption in New Zealand. Examples of possible amendments include:~~

   (a) Amend a recently issued or newly amended IPSAS in the process of adoption in New Zealand. Examples of possible amendments include:

      (i) improving the quality of the IPSAS in the New Zealand context by, for example, adding guidance or making changes to enhance the clarity and consistency of the requirements to enable public sector PBEs and ~~not-for-profit~~NFP PBEs~~entities and public sector PBEs~~ to apply the standard consistently;

      (ii) ~~or~~ adding guidance to assist ~~not-for-profit~~NFP PBEs~~entities~~ in applying the standard, given that the standard has been developed for application by public sector PBEs;

      (iii) amending as necessary to maintain the coherence of the suite of PBE Standards;

      (iv) excluding options that are not relevant in the New Zealand context; or

~~(i)~~(v) 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~~NFP PBEs~~entities~~.

(b) Rebut the presumption in paragraph 22 and thereby not adopt a new or amended IPSAS, or part(s) thereof. Given that PBE Standards are based primarily on IPSAS, a decision to rebut the presumption is expected to occur only in exceptional circumstances. Examples of such circumstances include where the NZASB has significant concerns that, in the New Zealand context:

(i) adoption of a new or amended IPSAS would lead to lower quality financial reporting by PBEs than would be the case if that new or amended IPSAS was not adopted; and

~~(i)~~(ii) the costs of adoption of a new or amended IPSAS would outweigh the benefits.

25. In the event that the presumption to adopt a new or amended IPSAS is rebutted, this will require the NZASB to report to the XRB Board:

(a) its decision and rationale for the decision; and

(b) what, if any, action(s) it plans to take in relation to the new or amended IPSAS, for example, whether a domestic standard will be developed and whether parts of the new or amended IPSAS will be incorporated into that domestic standard.

4.2 New or Amended NZ IFRS

~~25.~~26. New or amended NZ IFRS will require the NZASB to consider whether to initiate a development of the PBE Standards in the following circumstances:[6]

(a) an IFRS Standard that the IPSASB has used as the basis for an IPSAS is changed;

(b) the IASB issues an IFRS Standard on a new topic; and

(c) there is a change to an NZ IFRS that has been used as the basis for a PBE Standard.[7]

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[6] 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).

[7] ~~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 suite of 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*
- PBE IAS 34 *Interim Financial Reporting*
- NZ IFRIC 12 *Service Concession Arrangements* and NZ-SIC 29 *Service Concession Arrangements: Disclosures* (which are the basis for PBE FRS 45 *Service Concession Arrangements: Operator*).

4.2.1 An IFRS Standard that the IPSASB has used as the basis for an IPSAS is changed

~~26.~~27. As noted earlier, the PBE Standards are primarily based on IPSAS. In turn, many IPSAS are primarily based on IFRS Standards. 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.~~28. **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~~ will 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, including whether the IPSASB is expected to address the change in an acceptable timeframe.**

~~28.~~29. Given the presumption in paragraph 22 that any ~~standard~~ IPSAS 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.~~30. **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. However, the NZASB may issue an exposure draft that proposes the incorporation of these minor amendments into the equivalent PBE Standards at the same time as the IPSASB issues an exposure draft that proposes the incorporation of these minor amendments into IPSAS.

~~30.~~31. Where there is a major change to an IFRS Standard 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 Standard for international use is likely to be significantly higher than developing a PBE Standard based on an IFRS Standard 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 Standard on a new topic

~~31.~~32. An example of a new topic is where the IASB is considering issuing a standard on rate-regulated activities.

~~32.~~33. 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.~~34. As noted in paragraph 26~~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 *New Zealand Accounting Standards Framework*, adding further PBE Standards based on NZ IFRS is unlikely to be consistent with the objectives of that Framework.

~~34.~~35. 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.~~36. The NZASB has included selected ~~"frozen"~~ NZ IFRS in the suite of PBE Standards (see footnote 7~~5~~) in order to maintain current practice until the IPSASB addresses the related issues.

~~36.~~37. 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.~~38. 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 29~~8~~ above) are less likely to arise.

~~38.~~39. An implication of this policy is that those PBE Standards based on an ~~"frozen"~~ NZ IFRS (see footnote 7~~5~~) may need to be updated or replaced to align with the current equivalent NZ IFRS.

4.3 Domestic Developments

~~39.~~40. Domestic developments include developing standards to meet specific requirements in New Zealand.

~~40.~~41. 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* and PBE FRS 48 *Service Performance Reporting*. 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.~~42. In determining whether to initiate the development of a domestic standard for inclusion in the PBE ~~suite~~Standards, 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.~~43. The *New Zealand 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.~~44. 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.

June 2018

IFRS® Standards
Discussion Paper DP/2018/1

Financial Instruments with Characteristics of Equity

Comments to be received by 7 January 2019

IASB®

IFRS®

Financial Instruments with Characteristics of Equity

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This Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity* is published by the International Accounting Standards Board (Board) for comment only. The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by 7 January 2019 and should be submitted in writing to the address below, by email to commentletters@ifrs.org or electronically using our 'Open for comment' page at: http://ifrs.org/projects/open-for-comment/.

All comments will be on the public record and posted on our website at www.ifrs.org unless the respondent requests confidentiality. Such requests will not normally be granted unless supported by good reason, for example, commercial confidence. Please see our website for details on this and on how we use your personal data.

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Summary and invitation to comment

Why is the Board publishing this Discussion Paper?

IN1 The distinction between liabilities and equity plays a significant role in how entities provide information in their financial statements. Two important consequences of the distinction between liabilities and equity for the issuers of financial instruments are that:

(a) it provides structure to the statement of financial position by including carrying amounts of liabilities and equity in separate totals; and

(b) changes in the carrying amounts of liabilities meet the definition of income and expense and are therefore included in the statement of financial performance.

IN2 IAS 32 *Financial Instruments: Presentation* establishes principles for distinguishing financial liabilities from equity instruments. It applies to the classification of financial instruments as financial assets, financial liabilities or equity instruments. A financial instrument is a contract that gives rise to a financial asset of one entity (the holder) and a financial liability or an equity instrument of another entity (the issuer). The focus of the Financial Instruments with Characteristics of Equity research project (FICE project) is on the classification of financial liabilities and equity instruments from the perspective of the issuer (the entity). The requirements in IFRS 9 *Financial Instruments* for the accounting by the holder of financial assets are therefore outside the FICE project's scope.[1]

IN3 The requirements in IAS 32 have been applied to the classification of the majority of financial instruments without difficulty, and their application to these instruments has produced classification outcomes that provide useful information to users of financial statements. Furthermore, the International Accounting Standards Board (Board) is not aware of any evidence to suggest that there were fundamental problems with IAS 32 during the global financial crisis of 2007–8.

IN4 However, various challenges have arisen from the application of IAS 32 to a growing number of financial instruments that combine various features, including different features of both simple bonds and ordinary shares—financial instruments with characteristics of equity. Users of financial statements who wish to understand the consequences of these financial instruments on an entity's financial position and financial performance have raised questions about their classification. Users have also expressed concerns about the limited information provided through presentation and disclosure about various features of these instruments. Furthermore, entities have encountered challenges when applying IAS 32 to particular financial instruments with characteristics of equity. These challenges have been brought to the attention of the Board through responses to various consultations and through the IFRS Interpretations Committee (Committee). The Committee has been unable to

1 See paragraph IN17.

resolve some of these questions because it was unable to identify a clear and consistent classification principle in IAS 32.

IN5 In response to such feedback, the Board decided to add the FICE project to its research agenda to investigate the challenges with applying IAS 32 to financial instruments with characteristics of equity. To address the challenges it identified, the Board has developed preliminary views on the classification, presentation and disclosure of financial instruments with characteristics of equity.

IN6 The Board is seeking feedback on the topics explored in this Discussion Paper, in particular on:

(a) the financial reporting challenges the Board has identified;

(b) the possible approaches to addressing those challenges; and

(c) whether the Board's preferred approach should be developed into a standards-level solution.

What challenges has the Board identified?

IN7 Although many classification outcomes of IAS 32 are well understood, the Board observed that a number of challenges arise from the application of IAS 32 because it does not always provide a clear rationale for its requirements. For example:

(a) IAS 32 does not provide a clear rationale for the requirements in relation to obligations settled by delivering an entity's own equity instruments. The classification outcome of obligations to deliver an entity's own equity instruments is one of the differences that arises from applying the definition of a financial liability in IAS 32 compared to applying the definition of a liability in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). The lack of a clear and consistent rationale in IAS 32 and in the *Conceptual Framework*, makes it difficult for the Board to develop consistent classification requirements across IFRS Standards.

(b) Even when the application of IAS 32 is straightforward, the absence of a clear rationale has prompted questions from stakeholders about whether the financial reporting consequences provide useful information about particular types of financial instruments with characteristics of equity. For example, some stakeholders have questioned whether recognising, in profit or loss, income and expense arising from some financial instruments provides useful information—such as shares that are redeemable by the holder for their fair value.

(c) Furthermore, the absence of a clear rationale introduces challenges in applying IAS 32 to financial instruments for which IAS 32 does not contain specific guidance—such as some written put options on non-controlling interests (NCI puts) and some types of contingent convertible bonds—and has resulted in diversity in practice.

IN8 One of the challenges in distinguishing liabilities from equity is that claims[2] against entities can have a wide variety of features, and the classification of claims as liabilities or equity can only provide some of the information about those features. Consequently, instead of relying solely on classification to provide useful information about similarities and differences between claims, the Board has considered whether the provision of information about some aspects of claims through presentation and disclosure should be required in addition to classification.

Summary of the Board's preliminary views

IN9 To respond to the challenges it has identified, the Board developed an approach (the Board's preferred approach) that:

(a) articulates the principles for the classification of financial instruments as either financial liabilities or equity instruments with a clear rationale, but without fundamentally changing the existing classification outcomes of IAS 32 (paragraphs IN10–IN12);

(b) would improve the information provided through presentation and disclosure about features of financial liabilities and equity instruments not captured by classification alone (paragraphs IN13–IN14); and

(c) would improve the consistency, completeness and clarity of the requirements for classification, in particular for contractual rights and/or obligations to exchange financial instruments, in which at least one of the financial instruments to be exchanged is an entity's own equity instrument (derivatives on own equity) (paragraph IN15).

Classification principles

IN10 The Board's preferred approach would classify a financial instrument as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

2 This Discussion Paper refers to liabilities and equity collectively as 'claims'.

IN11 The table below shows how the Board's preferred approach would classify financial liabilities and equity instruments:

Distinction based on amount feature / Distinction based on timing feature	Obligation for an amount independent of the entity's available economic resources (such as fixed contractual amounts, or an amount based on an interest rate or other financial variable)	No obligation for an amount independent of the entity's available economic resources (such as an amount indexed to the entity's own share price)
Obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as scheduled cash payments)	Liability (eg simple bonds)	Liability (eg shares redeemable at fair value)
No obligation to transfer cash or another financial asset at a specified time other than at liquidation (such as settlement in an entity's own shares)	Liability (eg bonds with an obligation to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of cash)	Equity (eg ordinary shares)

IN12 The two key features described in paragraph IN10 are based on the information needs of users of financial statements. In particular, information provided through the classification of financial liabilities and equity instruments applying the Board's preferred approach would be relevant to the following assessments of an entity's financial position and financial performance:

(a) information about financial instruments that require a transfer of cash or another financial asset at a specified time other than at liquidation would help users of financial statements assess whether the entity will have the cash or another financial asset required to meet its obligations as and when they fall due.

(b) information about financial instruments that are obligations for a specified amount independent of the entity's available economic resources and information about how that amount changes over time would help users of financial statements to assess:

(i) whether the entity has sufficient economic resources to meet its obligations at a point in time; and

(ii) whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve.

Presentation and disclosure

IN13 The Board's preferred approach would provide additional information through separate presentation on the face of the financial statements, including:

(a) information about some financial liabilities (such as obligations to transfer cash equal to the fair value of ordinary shares) that would be provided through the separate presentation of income and expense recognised on those financial liabilities; and

(b) information about equity instruments that would be provided by attributing total income and expense to some equity instruments other than ordinary shares.[3]

IN14 The Board also identified additional information about both financial liabilities and equity instruments that would be provided through disclosure in the notes to the financial statements, including information about:

(a) the priority of claims on liquidation;

(b) potential dilution of ordinary shares; and

(c) terms and conditions.

Consistency, completeness and clarity

IN15 In addition, the Board considered how the application of the Board's preferred approach to financial instruments would address various application challenges of applying IAS 32 to derivatives on own equity. In order to increase the comparability and therefore the usefulness of financial statements, financial instruments with similar contractual rights and obligations should be classified consistently regardless of the structure of the financial arrangement. Therefore, the Board considered how the two features described in paragraph IN10 would apply to derivatives on own equity that could be either separate financial instruments or embedded derivatives, including:

(a) the classification of derivatives on own equity, including when there is some variability in the number of equity instruments to be delivered or in the amount of cash or another financial asset to be received by the entity in exchange;

(b) the accounting for compound instruments (such as convertible bonds and some types of contingent convertible bonds); and

(c) the accounting for obligations to redeem equity instruments (such as NCI puts).

Who would be affected if the preliminary views in this Discussion Paper were to be implemented?

IN16 The distinction between liabilities and equity plays an important role in how entities provide information through their financial statements. Therefore, the challenges of making the distinction affect a broad range of stakeholders,

3 The Board has not reached a view on the best approach to determine the amount of attribution for derivative equity instruments.

including users of financial statements, entities preparing financial statements, auditors, and prudential and securities regulators.

IN17 However, the application of IAS 32 to the majority of financial instruments does not present significant challenges. Therefore, the Board is seeking to limit unnecessary changes to classification outcomes that are already well understood and provide useful information. The Board's preliminary views, as discussed in this Discussion Paper, would also have limited consequences for holders of financial assets, whose accounting is set out in IFRS 9.

IN18 The Board expects most of the existing classification outcomes of IAS 32 to remain the same if the Board's preferred approach were to be implemented. For example:

(a) obligations to transfer cash and obligations to deliver a variable number of the entity's own shares with a total value equal to a fixed amount of currency would continue to be classified as financial liabilities; and

(b) ordinary shares, many non-cumulative preference shares and simple derivatives on own equity—such as written call options to deliver a fixed number of an entity's own ordinary shares for a fixed amount of cash—would continue to be classified as equity instruments.

IN19 In addition, the Board's preliminary view is that particular requirements of IAS 32 should be carried forward largely unaltered. For example:

(a) non-derivative financial instruments that include both a liability and an equity component (compound instruments) would continue to be separated as required by paragraph 28 of IAS 32;

(b) the exception to account for some financial liabilities as if they are equity instruments would be retained if they meet the conditions as set out in paragraphs 16A–16B or 16C–16D of IAS 32 (puttable exception); and

(c) the conclusions in IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* would also be carried forward.

IN20 Clarifying the rationale for distinguishing financial liabilities from equity instruments would help to explain many of the existing classification outcomes arising from applying IAS 32. The Board's preferred approach would also help address the challenges of applying IAS 32 that have led to diversity in practice. Improving the consistency in accounting for similar financial instruments and addressing other challenges that have been identified, such as the classification and presentation of foreign currency convertible bonds, would also improve the comparability of financial information.

IN21 Although application of the Board's preferred approach would not be expected to change classification outcomes for the majority of financial instruments, the Board is aware that entities would be likely to incur some costs on transition because they would need to assess the effect of the proposals, if finalised, on their existing financial instruments. The Board would consider how to alleviate these consequences if it develops an exposure draft to implement its preliminary views.

IN22 For some financial instruments, there would be some changes to the classification outcomes compared to applying IAS 32. For example:[4]

(a) financial instruments with obligations for fixed cumulative returns, such as cumulative perpetual preference shares, would be classified as financial liabilities. Applying IAS 32, some of these obligations for which an entity has an unconditional right to defer cash payment indefinitely are classified as equity instruments (see Section 3).

(b) derivatives to deliver a fixed number of an entity's own ordinary shares for a fixed amount of cash that are net-settled by delivering the entity's own equity instruments would be classified as equity instruments. Applying IAS 32, all net-share settled derivative financial instruments are classified as financial assets or financial liabilities (see Section 4).

(c) all derivatives to deliver a fixed number of an entity's own ordinary shares for a fixed amount of foreign currency would be classified as financial assets or financial liabilities. Applying IAS 32, some of these derivative financial instruments are classified as equity instruments if they meet the foreign currency rights issue exception (see Section 4).

IN23 If the Board's preliminary views on presentation and disclosure were to be implemented they would have a broader effect on entities and users of financial statements than would the implementation of its preliminary views on classification, particularly because very little information is specifically required to be provided about an entity's own equity instruments applying IFRS Standards. However, information about relevant distinctions within liabilities and within equity would help users of financial statements to make better assessments of an entity's prospects for future cash flows.

What does this Discussion Paper cover?

Section	Title	Summary
1	Objective, scope and challenges	Discusses the objective and scope of the FICE project and the challenges the Board identified in applying IAS 32.
2	The Board's preferred approach	Discusses the Board's preferred approach to the classification of liabilities and equity based on its analysis of various features of claims, and their economic consequences to the entity's financial position and financial performance.
3	Classification of non-derivative financial instruments	Discusses the application to non-derivative financial instruments of the Board's preferred approach.

continued...

4 Refer to Appendix D for a more detailed comparison of the classification outcomes.

...continued

Section	Title	Summary
4	Classification of derivative financial instruments	Discusses the application to derivative financial instruments of the Board's preferred approach.
5	Compound instruments and redemption obligation arrangements	Discusses the application to compound instruments and redemption obligation arrangements of the Board's preferred approach.
6	Presentation	Discusses what information about financial liabilities and equity instruments could be provided through presentation on the face of the financial statements.
7	Disclosure	Discusses what information about financial liabilities and equity instruments could be provided through disclosure in the notes to the financial statements.
8	Contractual terms	Discusses some of the challenges in determining whether obligations arise from contractual terms or some other mechanism and hence, whether particular rights or obligations are within the scope of the Board's preferred approach, including: (a) economic compulsion and indirect obligations; and (b) the relationship between contracts and law.

What are the next steps?

IN24 The views expressed in this Discussion Paper are preliminary and subject to change. This Discussion Paper does not cover all the matters that the Board would cover in an exposure draft to implement its preliminary views, for example, any transition requirements. The Board will consider the comments received on this Discussion Paper before deciding whether to develop an exposure draft with proposals to amend or replace parts of IAS 32 and/or to develop non-mandatory guidance. The feedback received will also be used to inform the Board's other projects.

Invitation to comment

The Board invites comments on all matters in this Discussion Paper and, in particular, on the questions set out at the end of each section under 'Questions for respondents'. Comments are most helpful if they:

(a) respond to the questions as they are set out in this Discussion Paper;

(b) indicate the specific paragraphs or group of paragraphs to which they relate;

(c) contain a clear rationale; and

(d) describe any alternative that the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional matters.

The Board will consider all comments received in writing by 7 January 2019 (180 days).

How to comment

We would prefer to receive your comments electronically, however, comments can be submitted using any of the following methods:

Electronically	Visit the 'Open for comment' page at: https://go.ifrs.org/open-for-comment
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Section 1—Objective, scope and challenges

1.1 This section discusses the objective and scope of the Financial Instruments with Characteristics of Equity research project (FICE project), the challenges the International Accounting Standards Board (Board) identified and its response to those challenges. In developing its response to the challenges identified, the Board observed that:

(a) the absence of a clear rationale for the classification requirements in IAS 32 has led to challenges concerning the application of the requirements, and to challenges with explaining classification outcomes even when the application of the requirements in IAS 32 is straightforward. Therefore, the Board decided to develop an approach that articulates the principles for classification of financial liabilities and equity instruments with a clear rationale. The approach would do so without fundamentally changing the classification outcomes that would arise when applying IAS 32.

(b) claims[5] against entities can have a wide variety of features, and their classification as liabilities or equity can only provide some information about the variety of those features. Therefore, in this Discussion Paper, the Board considers whether entities also should provide information about some aspects of claims through presentation and disclosure rather than relying solely on classification.

1.2 This section is structured as follows:

(a) Why the FICE project is on the Board's research agenda (paragraphs 1.3–1.10);

(b) The scope of the FICE project (paragraphs 1.11–1.22);

(c) The challenges the Board has identified (paragraphs 1.23–1.37);

(d) Whether the challenges merit the Board developing a standards-level solution (paragraphs 1.38–1.44); and

(e) Questions for respondents (paragraph 1.44).

Why the FICE project is on the Board's research agenda

1.3 The Board considered some aspects of distinguishing liabilities from equity as part of its project to revise the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*).[6] As part of that project the Board decided that the *Conceptual Framework* should continue to make a binary distinction between liabilities and equity.[7] However, in 2014 the Board decided to further explore how to distinguish liabilities from equity as part of a separate FICE project because it did not want to delay other much-needed improvements to the

5 This Discussion Paper refers to liabilities and equity collectively as 'claims'.
6 The Board issued the revised *Conceptual Framework* in May 2018.
7 See paragraphs BC4.89–BC4.92 of the Basis for Conclusions on the *Conceptual Framework*.

Conceptual Framework. Consequently, the 2018 *Conceptual Framework* does not address classification of financial instruments with characteristics of equity.[8]

1.4 Respondents to the Board's *2015 Agenda Consultation* agreed that adding the FICE project is needed:

(a) to follow on the Board's work on the *Conceptual Framework*;

(b) to address the issues with IAS 32 *Financial Instruments: Presentation* that have led to diversity in practice and the challenges of classifying new forms of financing; and

(c) to provide better information about financial instruments with characteristics of equity beyond that provided by classification.

1.5 Respondents to the Board's *2015 Agenda Consultation* also said that the requirements in IAS 32:[9]

(a) are, in some cases, complex, poorly understood and difficult to apply;

(b) lead to classification outcomes that do not reflect the economic substance of particular financial instruments common in some jurisdictions;

(c) have, over the years, been amended in a piecemeal fashion that has raised practical issues and resulted in diversity in practice; and

(d) are not robust enough to address the increasing complexity and sophistication of some financial instruments being issued.

1.6 Respondents to the Board's *2015 Agenda Consultation* and investors who participated in the accompanying online survey identified the FICE project as a high priority. Many respondents said that the FICE project is important to provide a more robust set of principles for distinguishing financial liabilities from equity. In their view, such principles should make it easier to resolve several long-standing issues and address possible future issues.

1.7 The Board has also become aware of challenges in distinguishing financial liabilities from equity instruments in IAS 32 from submissions to the IFRS Interpretations Committee (Interpretations Committee). The Interpretations Committee was unable to reach a consensus on some of these submissions because the Committee found it difficult to identify a clear and consistent classification principle in IAS 32. These submissions highlighted some inconsistencies and complexity as well as some disagreement about some of the classification outcomes of applying IAS 32.

1.8 In addition, the Board has previously acknowledged the differences between the definition of a liability in the *Conceptual Framework* and the definition of a financial liability in IAS 32.[10] These differences have resulted in inconsistencies in how IFRS Standards distinguish liabilities from equity (see Appendix B).

8 Appendix B includes further discussion on the relationship between the FICE project and the *Conceptual Framework*.

9 Respondents identified similar issues with IAS 32 *Financial Instruments: Presentation* in their feedback on the *2011 Agenda Consultation* (see paragraph 1.20).

10 Most recently these differences were acknowledged in the 2013 Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (*Conceptual Framework* DP).

1.9 In response to feedback on the Board's *2015 Agenda Consultation*, and to address issues brought to the Board's attention in other ways, the Board confirmed the FICE project as a priority project and therefore as part of its active research agenda.

1.10 The purpose of the Board's research agenda is to analyse possible financial reporting problems by collecting evidence on the nature and extent of the perceived problems and assessing potential ways to improve financial reporting or to remedy identified deficiencies. Accordingly, the objective of this Discussion Paper is to obtain initial views and comments to help the Board decide whether it should add a project to its standard-setting programme to amend or replace IAS 32.

The scope of the FICE project

1.11 To set the scope of the FICE project, the Board considered the feedback from its agenda consultations and from its previous consultations on similar topics. It also received feedback from the Accounting Standards Advisory Forum (ASAF).

1.12 The Board considered two different approaches to the scope of the project:

(a) a fundamental review of the underlying concepts for distinguishing between liabilities and equity and of the requirements of IAS 32 unconstrained by existing concepts and requirements; and

(b) a narrow-scope review of the requirements of IAS 32 to address particular application challenges without reconsidering the underlying concepts in IAS 32.

1.13 To respond to emerging issues regarding the classification of financial instruments, such as particular puttable instruments and foreign currency rights issues, the Board has in the past made narrow-scope amendments to IAS 32. However, concerns about narrow scope amendments include:

(a) previous narrow-scope amendments introduced exceptions to, and inconsistencies in, the requirements of IAS 32 and may have contributed to some of the challenges identified by respondents to the Board's agenda consultations (for example, see paragraph 1.36(b)).

(b) the Board may be unable to address some of the challenges it has identified through a narrow-scope project (see paragraph 1.26). For example, reasons cited by the Committee for referring some of the submissions on IAS 32 to the Board include:

(i) the issue raised in the submission was broader than the particular fact pattern in the submission;

(ii) the difficulty in identifying a clear and consistent classification principle in IAS 32; and

(iii) the lack of a basis for conclusions to justify the outcomes of applying IAS 32.

(c) some ASAF members cautioned the Board that a narrow-scope project to address only particular application issues could introduce further exceptions and inconsistencies. Those ASAF members suggested that a fundamental review of the distinction between liabilities and equity based on sound concepts has the advantage of avoiding further inconsistencies and exceptions.

1.14 The Board performed a fundamental review of the underlying concepts for distinguishing between liabilities and equity in its predecessor FICE project.[11] To address the challenges identified in the predecessor project and simplify the distinction between financial liabilities and equity instruments, that project explored a replacement of IAS 32 that would have classified only the most subordinate claim as an equity instrument. Following feedback on that proposed approach, the Board considered other approaches that might have required a less significant change than such a classification approach. However, the Board had to reassess its agenda priorities and suspend the project before it was able to reach a consensus on a distinction between financial liabilities and equity instruments that would have provided more useful information than that provided by the classification outcomes that result from applying IAS 32.

1.15 Notwithstanding the challenges the Board identified with IAS 32, the Board has found little evidence that it needs to reconsider all, or even most of, the classification outcomes that result from applying IAS 32. The Board observed that:

(a) for most financial instruments, applying IAS 32 provides useful information to users of financial statements and creates few application challenges for preparers; and

(b) problems with IAS 32 were not evident as a result of the global financial crisis of 2007–8, although challenges have arisen when applying IAS 32 to some financial instruments that became popular as a means of addressing the crisis, such as some types of contingent convertible bonds (see paragraph 1.25(b)).

1.16 Based on these observations, many ASAF members suggested that, while a comprehensive review of the requirements should be undertaken, the Board should not disregard the principles and requirements in IAS 32 and start from a blank sheet of paper. ASAF members recommended that, instead of introducing an approach that changes well-understood classification outcomes, the project should provide a better foundation for classification outcomes by focusing on identifying the underlying rationale for distinguishing financial liabilities from equity instruments.

1.17 Accordingly, the Board decided that, while the objective of the FICE project is to respond to challenges in distinguishing financial liabilities from equity instruments when applying IAS 32, any potential solution should limit unnecessary changes to classification outcomes that are already well understood. Therefore, the Board agreed with the ASAF that while the scope of the project should be comprehensive, the starting point should be based on the

11 The predecessor project was a joint project led by the US Financial Accounting Standards Board (US FASB). That project resulted in the publication of the Discussion Paper *Financial Instruments with Characteristics of Equity* in February 2008 (the 2008 Discussion Paper). The current FICE project is not a joint project. The Board has considered the work performed and feedback received on the predecessor project in developing this Discussion Paper.

existing principles and requirements of IAS 32 with a focus on identifying the underlying rationale for distinguishing financial liabilities from equity instruments.

1.18 The Board observed that changes or refinements to classification principles might not be sufficient to resolve all the challenges it has identified. In its Conceptual Framework project, the Board explored whether enhancing presentation and disclosure requirements could help address some of those challenges. The Board's preliminary view in the *Conceptual Framework* DP was that additional information about subclasses of equity—in particular, information about the transfer of wealth among equity claims—would provide useful information to users of financial statements. However, the Board did not develop those preliminary views as part of the Conceptual Framework project; instead the Board decided to explore them further as part of the FICE project.

1.19 Some respondents to the *Conceptual Framework* DP agreed with the preliminary view to provide additional information about equity instruments. These respondents suggested that doing so would reduce the differences in the information provided about liabilities and equity, thereby mitigating the consequences when entities structure financial instruments to achieve a particular accounting outcome. Some of these respondents thought that such additional information about equity instruments might be more useful if entities presented it in a different way. These respondents suggested that the Board explore approaches to providing additional information about subclasses of equity in more detail. Some users of financial statements, in particular, supported providing this information through the statement of changes in equity. In addition, some users of financial statements suggested that entities might need to supplement that information by expanding the disclosure of potential dilution in different scenarios.

1.20 Furthermore, users of financial statements have asked for more information about the wide variety of financial instruments issued by entities. In their responses to past consultations,[12] including the Board's *2015 Agenda Consultation*, they have requested improvements to the information provided about:

(a) the nature, terms and conditions and other features of financial instruments, regardless of their classification as financial liabilities or equity instruments;

(b) the potential dilution of existing equity instruments through the issue of additional equity instruments; and

(c) an entity's overall capital structure including liquidity needs and the priority of claims on liquidation.

1.21 Accordingly, the Board decided that the FICE project should investigate the presentation and disclosure requirements for financial instruments in addition to their classification.

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12 Including the *Conceptual Framework* DP, the Board's *2015 Agenda Consultation* and *2011 Agenda Consultation*, the Investor Perspectives article, *Better communication—A table is worth 1000 words*, and the 2008 Discussion Paper.

1.22 The focus of the FICE project is on the classification of financial instruments as financial liabilities, financial assets, or equity instruments. The Board decided not to consider changes to the recognition and measurement requirements that apply to financial assets and financial liabilities as part of this project. After an entity has classified a financial instrument as a financial asset or a financial liability by applying IAS 32, it then applies IFRS 9 *Financial Instruments* and, when relevant, IFRS 13 *Fair Value Measurement* for recognition and measurement. The Board has kept in mind the relationship between the requirements of IAS 32 and IFRS 9 when considering how an entity would provide information about financial liabilities.

The challenges the Board has identified

1.23 Most, if not all, possible approaches to the distinction between financial liabilities and equity instruments would classify simple financial instruments, such as simple bonds and ordinary shares, as financial liabilities and as equity instruments respectively. However, market forces, financial innovation and changes in bank capital regulations have generated a wide range of financial instruments that combine various features, including features of both simple bonds and ordinary shares (financial instruments with characteristics of equity). Such financial instruments allow entities to raise finance from investors with varied preferences for risk and expected returns and, in response to those preferences, the mix of features found in financial instruments is constantly changing.

1.24 The application of IAS 32 to many financial instruments with characteristics of equity, such as simple convertible bonds, has provided useful information to users of financial statements. Entities have also been applying IAS 32 to most of these financial instruments without any significant problems. However, a growing set of financial instruments with characteristics of equity have presented challenges when entities apply IAS 32. For some of these financial instruments, the application of IAS 32 is clear; however, some stakeholders disagree with the classification outcome, or with some of the financial reporting consequences of that outcome, such as recognising the resulting income and expense for particular financial liabilities—for example, for shares redeemable at fair value—in profit or loss. For other financial instruments, it is unclear how entities should apply the requirements of IAS 32 to classify them as financial liabilities or equity instruments and that results in diversity in practice.

1.25 Examples of financial instruments that have presented such challenges include:

(a) put options written on non-controlling interests (NCI puts) with a strike price at fair value—such instruments require an entity to repurchase the non-controlling interest shares in a subsidiary in exchange for an amount of cash equal to their fair value, at the option of the holder of the NCI put (typically the non-controlling interest shareholder) (see paragraphs 1.32 and 1.36(c)).

(b) contingent convertible bonds—of the many varieties that exist in practice, the particular financial instrument that the Committee considered was one that pays interest at the discretion of the issuer and mandatorily converts to a variable number of the issuer's own shares if the issuer breaches its 'Tier 1 Capital ratio'.[13] The value of the variable number of shares an entity is obliged to deliver on conversion is equal to the face value of the claim (ie a variable number of the entity's own shares with a total value equal to a fixed amount of currency) (see paragraph 1.36(d)).

1.26 The Committee has considered the application of IAS 32 to the financial instruments described in paragraph 1.25; however, the issues in these submissions remain unresolved.

1.27 Any project that seeks to distinguish liabilities from equity will need to respond to:

(a) the conceptual challenge of identifying the rationale for distinguishing liabilities from equity (paragraphs 1.28–1.34); and

(b) the application challenge of developing principles that balance the benefits of the information provided with the costs and complexity of their application (paragraphs 1.35–1.37).

Conceptual challenges

1.28 Identifying a rationale for distinguishing liabilities from equity is difficult because of the variety of claims with different features that have different consequences for an entity's prospects for future cash flows. Different features include, for example, the timing of a required transfer of economic resources, the amount of the claim and its priority relative to other claims against the entity. Information about all those features is relevant to users of financial statements and many of those features could form a basis for distinguishing liabilities from equity. Currently, IAS 32, other IFRS Standards and the *Conceptual Framework* use various features to distinguish liabilities from equity, often without a clear basis for selecting the distinguishing features.

1.29 Applying IAS 32, an entity classifies a financial instrument as a financial liability if it gives rise to either of the following:

(a) a contractual obligation to deliver cash or another financial asset or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable to the issuer. If an entity has such a contractual obligation, such as an unavoidable obligation to pay cash, the financial instrument is a financial liability, regardless of how the amount payable or receivable is determined.

(b) a contractual obligation to deliver a variable number of its own equity instruments (for example, an obligation to deliver a variable number of an entity's own ordinary shares with a total value equal to CU100).[14] If an entity has such a contractual obligation, the financial instrument is a financial liability, even though the entity does not have a contractual obligation to deliver any of its economic resources.[15]

13 'Tier 1 Capital ratio' is the ratio of a bank's Tier 1 capital to its total risk-weighted assets as defined by a prudential regulator.

14 In this Discussion Paper amounts are denominated in Currency Units (CU).

15 Equity instruments issued by an entity are not economic resources of the entity (see paragraph 4.10 of the *Conceptual Framework*).

1.30 However, IAS 32 does not use the same features consistently (see paragraph 1.36(b)) and the Board's reasons for selecting those features are sometimes unclear. For example, IAS 32 does not provide a clear rationale for the classification of the contractual obligation described in paragraph 1.29(b). The classification of obligations settled by delivering an entity's own equity instruments is one of the differences between the definition of a financial liability in IAS 32 and the definition of a liability in the *Conceptual Framework*. The *Conceptual Framework* defines a liability as 'a present obligation to transfer an economic resource as a result of past events'.[16] Like IAS 32, the *Conceptual Framework* does not provide a rationale for the classification of obligations to deliver equity instruments.

1.31 The use of different features to classify liabilities and equity both within IAS 32 and in other IFRS Standards[17] introduces inconsistencies, reduces comparability and makes financial statements less understandable. This is because the distinction between liabilities and equity is fundamental to IFRS Standards and has significant and polarised consequences for an entity's financial statements. These consequences include how the entity's financial position and financial performance is depicted, and differences in other information provided about liabilities compared to equity, such as through measurement and disclosure requirements.

1.32 The conceptual challenges can be illustrated by considering the type of NCI put as described in paragraph 1.25(a), in which the contractual obligation to transfer cash is similar to the contractual obligation to transfer cash in a simple bond. Classifying that obligation in the NCI put as a liability depicts the obligation to deliver cash in the same way as a simple bond. Unlike the bond, however, the amount of cash the entity is obliged to transfer equals the fair value of the underlying non-controlling interest share. Therefore, recognising changes in the carrying amount of that liability as income or expense would depict the return on that claim differently from how a similar economic return on ordinary shares would be depicted. In contrast, if that obligation in the NCI put were classified as equity it would depict returns similarly to how a similar economic return on ordinary shares would be depicted. However, classifying that obligation in the NCI put as equity would not reflect its similarity to a simple bond—the obligation to transfer cash.

1.33 Contrasting views about classification outcomes are inevitable because classifying a financial instrument that shares characteristics of both financial liabilities and equity instruments as one or the other inevitably results in capturing some but not all of the similarities and differences.

1.34 Consequently, given that claims against entities can have a wide variety of features, classification as liabilities or equity can provide only some information about the features of an instrument. Therefore, this Discussion Paper sets out the Board's consideration of whether it is necessary to provide information about some aspects of claims through presentation and disclosure rather than relying solely on classification.

16 See paragraph 4.26 of the *Conceptual Framework*.

17 For example, IFRS 2 classifies obligations to deliver equity instruments differently to IAS 32.

Application challenges

1.35 IAS 32 includes two main requirements for classification (see paragraph 1.29), as well as additional requirements that apply to particular transactions and circumstances. Respondents to previous consultations have suggested that some financial instruments have challenged the consistency, completeness and clarity of the requirements in IAS 32. Some of these challenges are also evident from issues submitted to the Committee, some of which remain unresolved.

1.36 Issues raised by interested parties relate to the following requirements:

(a) derivative financial instruments—IAS 32 classifies a contract as a financial asset or a financial liability if it is 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 (fixed-for-fixed condition). Questions have arisen regarding the application of the fixed-for-fixed condition to particular types of financial instruments. For example, some respondents have asked for guidance on how to apply the fixed-for-fixed condition to a written call option to deliver a fixed number of an entity's own shares in exchange for a fixed amount of cash when the number of shares changes only as a result of an anti-dilution provision.

(b) foreign currency rights issue exception—as an exception to the fixed-for-fixed condition, IAS 32 classifies rights, options, or warrants to issue a fixed number of an entity's own equity instruments in exchange for a fixed amount of any currency as equity instruments, if, and only if, the entity offers those instruments pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Interested parties question why derivative financial instruments that meet this exception should be classified differently to conversion options in foreign currency convertible bonds, which are classified as financial liabilities.

(c) contracts that contain obligations to purchase an entity's own equity instruments—paragraph 23 of IAS 32 includes requirements for some written put options and forward purchase contracts on an entity's own equity instruments. Applying those requirements results in a financial liability for the present value of the redemption amount (ie the contract is 'grossed-up'). Some respondents to previous consultations questioned:

  (i) whether it is appropriate that such derivative financial instruments are grossed-up rather than measured on a net basis like other derivative financial instruments, in particular when the obligation is conditional on exercise of an option, as it is in NCI puts.

  (ii) the lack of requirements in IAS 32 on how to account for some transactions within equity. For example, for NCI puts, it is not clear whether the non-controlling interest should be derecognised when the redemption liability is recognised, or whether an 'equity receivable' should be recognised as a debit to the parent interest component of equity.

(d) contingent settlement provisions—paragraph 25 of IAS 32 includes requirements for contingent settlement provisions triggered by the occurrence (or non-occurrence) of uncertain future events that are beyond the control of both the issuer and the holder (such as a change in a stock market index or changes in an entity's capital ratio). However, when applying these requirements, questions have been raised about whether the liability component should include the conditionality of the settlement outcome, in particular for some types of contingent convertible bonds.

(e) contractual terms—IAS 32 includes principles for the classification of contracts that contain an obligation to transfer cash or another financial asset through their contractual terms. The contractual terms might establish such an obligation explicitly or indirectly. However, in some circumstances, it is unclear whether obligations arise from the contractual terms or some other mechanism. For example:

    (i) the terms of a contract may not establish an obligation explicitly or indirectly, but economic incentives may force an entity to transfer cash or another financial asset—for example, some types of preference shares with dividend rates that increase over time that incentivise redemption.

    (ii) obligations may be introduced through a mechanism other than a contract (such as those established by statutory or regulatory requirements). For example, law or regulation in some jurisdictions obliges some entities to offer to purchase the non-controlling interests when acquiring a controlling interest (mandatory tender offer).

1.37 While the issues discussed in paragraph 1.36 are important application questions, they do not question the usefulness of information from classification outcomes resulting from the application of existing requirements to most types of simple financial instruments. Consequently, the Board decided that the FICE project's objective should be to articulate the principles for the classification of financial liabilities and equity instruments with a clear rationale, without fundamentally changing the existing classification outcomes of IAS 32. This Discussion Paper sets out the Board's consideration of how those principles would improve the consistency, completeness and clarity of the requirements for classification in IAS 32.

Whether the challenges merit the Board developing a standards-level solution

1.38 Given the consequences of distinguishing financial liabilities from equity instruments, any change to that distinction may have a pervasive effect across many jurisdictions and many different types of entities. As stated in paragraph 1.24, the application of IAS 32 to most types of simple financial liabilities and equity instruments does not present any significant challenges. However, continuing financial innovation has increased the variety of claims to which the requirements of IAS 32 apply.

1.39 The Board observed that issues with classifying financial instruments as financial liabilities or equity instruments results in challenges for the primary users of financial statements, such as investors, lenders and other creditors. Such challenges include estimating the expected return on their investments, comparing the financial position and performance among entities and understanding an entity's financial performance and financial position. Users of financial statements are also affected by diversity in practice arising from the application of IAS 32. Application challenges, if unresolved, have the potential to increase such diversity in practice, further reducing the comparability and understandability of financial statements.

1.40 The Board also observed that users of financial statements are affected not only by challenges in distinguishing liabilities from equity but also by a lack of information about other relevant distinctions within liabilities and within equity. For example, respondents to previous consultations have requested:

(a) information about claims that participate in the upside potential of an entity's economic resources;

(b) information to help users of financial statements better assess the risk and rewards for each equity instrument and to estimate the return on their investment; and

(c) information about terms and conditions of equity instruments and about equity instruments issued and redeemed during a reporting period.

1.41 IFRS Standards have more comprehensive disclosure requirements for financial liabilities than for equity instruments. The absence of specific IFRS requirements to provide more detailed information about various equity instruments is one of the reasons why some equity investors and analysts support a narrow definition of equity. Under such a classification approach, all financial instruments other than ordinary shares would have been accounted for as liabilities and consequently would have resulted in the provision of more detailed information under the more comprehensive disclosure requirements.

1.42 Parties other than the primary users of financial statements are also affected by classification issues, including:

(a) preparers who have an interest in presenting relevant information about their financial position and financial performance as faithfully as possible, and an interest in limiting the complexity and costs of applying the requirements.

(b) prudential and securities regulators who have an interest in how the financial statements represent the financial position and financial performance of entities and an interest in the enforceability of the requirements. Regulators also want to know how robust the distinction is between liabilities and equity, and to understand its relationship to other regulatory requirements. The Board expects that the preliminary views in this Discussion Paper will not have a direct impact on prudential capital requirements, as prudential regulators have their own requirements for defining regulatory capital.

(c) auditors who have an interest in the auditability of the requirements. Auditors are also interested in the clarity of the distinction between liabilities and equity, and the complexity and cost of applying the accounting requirements.

1.43 The Board observed that the challenges in the application of IAS 32 and of the understanding of its classification outcomes, relate to financial instruments with particular sets of features, and therefore will affect some entities more than others. However, in many cases, the transactions in question are large and, therefore, the classification of a financial instrument as either a financial liability or an equity instrument will have a significant effect on some entities' financial statements. For example:

(a) new capital requirements that banking regulators introduced after the global financial crisis of 2007–8 have prompted financial institutions to issue more and increasingly varied contingent convertible bonds. The contingent convertible bonds described in paragraph 1.25(b) are one type of this new financial instrument.

(b) in some economies, entities issue foreign currency convertible bonds (paragraph 1.36(b)) to access capital markets in other economies.

(c) mandatory tender offers arising from acquisitions of controlling interests are regulatory requirements in some jurisdictions but not in others.

(d) some financial instruments contain features that reflect the specific needs of particular investors in a particular entity. For example, sometimes the acquirer in a business combination offers a holder of a non-controlling interest the right to sell their shares to the acquirer at their fair value (a fair value written put option). The acquirer might make such an offer to provide liquidity to the non-controlling interest in cases when a subsidiary's shares are not listed.

1.44 Given the considerations outlined in paragraphs 1.38–1.43, the Board concluded that the challenges identified in paragraphs 1.23–1.37 merit the investigation of a standards-level solution. In response to those challenges, the Board has:

(a) developed an approach that provides the underlying rationale for the classification of liabilities and equity (Section 2). That approach is based on the Board's preliminary views on:

   (i) the information that is best provided using the distinction between liabilities and equity; and

   (ii) the information that is best provided through presentation and disclosure requirements.

(b) articulated principles for the classification of financial instruments as financial liabilities and equity instruments, based on the underlying rationale of the approach in (a), and considered how the principles address the challenges of applying IAS 32, including improving the consistency, completeness and clarity of the requirements in IAS 32 (Sections 3, 4 and 5).

(c) developed principles for the presentation and disclosure of financial instruments (Sections 6 and 7).

Questions for respondents

Question 1
Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes. (a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges? (b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

Section 2—The Board's preferred approach

2.1 This section sets out the Board's preliminary views regarding the underlying rationale of the distinction between liabilities and equity. The Board's preliminary views are based on its analysis of various features of claims, and their consequences for an entity's financial position and financial performance. In the Board's preliminary view, its preferred approach would strike the best balance between the information provided through classification and that provided through presentation and disclosure. The Board's preferred approach would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

2.2 This section is structured as follows:

(a) What features of claims are relevant to users of financial statements? (paragraphs 2.3–2.12)

(b) What are the consequences of the distinction between liabilities and equity? (paragraphs 2.13–2.14)

(c) What features are relevant to which assessments? (paragraphs 2.15–2.31)

(d) Which features should be depicted through classification and which through presentation and disclosure? (paragraphs 2.32–2.47); and

(e) Summary of preliminary views and questions for respondents (paragraphs 2.48–2.52)

What features of claims are relevant to users of financial statements?

2.3 The Board identified various features of claims that affect an entity's cash flows and, in particular, how an entity's cash flows will be distributed among holders of claims against the entity. Information about the features identified should help users of financial statements make assessments that will inform their decisions about providing resources to the entity.

2.4 One claim that is clearly a liability, and which would always be classified as such is a simple bond with an obligation to pay cash equal to CU100 in two years that is senior to all other claims.

2.5 One feature of the simple bond in paragraph 2.4 is that it requires the entity to transfer economic resources at a specified time other than at liquidation, ie in two years. Information about this feature of the simple bond is relevant to users of financial statements because, to meet its obligation, the entity will be required to sacrifice its assets, or to obtain some other economic resources by, say, getting a loan or issuing some other claim. In this Discussion Paper, such a feature is referred to as the timing of the required transfer of economic resources (or simply the timing feature). The timing feature might be specified as a fixed date, or for example as:

(a) payable on demand;

(b) dates of coupon or interest payments;

(c) dates of principal payment (eg at maturity or over the life of the instrument);

(d) option exercise dates; and

(e) at liquidation (ie perpetual term).

2.6 The timing of the required transfer of economic resources is often regarded as the key feature by which liabilities can be distinguished from equity. However, the simple bond in paragraph 2.4 also has a number of other features that affect the entity in different ways; information about these features is also relevant to users of financial statements.

2.7 One of the other features of the simple bond in paragraph 2.4 for which information would be relevant to users of financial statements is that the amount of cash that the entity is required to transfer is fixed. The fixed nature of the amount is relevant because such an amount does not change in response to changes in the entity's available economic resources. Therefore, the fixed nature of the amount introduces the risk that the entity may not have sufficient economic resources, or produce a sufficient return on those economic resources, to meet its obligation.[18] This Discussion Paper refers to how the amount of an obligation is specified as the 'amount' of the obligation, and it might be specified as a fixed number of currency units or:

(a) face values, interest payments, or amounts indexed to units of a selected commodity, financial asset, or a basket or index of assets.[19]

18 The 'amount' does not refer to the fair value of the financial instrument, but rather to the amount specified in the contract (see further discussion in paragraph 3.21).

19 Typically, the amount of resources required to settle a claim will be specified using the same units as the type of resource required to be transferred; however sometimes such amounts differ. For example, many derivatives are required to be settled with cash, but the amount of cash required to settle the claim may be determined by reference to commodities or share prices.

(b) an amount indexed to a reference rate. The reference rate could be market interest rates, fixed rates or changes in the prices of a market variable such as a currency, commodity, financial asset or a basket or index of assets.

(c) a proportionate share of the entity's economic resources after deducting the economic resources required to meet all other claims.

2.8 Information would also be relevant to users of financial statements about some of the other features of the simple bond in paragraph 2.4, including:

(a) that the type of economic resource the entity is required to transfer is cash. If the entity's assets are illiquid and the entity is required to transfer cash then it will introduce the risk that the entity may not be able to obtain the cash required to meet its obligation, or incur significant costs, even if the entity has sufficient economic resources. Other claims might specify the type of economic resource as a particular financial asset or a specific type of good or service.

(b) that the simple bond is senior to other liabilities, which means that the risks arising from its other features—such as whether the entity will have a sufficient amount of cash at the required time—are lower for this simple bond than they would be for subordinated claims. The priority (sometimes referred to as the seniority or rank) of a claim is specified relative to other claims.

2.9 An ordinary share differs from a simple bond in terms of all the features discussed in paragraphs 2.5–2.8. Unlike the simple bond in paragraph 2.4, an ordinary share does not require the transfer of a specific type of economic resource, or a specific amount of economic resource at a specified time other than at liquidation. For the purposes of this Discussion Paper, an ordinary share is a claim that has the following features:[20]

(a) it is the most subordinated claim; and

(b) it requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred is equal to a pro rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.

2.10 Some other rights and obligations of a claim might indirectly affect the expected returns on the claim but might not directly relate to how future net cash inflows are distributed among claims. For example, a bond may include covenants that restrict an entity's use of resources; or an ordinary share may include a right to vote on particular matters, and the exercise of these rights could affect how the entity uses its economic resources.

2.11 Other claims could have various combinations of the features of ordinary shares and the simple bond described in paragraphs 2.4–2.9. For example:

20 Refer to Section 6 for a more detailed discussion about distinguishing other equity claims from equity instruments that have the features of ordinary shares.

(a) shares redeemable at fair value—shares that are redeemable on demand by the holder, for an amount of cash equal to the fair value of an ordinary share. The requirement to transfer economic resources, and specifically cash, on demand has implications similar to the same requirement in the simple bond, requiring an entity either to transfer or sell its assets, or to obtain cash some other way. However, the amount of the obligation will change in response to changes in the price of the entity's ordinary shares.

(b) share-settled bond—a bond that requires an entity to deliver[21] a variable number of the entity's own shares with a total value equal to CU100 in two years. Because an entity's ordinary shares are not an economic resource of the entity, this type of bond, like an ordinary share, does not have implications for the entity's economic resources. However, like the simple bond, the amount of the obligation will not change in response to changes in the entity's available economic resources, introducing the risk that the entity may not be able to meet its obligation (for example, in extreme circumstances, its own shares may not be worth CU100 in total because the amount of all other claims exceed the entity's economic resources).

2.12 Useful information about all of a claim's various features should be provided in the financial statements in one way or another. In order to decide what information is best provided through the classification of liabilities and equity and what information is best provided through presentation and disclosure requirements, the Board considered the consequences of the distinction between liabilities and equity.

What are the consequences of the distinction between liabilities and equity?

2.13 Based on the definitions of the elements of financial statements in the *Conceptual Framework* and the existing requirements in IFRS Standards, the distinction between liabilities and equity has the following primary consequences:

(a) total recognised liabilities are distinguished from total recognised equity in reporting an entity's financial position;

(b) changes in the carrying amount of recognised liabilities are included in reporting an entity's financial performance while changes in the carrying amount of equity are not;

(c) the carrying amounts of recognised liabilities are updated through subsequent measurement (such as interest accretion or, in some cases, fair value changes), while the carrying amount of total equity, a residual, changes in response to changes in the carrying amounts of recognised assets and liabilities; and

(d) the disclosure and presentation requirements in IFRS Standards are more extensive for liabilities than for equity.

21 In this Discussion Paper, unless stated otherwise, the examples assume that entities are able to issue as many shares as required to be delivered by the contract, as and when required by the contract.

2.14 Under any approach to classification, the distinction between liabilities and equity will provide only one set of information—that is, whether the claim has the features of a liability or those of equity. Therefore, any additional information about liability and equity claims will have to be provided separately. The Board intends to mitigate the consequences described in paragraphs 2.13(c)–2.13(d) by requiring entities to provide—through presentation and disclosure—information about features of claim that is not provided through its classification as a liability or equity.

What features are relevant to which assessments?

2.15 The statement of financial position of the entity provides information about the entity's economic resources (its assets) and the claims against the entity (its liabilities and equity) at a point in time. Information about the nature and amounts of an entity's economic resources and claims can help users of financial statements assess the reporting entity's financial strengths and weaknesses, its liquidity and solvency, and its needs for additional financing and how successful it is likely to be in obtaining that financing.[22]

2.16 Furthermore, to properly assess the prospects for future cash flows from the entity, users of financial statements need to be able to distinguish between changes in the reporting entity's economic resources and changes in claims that have resulted:

(a) from that entity's financial performance; and

(b) from other events or transactions such as issuing debt or equity instruments.[23]

2.17 Based on the concepts described in paragraphs 2.15 and 2.16, and feedback from users of financial statements and other interested parties to prior consultations, the Board identified two broad assessments of financial position and financial performance that depend on information about different sets of features of claims. They are:

(a) assessments of funding liquidity and cash flows, including whether an entity will have the economic resources required to meet its obligations as and when they fall due. These assessments are driven by information about requirements to transfer economic resources at a specified time other than at liquidation (the timing feature) (see paragraphs 2.19–2.25).

(b) assessments of balance-sheet solvency and returns (measured on an accrual basis), including whether an entity has sufficient economic resources required to meet its obligations at a point in time, and whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve. These assessments are driven by information about the amount of the obligation (the amount feature) (see paragraphs 2.26–2.31).

2.18 The two assessments in paragraph 2.17 are considered separately in this Discussion Paper because they are driven by different features of claims. Many

22 See paragraph 1.13 of the *Conceptual Framework*.
23 See paragraph 1.15 of the *Conceptual Framework*.

claims will have features that are relevant to both of these assessments, such as the simple bond described in paragraph 2.4. However, other financial instruments, such as those described in paragraph 2.11, contain features that are relevant to one assessment but not the other. Therefore, it is important to establish which of these features should form the underlying rationale for distinguishing liabilities from equity.

Assessments of funding liquidity and cash flows (the timing feature)

2.19 Users of financial statements assess whether an entity will have sufficient economic resources to meet its obligations as and when they fall due. Such an assessment is made because an obligation to transfer economic resources at a specified time requires the entity to generate or otherwise obtain the economic resources required by the settlement date and reduces the economic resources the entity will have available to produce future cash flows beyond that date.

2.20 By specifying the point(s) in time at which an entity is required to transfer economic resources, a financial instrument introduces the risk that the entity will not have the particular type of economic resource required to settle the claim when it is required to do so. This might be the case even if the entity has a sufficient amount of other types of economic resources to meet its obligations. Such a situation raises prospects of potential costs of financial distress or potential business disruption that might occur if the entity needs to convert illiquid assets (such as land or intangible assets) to cash, or if it needs to obtain the required economic resources by issuing new claims. For example, to the extent that the entity has to produce or convert existing economic resources, or obtain economic resources by issuing other claims, the costs incurred to meet the obligation will flow to other claim-holders (for example, losses and transaction costs on asset sales to generate cash). If an entity changes its economic resources, financial statements will reflect those changes in accordance with the recognition and measurement requirements for the affected economic resources.

2.21 In making assessments of funding liquidity and cash flows, users of financial statements typically consider:

(a) whether the expected timing of cash generated by an entity's economic resources will precede the timing of required payments;

(b) to what extent the entity has financed long-term illiquid assets using claims with short-term liquidity demands (ie whether there is a potential liquidity shortfall);

(c) to what extent the entity is exposed to changes in the market liquidity of its assets (for example, if it needs to convert its assets to cash) and the liquidity of financial markets (for example, if it needs to obtain additional financing); and

(d) whether the entity manages its cash flows efficiently and effectively.

2.22 Consequently, in the Board's preliminary view, to assess an entity's funding liquidity and cash flows, users of financial statements need information that distinguishes between claims that require the entity to transfer economic resources at a specified time other than at liquidation,[24] and those claims that do not have such a requirement. This is the primary distinction based on the timing feature that is relevant to users of financial statements making such an assessment.

2.23 The primary distinction described in paragraph 2.22 establishes the best starting point for further disaggregated information about claims that require a transfer of economic resources at different specified times other than at liquidation or of different types of economic resources. However, in the Board's preliminary view, these are secondary distinctions based on the timing feature and the type of economic resource that would help users of financial statements refine their assessments of funding liquidity and cash flows. For example, a distinction between an obligation to transfer cash within 12 months, and an obligation to transfer cash in 20 or 30 years' time would provide additional information to help a user assess an entity's funding liquidity and cash flows.

2.24 Information about secondary distinctions could be provided through additional subclassifications of claims, such as current/non-current, the order of liquidity or disclosure of a maturity analysis. Such information would allow users of financial statements to identify maturity mismatches and predict particular times when maturities are concentrated, and to produce and analyse various ratios, including:

(a) the ratio of current assets to current claims (claims that require transfers of resources within 12 months);

(b) the ratio of liquid assets to on-demand claims (claims that require a transfer of economic resources on demand); and

(c) the order of liquidity of claims (such as that required by IAS 1 *Presentation of Financial Statements*) compared to the expected timing of cash flows from assets.

2.25 The Board considered whether the timing feature is relevant to assessments of financial performance in addition to financial position. As discussed in paragraph 1.17 of the *Conceptual Framework*, accrual accounting depicts effects of transactions and other events on an entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. Such information provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during the period. Such effects on an entity's economic resources would be captured by the relevant IFRS Standard that applies to the accounting for the particular asset; and effects on an entity's claims would be captured by requirements for depicting the amount of the claim (for example, interest expense calculated using the effective interest method) (see paragraphs 2.26–2.31). In contrast, information about changes

24 If liquidation is contractually specified, such as in a limited-life entity, or occurs in tandem with a particular event or at the option of the holder, information about obligations to transfer economic resources at such dates will also be relevant to assessments of funding liquidity and cash flows. For the purposes of this Discussion Paper, liquidation does not include contractually specified liquidation. Therefore, references to contracts that require a transfer of economic resources only at liquidation include only perpetual contracts.

resulting from flows of economic resources, and in particular cash flows, during a period is relevant for assessing how the entity obtains and spends cash, including returns to investors (for example through the payment of interest and dividends that embody returns). Therefore, the Board concluded that information about the timing of the required transfer of economic resources is not relevant to assessments of financial performance.

Assessments of balance-sheet solvency and returns (the amount feature)

2.26 Users of financial statements often also assess:

(a) whether the entity has sufficient economic resources to meet its obligations at a point in time; and

(b) whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve.

2.27 How the amount of a claim is specified, and its priority relative to other claims, will determine the allocation of an entity's total economic resources among claims and how that allocation changes over time—that is, the returns on the claim (sometimes also referred to as the pay-off or yield). A claim that specifies an amount that is independent of the entity's available economic resources (eg a fixed amount of currency units) introduces the risk that the amount of the obligation may exceed the entity's available economic resources.[25] This risk arises even if the claim does not require the transfer of economic resources other than at liquidation, such as claims settled with an entity's own equity instruments. The amount of a claim affects the returns on the claim regardless of the timing of required settlement. Likewise, the changes in the amount during a reporting period will be the primary driver of the returns to holders of claims during that period, even if the resulting cash payments (or transfers of other assets) occur in a different period (see paragraph 2.25).

2.28 In making assessments of balance-sheet solvency and returns, users of financial statements typically consider:

(a) whether an entity has sufficient economic resources to meet its obligations and the potential allocation of any shortfall in economic resources among the claims.

(b) the extent to which the entity has claims that respond to future changes in the entity's available economic resources. This assessment will show how resilient the entity's financial position is to reductions in the value of its economic resources. This assessment also identifies which claims participate in future reductions and appreciation of its available economic resources.

(c) the extent to which the entity has the ability to obtain new economic resources by issuing new claims, or to retain existing economic resources by refinancing existing claims. A shortfall in available economic resources would normally impair an entity's ability to access capital markets regardless of market liquidity.

25 See further discussion of 'available economic resources' in paragraph 3.17.

2.29 Consequently, in the Board's preliminary view, to make assessments of balance-sheet solvency and returns, users of financial statements need information that distinguishes claims for an amount independent of an entity's available economic resources from those claims that do not have such a requirement. This is the primary distinction based on the amount feature that is relevant to users of financial statements making such assessments.

2.30 The primary distinction in paragraph 2.29 establishes the best starting point for further disaggregated information about how a claim specifies the amount, and the priority of the claim on liquidation. Information about these secondary distinctions would help users of financial statements make more detailed assessments of balance-sheet solvency and returns, for example in order to assess how any potential surplus or deficit in economic resources and returns will be allocated among claims. The priority of claims is commonly referred to as the 'waterfall'; and to the extent that an entity has insufficient economic resources to satisfy the amount of a claim, which claim-holder bears the cost of a shortfall will depend on each claim's priority relative to other claims.

2.31 Information about the secondary distinctions could be provided through additional subclassifications of claims, for example, the order of priority; or through additional presentation and disclosure about the various pay-offs. Such information would allow users of financial statements to assess the various pay-offs in possible future scenarios, and produce and analyse various ratios including:

(a) capital ratios;

(b) loss-absorbing capacity ratios;

(c) financial leverage ratios;

(d) interest-coverage ratios (for example, earnings before interest and tax (EBIT)/interest expense); and

(e) return-leverage analysis (for example, debt/EBIT and return on equity).

Which features should be depicted through classification and which through presentation and disclosure?

2.32 Both of the assessments identified in paragraph 2.17 are key assessments that would be affected by the distinction between liabilities and equity because of its consequences for the structure of the statement of financial position, and for what is included in the statement of financial performance.

2.33 In the Board's preliminary view, the best information to provide through the classification of liabilities and equity is information about the primary distinctions that are relevant to both of the assessments identified (see paragraphs 2.22 and 2.29). Consequently, the Board's preferred approach would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

2.34 The Board's preferred approach would define equity as 'the residual interest in the assets of the entity after deducting all of its liabilities', consistent with the definition in paragraph 4.63 of the *Conceptual Framework*. Thus, equity claims under the Board's preferred approach could not contain either of the features in paragraph 2.33.

2.35 As mentioned in paragraph 2.18, applying the Board's preferred approach, many claims would contain both of the features of a liability in paragraph 2.33, and therefore information about them would be relevant to both assessments identified in paragraph 2.17. However, some claims would be classified as liabilities because they contain only one of the two features, and hence information about them would be relevant for only one of the assessments. Therefore, to provide information that will help users of financial statements make each of the identified assessments separately, the Board's preferred approach would provide additional information by requiring separate presentation of liabilities that have only one of the two features in paragraph 2.33 (see Section 6).

2.36 The application of the Board's preferred approach is illustrated in the following table:

Distinction based on amount feature / Distinction based on timing feature	Obligation for an amount independent of the entity's available economic resources (such as fixed contractual amounts, or an amount based on an interest rate or other financial variable)	No obligation for an amount independent of the entity's available economic resources (such as an amount indexed to the entity's own share price)
Obligation to transfer economic resources at a specified time other than at liquidation (such as scheduled cash payments)	Liability (eg simple bonds)	Liability (eg shares redeemable at fair value)
No obligation to transfer economic resources assets at a specified time other than at liquidation (such as settlement in own shares)	Liability (eg share-settled bonds)	Equity (eg ordinary shares)

2.37 Information about secondary distinctions (as discussed in paragraphs 2.23 and 2.30) is also relevant to users of financial statements. Therefore, in the Board's preliminary view, information about these other features would be provided through presentation and disclosure, including:

(a) information about equity claims with pay-offs different from ordinary shares (Section 6); and

(b) information about the priority of liabilities and equity (Section 7).

2.38 The Board thinks that its preferred approach:

(a) would provide the best information about the features of claims identified through the distinction between liabilities and equity, because those features are relevant to the assessments of financial position and financial performance; and

(b) would be the best starting point for providing additional information through presentation and disclosure about both liabilities and equity.

2.39 The Board also observed that its preferred approach would provide a clear rationale without fundamentally changing the existing classification outcomes of IAS 32.

2.40 Adopting an approach based on only one of the primary distinctions might make classification simpler than the Board's preferred approach; however, such an approach would only shift the complexity of making the other primary distinction somewhere else. Given that claims against entities can have a wide variety of features, their classification as liabilities or equity can provide only some of the information about the variety of those features. Therefore, any approach to classification of liabilities and equity will require entities to provide additional information through presentation and disclosure. In particular, using only one of the primary distinctions for classification would result in more instruments being classified as equity, increasing the need to provide useful information about a greater variety of equity instruments through some combination of presentation and disclosure. Because both primary distinctions are relevant to assessments of financial position and financial performance, the Board thinks that an approach based on only one of the primary distinctions would not provide the best information from using the distinction between liabilities and equity.[26]

2.41 The Board considered an approach that would provide information through the classification of liabilities and equity that would only be relevant to assessments of funding liquidity and cash flows. However, such an approach would require entities to provide information that is relevant to assessments of balance sheet solvency and returns through other means, such as presentation and disclosure. In particular, under this approach:

(a) some claims classified as equity might contain obligations for an amount independent of the entity's available economic resources, such as share-settled bonds with a claim equal to a fixed amount. Therefore, separate presentation requirements within equity would be more important for providing information about the varied returns of different equity claims than under the Board's preferred approach.

(b) providing information that is useful for assessing an entity's financial performance would be particularly challenging because distinctions would have to be made both in liabilities and in equity. Claims that contain obligations for the same amount could be included in either

26 Appendix A considers the consequences of the approaches based on only one feature in further detail.

liabilities or equity depending on whether the claim is settled by transferring economic resources (for example, a simple bond to pay CU100 in cash), or by delivering an entity's own equity instruments (for example, a share-settled bond to deliver a variable number of the entity's own shares with a total value equal to CU100). Presentation or disclosure requirements would need to be developed to help users of financial statements assess whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve. In contrast, applying the Board's preferred approach, all changes in the carrying amounts of claims that are relevant to the assessments of balance-sheet solvency and returns would be included as income and expense and requirements would only be needed to present separately income and expenses that are not relevant to these particular assessments.

2.42 The Board considered another approach that would provide information through the classification of liabilities and equity that would only be relevant to assessments of balance-sheet solvency and returns. In particular, under this approach, some claims classified as equity might require the transfer of resources at a specified time other than at liquidation, such as shares redeemable at fair value. However, such an approach would have to provide information that is relevant to assessments of funding liquidity and cash flows through other means, such as presentation and disclosure. Therefore, in contrast to the Board's preferred approach, there would be a greater need for separate presentation requirements within equity to provide information about claims that might require the entity to transfer economic resources at a specified time other than at liquidation. Applying the Board's preferred approach, all claims that are relevant to assessments of funding liquidity and cash flows would be classified as liabilities.[27]

Other approaches to classification that provide information to support assessments other than those identified

2.43 In their response to previous consultations, many users of financial statements, in particular investors in ordinary shares, have suggested an approach that would classify only ordinary shares, or their equivalents, as equity (sometimes called a narrow equity or basic ownership instrument approach). Such an approach would classify all other claims as liabilities. Reasons for supporting such an approach include:

(a) only the most residual class of claims should be classified as equity, as that class bears the residual risk.

(b) it would be consistent with preparing financial statements from the perspective of the proprietors. Thus, such an approach would depict financial position and financial performance from the point of view of the holders of ordinary shares (see also paragraph 2.47).

27 See Section 3 for a discussion of the puttable exception.

(c) existing requirements do not include specific requirements to provide information about different equity claims, although IAS 1 contains general principles for disclosing information that is useful, and some information about different equity claims is required when presenting earnings per share applying IAS 33 *Earnings per Share*.

2.44 Classification of a claim as equity should not preclude, even in the absence of a specific requirement, the provision of relevant information about that claim. Entities can always choose to provide additional information about equity instruments. However, the Board considered different ways of improving the usefulness of information about different equity claims—some of those ways would provide approximately the same level of information as does a narrow equity approach.

2.45 A particular strength of the Board's preferred approach is that it can provide the same information as a narrow equity approach while also providing other relevant information about an entity's financial position and financial performance; and it can provide this information more directly via classification and presentation. For example, information about the most subordinate equity claim can be provided by presenting subclasses of equity (see Section 6).

2.46 The Board also considered and rejected distinguishing liabilities from equity based on features such as rights that may affect how an entity uses its economic resources (such as voting or protective rights). A financial instrument may specify voting rights or protective rights over an entity's activities, including rights to vote at shareholder meetings, debt covenants, or other restrictions over the types of activities the entity may undertake or over how it uses its resources. Specified voting and restrictive rights allocate to claim holders different levels of influence over an entity's activities. Even though such rights may only indirectly affect an entity's economic resources and the prospects for future cash flows from those resources, the disclosure of such rights may help users of financial statements to understand how claims distribute the ability to influence an entity's activities and economic resources among holders of claims.

2.47 The Board also considered whether the entity perspective adopted in financial statements has any consequences for the distinction between liabilities and equity. As stated in paragraph 3.8 of the *Conceptual Framework*, financial statements 'provide information about transactions and other events viewed from the perspective of the reporting entity as a whole, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors'. The entity perspective provides a rationale for the separation of an entity from its capital providers. However, the entity perspective does not provide any explicit guidance about what information would be best provided to users of financial statements through the distinction between liabilities and equity.

Summary of preliminary views and questions for respondents

2.48 In clarifying the underlying rationale for distinguishing liabilities from equity, the Board considered:

(a) what information is best provided through classification using the distinction between liabilities and equity; and

(b) what information is best provided through presentation and disclosure requirements.

Classification

2.49 The Board's preferred approach would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

2.50 The information that would be provided through classification of liabilities and equity applying the Board's preferred approach would be relevant to the following assessments of the entity's financial position and financial performance:

(a) assessments of funding liquidity and cash flows—information about financial instruments that require a transfer of cash or another financial asset at a specified time other than at liquidation would help users of financial statements to assess whether an entity will have the cash or another financial asset required to meet its obligations as and when they fall due.

(b) assessments of balance-sheet solvency and returns—information about financial instruments that are obligations for an amount independent of the entity's available economic resources and information about how that amount changes over time would help users of financial statements to assess:

  (i) whether an entity has sufficient economic resources to meet its obligations at a point in time; and

  (ii) whether an entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige it to achieve.

Presentation and disclosure

2.51 To help users of financial statements make each of the assessments in paragraph 2.50 separately, the Board's preferred approach would provide additional information through separate presentation, including about liabilities that have only one of the features of a liability in paragraph 2.49 (Section 6).

2.52 While information about other features is also relevant to users of financial statements, the Board's preliminary view is that information about such features should be provided via presentation and disclosure. Hence, the Board's preferred approach would provide useful information about other features of claims not depicted by classification through presentation and disclosure, including:

(a) information about different types of equity (Section 6); and

(b) information about the priority of liabilities and equity (Section 7).

Question 2
The Board's preferred approach to classification would classify a claim as a liability if it contains: (a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or (b) an unavoidable obligation for an amount independent of the entity's available economic resources. This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50. The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure. Do you agree? Why, or why not?

Section 3—Classification of non-derivative financial instruments

3.1 This section sets out the Board's preliminary views on the application to non-derivative financial instruments of the Board's preferred approach to classification.

Scope of the Board's preferred approach

Scope of IAS 32

3.2 IAS 32 applies to all types of financial instruments other than those that fall within the scope of another IFRS Standard that is listed in paragraph 4 of IAS 32.

3.3 IAS 32 defines a financial instrument as 'any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity'. Therefore, one defining aspect of all financial instruments is that all the rights and obligations arise from contracts. Rights and obligations that are not contractual, for example, rights and obligations that arise from statutory requirements imposed by government, are not financial instruments.[28]

3.4 IAS 32 also defines a financial asset, a financial liability and an equity instrument.[29] One of the defining aspects of financial assets and financial liabilities is the right to receive and the obligation to transfer cash or other

28 The Board is aware of the challenges in applying the existing scope requirements of IAS 32 with respect to identifying the scope of contractual terms. This Discussion Paper discusses those matters further in Section 8.

29 Other IFRS Standards, including IFRS 9 *Financial Instruments*, also use these definitions to set the scope of their application, and for some of their requirements.

financial instruments. Other IFRS Standards apply when an entity has a right or obligation to receive, transfer or exchange other types of economic resources.[30]

3.5 Given the scope of IAS 32, the Board sought to articulate classification principles for financial instruments based on its preferred approach that also:

(a) are limited to rights and obligations arising from contracts; and

(b) exclude rights and obligations to receive, transfer or exchange types of economic resources other than cash or other financial instruments.

3.6 Therefore, while the application of the Board's preferred approach might change the classification of a financial instrument as a financial asset, financial liability or an equity instrument, the scope would remain unchanged from those that are within the scope of IAS 32.

Types of contracts

3.7 IAS 32 contains separate classification principles for derivative and non-derivative financial instruments. In applying the Board's preferred approach to financial instruments, the Board also developed separate classification principles for each of derivative and non-derivative financial instruments because of particular classification challenges arising from derivatives on own equity. The classification of derivatives on own equity is considered in Sections 4 and 5. The rest of this section discusses the application of the Board's preferred approach to the classification of non-derivative financial instruments as financial liabilities and equity instruments.

Classification of non-derivative financial instruments applying the Board's preferred approach

3.8 In the Board's preliminary view, applying its preferred approach to financial instruments, a non-derivative financial instrument would be classified as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

3.9 Applying the Board's preferred approach, an equity instrument is any contract that evidences a residual interest in the assets of the entity, after deducting all of its liabilities.[31] Consequently, a contract classified as an equity instrument would contain neither:

30 Except for some particular types of contracts to buy or sell non-financial items, for example, some contracts that can be settled in cash. For further details, see paragraphs 8–10 of IAS 32. The Board is not considering any changes to these requirements.

31 The *Conceptual Framework* defines equity as a residual interest in the assets of the entity, after deducting all of its liabilities. The definition of an equity instrument in the Board's preferred approach is consistent with this definition.

(a) an unavoidable obligation to transfer economic resources (including financial and non-financial assets) at a specified time other than at liquidation;[32] nor

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

3.10 A non-derivative financial instrument may contain more than one possible settlement outcome that might depend on future events, or on the holder or issuer exercising rights (for example, a financial instrument that requires payment in cash of a fixed principal amount in four years, and that pays discretionary dividends). A settlement outcome refers to the result of an entity fulfilling its contractual obligations. If an entity does not have the unconditional contractual right to avoid a settlement outcome that has one or both of the features of a financial liability (this could be the case, for example, for a financial instrument that requires the entity, in circumstances beyond its control, to deliver a variable number of its own shares with a total value equal to a fixed amount of currency), then the entity identifies that unavoidable obligation first and classifies that obligation as a non-derivative financial liability. If the non-derivative financial instrument also contains another possible settlement outcome that does not have the feature(s) of a financial liability (for example, it requires the entity, at the option of the holder, to transfer a fixed number of its own shares), then the entity considers whether the instrument is a compound instrument applying the requirements in paragraphs 3.25–3.28 and Section 5.

Comparison to IAS 32

3.11 The Board compared the application of its preferred approach to non-derivative instruments to the existing requirements of IAS 32. Applying IAS 32, a non-derivative financial instrument that contains the following features is classified as a financial liability:

(a) an obligation to deliver cash or another financial asset (the first feature); or

(b) an obligation to deliver a variable number of equity instruments (the second feature).

3.12 The classification requirements for non-derivative financial instruments applying the Board's preferred approach would have many similarities with the requirements in IAS 32. Under either approach, non-derivative financial liabilities include contractual obligations that contain at least one of two features. One of those two features, the requirement to transfer cash or another financial asset, is the same under IAS 32 and the Board's preferred approach and results in a financial liability classification applying both approaches.

3.13 The Board's preferred approach and IAS 32 differ in how the second feature is articulated. Instead of the second feature being articulated based on whether

32 Equity instruments would not include any obligation that meets the definition of a liability and not just financial liabilities. A non-financial liability may contain an unavoidable obligation to transfer economic resources other than cash or another financial asset at a specified time other than at liquidation.

the number of equity instruments to be delivered is variable, the Board's preferred approach would articulate the second feature by reference to whether the amount of the obligation is independent of the entity's available economic resources. The articulation of the amount feature applying the Board's preferred approach is derived from the underlying rationale in Section 2 (see paragraphs 2.26–2.31). Even with this change in articulation, the Board expects the classification outcomes would remain largely the same for most types of financial instruments. However, the classification outcomes for some instruments might differ from those applying IAS 32 because of the differences arising from clarifying the rationale and rearticulating the second feature accordingly.

3.14 One classification outcome that would not change is that of a share-settled bond as described in paragraph 2.11(b). IAS 32 classifies a share-settled bond as a financial liability because of the obligation to deliver a variable number of equity instruments. The Board's preferred approach would also classify the same financial instrument as a financial liability; however, it would do so because the obligation for a fixed amount is independent of the entity's available economic resources (paragraph 3.8(b)). By articulating the second feature based on a clear rationale, the basis for this classification outcome can be explained more easily than the requirement in IAS 32. The requirement in IAS 32 depends on whether there is an obligation to settle in a variable number of equity instruments, regardless of how the number of shares to be transferred is determined.

3.15 One classification outcome that would change as a result of the articulation of the second feature is that of irredeemable fixed-rate cumulative preference shares (see paragraph 3.23(c)). IAS 32 classifies such cumulative preference shares as equity instruments because there is no contractual obligation to transfer cash or another financial asset or to deliver a variable number of shares at a specified time other than at liquidation. In contrast, the Board's preferred approach would classify such cumulative preference shares as financial liabilities because the entity has an obligation for an amount independent of the entity's available economic resources (paragraph 3.8(b)). This is because the fixed-rate dividends accumulate over time and changes in the entity's available economic resources will not result in changes in the amount of the obligation for the cumulative preference shares, even though the entity is only required to transfer economic resources at liquidation.

3.16 In the Board's view, articulating the second feature by reference to the amount of the obligation would improve consistency in the classification of financial instruments with features that would be useful for the assessments identified in Section 2. In addition, the rationale of the articulation would help explain and support the application of the classification principles. Information about both the share-settled bond and the irredeemable fixed-rate cumulative preference shares is relevant for assessments of balance-sheet solvency and returns. The Board's preferred approach would provide information that is useful to those assessments by consistently classifying these instruments as financial liabilities. Because neither financial instrument requires the transfer of economic resources at a specified time other than at liquidation, information about these instruments is not needed for assessments of funding liquidity and cash flows. To help make the two assessments identified in Section 2 separately, additional information would be provided through presentation (see Section 6).

Further guidance on an amount independent of the entity's available economic resources

3.17 An entity's available economic resources are the total recognised and unrecognised assets of the entity that remain after deducting all other recognised and unrecognised claims against the entity (except for the financial instrument in question). An entity should not need to determine its available economic resources to assess whether the amount of a financial instrument (that is, the amount of the contractual obligation of a financial instrument) is independent of its available economic resources. Whether the amount of a financial instrument is independent of the entity's available economic resources should be clear from the instrument's contractual terms.

3.18 An amount is independent of the entity's available economic resources if:

(a) the amount does not change as a result of changes in the entity's available economic resources; or

(b) the amount changes as a result of changes in the entity's available economic resources but does so in such a way that the amount could exceed the available economic resources of the entity.

3.19 As mentioned in paragraph 3.10, a non-derivative financial instrument may contain more than one possible settlement outcome that might depend on future events, or on the holder or issuer exercising rights. For such instruments, an entity would apply paragraph 3.18 to each settlement outcome separately. If a non-derivative financial instrument contains at least one settlement outcome that is for an amount independent of the entity's available economic resources that the entity does not have the unconditional contractual right to avoid, then the entity would identify that unavoidable obligation first and classify it as a non-derivative financial liability. For example, a financial instrument requires an entity to deliver a variable number of its own shares with a total value equal to CU100 with a cap of 50 shares. Applying the Board's preferred approach, the entity would consider the unavoidable obligation to deliver a variable number of its own shares with a total value equal to CU100 separately, and would classify that unavoidable obligation as a non-derivative financial liability because the amount is independent of the entity's available economic resources. Given that the cap is a fixed number of shares, the entity considers whether the instrument is a compound instrument applying the requirements in Section 5.

3.20 The amount of a particular financial instrument might be specified using the entity's available economic resources as a reference. A link to the entity's available economic resources does not automatically mean that the amount of the financial instrument depends on the entity's available economic resources. Although the amount of a financial instrument may be affected by the entity's available economic resources, the entity would have to consider whether the amount could exceed the entity's available economic resources under any possible scenario based on the terms of the financial instrument at initial recognition. For example, if the amount of a financial instrument is indexed to twice the change in the fair value of the recognised and unrecognised net assets of the entity, then the amount of the financial instrument will increase twice as much as the available economic resources of the entity, and thus could potentially exceed the entity's available economic resources. Because the amount can exceed the entity's available economic resources it is an amount independent of the entity's available economic resources. The financial instrument would be classified as a financial liability under the Board's preferred approach. Information about the instruments would be useful for assessments of balance-sheet solvency and returns.

3.21 The 'amount' of a particular financial instrument as used in the Board's preferred approach (see paragraph 2.7) is not the fair value of the financial instrument even though the fair value of financial instruments will be affected by their amounts. The fair value of all financial liabilities and equity instruments is affected by changes in the available economic resources of the issuer entity. For example, the fair value of a financial instrument that requires a transfer of CU100 in cash in two years' time is likely to change over its life in response to a number of factors including changes in the entity's credit risk. The assessment of the amount feature for classification applying the Board's preferred approach depends on whether the amount specified in the contract (the contractual pay-off) changes in response to the available economic resources. The amount of a financial instrument with a contractual obligation to transfer CU100 is CU100 regardless of changes in the entity's available economic resources, or changes in the fair value of the instrument, and therefore the amount is independent of the entity's available economic resources.

3.22 The amount of a particular financial instrument might be specified by reference to the entity's total economic resources (excluding the effect of other claims) or to changes in the entity's total economic resources. While the amount of the financial instrument in isolation may not exceed the economic resources of the entity, when considered in combination with other claims against the entity, it could result in an amount that exceeds the entity's available economic resources. Hence, if the amount does not take into account the effect of other claims against the entity (for example, if the amount is specified as a fixed percentage of a particular recognised or unrecognised asset) the amount is independent of the entity's available economic resources. Applying the Board's preferred approach, such claims would be classified as financial liabilities.

3.23 Examples of financial instruments with amounts independent of the entity's available economic resources include:

(a) a bond or other obligation for a fixed amount of a particular currency, or an amount based on changes in an underlying variable, such as an interest rate or commodity index. An entity's available economic resources may be affected by changes in the currency or other specified variable. However, such amounts are independent of the entity's available economic resources because the amount of the bond does not change *as a result of* the changes in the entity's available economic resources (that is, its recognised and unrecognised assets and other claims).

(b) a financial instrument with an obligation for an amount specified by reference to a specific recognised or unrecognised asset the entity controls. Such an amount is independent of the entity's available economic resources, even if the entity controls the specific economic resource at a particular point in time. For example, if a financial instrument contains an obligation for an amount based on changes in the price of a particular asset of the entity (such as property or a brand value), the amount of the financial instrument is independent of the entity's available economic resources. That is because changes in the entity's overall economic resources and changes in the entity's other claims will not result in changes in the amount of the financial instrument. It is possible for the entity's available economic resources to fall while the price of the particular asset rises, in which case the entity may not have sufficient economic resources available to satisfy the obligation arising from the financial instrument.

(c) an irredeemable fixed-rate cumulative preference share, with a stated coupon or dividend amount that accumulates in the case of non-payment. The amount of the cumulative preference share is independent of the entity's available economic resources because changes in the entity's available economic resources will not result in changes in the amount of coupon or dividend right of the cumulative preference shares. The amount of the cumulative preference share and the amount of the bond described in paragraph 3.23(a) are both independent of the entity's economic resources.

(d) a share with a dividend feature that does not accumulate but is reset periodically when not paid. The required dividend rate resets to a higher rate each year in which the dividend is not paid, until the dividend is paid at the option of the entity or it is finally paid at liquidation. For example, the dividend rate is 5% in the first year and increases by an additional 5% each year until the dividend is paid. Even though the dividend is described as non-cumulative, it increases over time if the dividend for one year is not paid. The fact that the dividend rate increases at a specified rate when it is not paid results in an amount that is independent of the entity's available economic resources.[33]

3.24 Examples of financial instruments with amounts that are not independent of the entity's available economic resources include:

(a) an ordinary share (as described in paragraph 2.9), with a right to participate in distributions and to a pro rata share of net assets at liquidation, would always depend on the residual cash flows from the entity's economic resources minus all other claims.

33 See Section 8 for a discussion of preference shares with resets.

(b) an irredeemable non-cumulative preference share with a stated coupon or dividend amount that is a specified rate of return or a specified amount of cash, but the coupon or dividend amount is cancelled if the coupon is not paid by the entity. Because the entity has the unconditional right to avoid paying coupons or dividends, this stream of cash flows is not considered to be independent of the available economic resources. The irredeemable non-cumulative preference share may also require a fixed amount to be paid at liquidation, for example in the form of a principal amount. If so, such instruments are compound instruments. The fixed amount payable at liquidation is independent of the entity's available economic resources, however, on initial recognition, that fixed amount would be discounted back to nil or an insignificant amount if measured on a going concern basis.

(c) an ordinary share in a subsidiary held by a non-controlling interest as the ordinary share would depend on the available economic resources of the subsidiary, which are a part of the available economic resources of the consolidated group. The amount of the non-controlling interest is not independent of the subsidiary's available economic resources, because the amount will not exceed the available economic resources of the subsidiary. Unlike a financial instrument whose amount is specified as a share of total assets as described in paragraph 3.22, the group has no contractual obligation to deliver to the non-controlling interest more than the subsidiary's (and thus a portion of the group's) available economic resources.

Compound instruments with non-derivative components

3.25 The Board's preliminary view is to carry forward in the Board's preferred approach the requirement in IAS 32 that the issuer of a non-derivative financial instrument evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components would continue to be classified separately as financial liabilities, financial assets or equity instruments.

3.26 Many compound instruments include derivative components, for example, convertible bonds. This Discussion Paper discusses the application of the Board's preferred approach to such compound instruments in Section 5. However, some compound instruments include liability and equity components that are both non-derivatives. An entity classifies the components of such instruments separately as financial liabilities, financial assets and equity instruments.

3.27 For example, a financial instrument issued for CU1000 might contain a requirement to repay the principal amount in four years' time as well as to pay discretionary dividends equal to any dividends paid to ordinary shareholders while the instrument is outstanding. The entity would classify the obligation to pay CU1000 in four years' time—the liability component—as a financial liability, measured in accordance with IFRS 9 (assume CU800), because of the contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (also because of the obligation for an amount independent of the entity's available economic resources). The entity would classify the discretionary dividends as an equity instrument because the entity has the unconditional right to avoid paying the discretionary dividends. The difference between the transaction price and the liability component is allocated to the equity component (in this case CU200). The classification outcomes applying the Board's preferred approach to such an instrument are the same as would result from applying IAS 32.

3.28 Sometimes, a financial instrument specifies a fixed amount that is required to be paid at liquidation, for example in the case of some non-cumulative preference shares. That fixed amount is independent of the entity's available economic resources and therefore meets the definition of a liability, similar to the example in paragraph 3.24(b).

Questions for respondents

Question 3

The Board's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or

(b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources.

This will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability.

Do you agree? Why, or why not?

Puttable exception

3.29 In 2008, the Board introduced an exception to the definition of a financial liability for particular puttable financial instruments. The exception in IAS 32 requires issuers to classify obligations with particular features to transfer economic resources as equity, even though the instruments meet the definition of a financial liability (puttable exception).

3.30 Paragraphs 16A and 16B of IAS 32 require:

> 16A A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all the following features:
>
> (a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
>
> (i) dividing the entity's net assets on liquidation into units of equal amount; and
>
> (ii) multiplying that amount by the number of the units held by the financial instrument holder.
>
> (b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:
>
> (i) has no priority over other claims to the assets of the entity on liquidation; and
>
> (ii) does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.
>
> (c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.
>
> (d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

continued...

...continued

(e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).

16B For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract) and

(b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 16A that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

3.31 When revising IAS 32 in 2003, the Board initially concluded that all financial instruments that give the holder the right to put the instrument back to the issuer for cash or another financial asset meets the definition of a financial liability and should be classified as such. However, in 2007, the Board reconsidered its conclusion with regard to particular puttable instruments that represent the most subordinate claim to the net assets of the entity (paragraphs 16A and 16B of IAS 32). At that time, the following concerns were raised about classifying such instruments as liabilities as stated in paragraph BC50 of the Basis for Conclusions on IAS 32:

(a) On an ongoing basis, the liability is recognised at not less than the amount payable on demand. This can result in the entire market capitalisation of the entity being recognised as a liability depending on the basis for which the redemption value of the financial instrument is calculated.

(b) Changes in the carrying value of the liability are recognised in profit or loss. This results in counter-intuitive accounting (if the redemption value is linked to the performance of the entity) because:

  (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss is recognised.

  (ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain is recognised.

(c) It is possible, again depending on the basis for which the redemption value is calculated, that the entity will report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.

(d) The issuing entity's statement of financial position portrays the entity as wholly, or mostly, debt funded.

(e) Distributions of profits to shareholders are recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not performance.

Does the Board's preferred approach eliminate the need for the puttable exception?

3.32 Simply applying the Board's preferred approach, a puttable instrument would meet the definition of a financial liability (paragraph 3.8(a)). This is because the instrument contains an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation. The entity has the obligation to transfer cash or another financial asset in exchange for redeeming the financial instrument at the option of the holder or on the occurrence of an event other than liquidation.

3.33 The same conclusion would also apply to financial instruments that meet the requirements of the exception in paragraphs 16C and 16D of IAS 32. These financial instruments are similar to puttable financial instruments that meet the exception in paragraphs 16A and 16B of IAS 32, however, instead of the condition in paragraph 16A(e), they impose on the entity an obligation to deliver a pro rata share of the net assets of the entity only on liquidation, if liquidation is at a specified time or at the option of the instrument holder. Although such instruments impose an obligation only on liquidation, because liquidation is at a specified time (as with, for example a limited life entity) or liquidation is at the option of the holder, the entity has a contractual obligation to transfer cash or another financial asset at a specified time. Therefore, classification as a liability would provide information that is relevant to assessments of an entity's funding liquidity and cash flows.

3.34 Although a financial instrument that meets the conditions of the puttable exception in paragraphs 16A–16B or 16C–16D of IAS 32 would be classified as a liability under the Board's preferred approach, it might be eligible for separate presentation[34] due to its features as outlined in paragraph 16A(e). If separate presentation requirements apply to such instruments, some of the concerns identified in paragraph 3.31 would be addressed. In particular changes in the carrying amounts of such financial instruments would be presented separately, which may mitigate the counter-intuitive effects on profit or loss.

3.35 However, the classification and presentation principles of the Board's preferred approach do not address the challenge that arises when all an entity's claims meet the definition of a liability and no claim qualifies for classification as equity.

3.36 The absence of a claim that meets the definition of equity would:

(a) lead to the concerns identified in paragraphs 3.31(a) and 3.31(c)–3.31(d);

(b) raise questions as to what the difference between the assets and liabilities would represent, and how an entity would faithfully represent that difference in its financial statements, since equity is typically the element measured as a residual for the purposes of recognition and measurement; and

(c) raise other challenges because the definitions of income and expense assume the existence of equity (a change in an asset or a liability needs to result in a change in equity to meet the definition of income and expense).

Summary of preliminary views and questions for respondents

3.37 In the Board's preliminary view, the puttable exception would continue to be required under the Board's preferred approach. The Board came to this view because:

(a) applying the Board's preferred approach to financial instruments that meet the exception might address some, but not all, of the previous concerns that led to the exception. In particular, the incomplete recognition and measurement of assets and liabilities means that if at least one claim is not recognised and measured as a residual, the usefulness of the statement of comprehensive income is reduced.

34 This Discussion Paper discusses separate presentation requirements further in Section 6.

(b) the scope of the puttable exception is restricted to a narrow set of circumstances in which no other financial instrument or contract is more subordinated and holders of the puttable instruments represent the most residual interest in the entity's net assets.[35]

(c) the Board is not aware of any issues with the application of the puttable exception as set out in paragraphs 16A–16B or 16C–16D, of IAS 32.

3.38 Classifying particular puttable instruments as equity would not provide the information required for users of financial statements to assess the entity's funding liquidity and cash flows. This concern is mitigated by the current disclosure requirements in paragraph 136A of IAS 1, which provide some information on the entity's redemption obligations relating to puttable instruments so that users of financial statements can estimate the potential cash outflows from these claims. Hence, if the exception in paragraphs 16A–16B, and paragraphs 16C–16D, of IAS 32 is retained, the Board thinks that the disclosure requirements in paragraph 136A of IAS 1 should also be retained, enabling users of financial statements to estimate the expected cash flows on settlement for all the financial instruments within the scope of the exception.

Question 4
The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

Section 4—Classification of derivative financial instruments

4.1 As stated in Section 3, the Board developed separate classification principles to apply the Board's preferred approach to derivative financial instruments because of particular challenges associated with derivatives on own equity. This section sets out the Board's preliminary views on classification of derivatives on own equity, the rationale that supports those preliminary views and alternative views the Board has considered. Derivatives that include an obligation to extinguish[36] an entity's own equity instruments and derivatives embedded in compound instruments are discussed in Section 5. The Board's preliminary views for derivatives on own equity, other than those derivatives discussed in Section 5, are as follows:

(a) a derivative on own equity would be classified in its entirety. Such a derivative may be classified as an equity instrument, a financial asset or a financial liability in its entirety. The individual legs of the exchange would not be separately classified.

(b) such a derivative on own equity would be classified as a financial asset or a financial liability if:

35 See paragraph BC61 of the Basis for Conclusions on IAS 32.

36 In this Discussion Paper, extinguishment of financial liabilities and equity instruments includes redemption or repurchase. Since an entity's own equity instruments would not meet the definition of an asset, own equity instruments redeemed or repurchased by an entity would be deducted from equity, consistently with IAS 32.

(i) it is net-cash settled—the derivative could require the entity to deliver cash or another financial asset, and/or contains a right to receive cash, for the net amount at a specified time other than at liquidation; and/or

(ii) the 'net amount'[37] of the derivative is affected by a variable that is independent of the entity's available economic resources.

4.2 This section is structured as follows:

(a) Derivatives on own equity (paragraphs 4.3–4.10);

(b) Challenges associated with classification of derivatives on own equity (paragraphs 4.11–4.14);

(c) Applying the Board's preferred approach to derivatives on own equity (paragraphs 4.15–4.37);

(d) Summary of preliminary views and questions for respondents (paragraphs 4.38–4.44); and

(e) Further guidance on variables that affect the net amount of derivatives on own equity (paragraphs 4.45–4.66).

Derivatives on own equity

4.3 IFRS 9 defines a derivative as '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.'[38]

4.4 Derivative financial instruments contain contractual rights and obligations to exchange underlying financial assets, financial liabilities or equity instruments with another party.[39] Consequently, derivative financial instruments can also be described as exchange contracts that have two 'legs', with each leg representing one side of the exchange. For example, in a typical warrant, at the option of the holder, the entity (the issuer) is obliged to deliver its own ordinary shares in exchange for cash. The obligation to deliver own shares is one leg (equity leg) and the right to receive cash is the other leg (asset leg). If at least one leg of a derivative involves delivery or extinguishment of an entity's own equity instruments, or the underlying of a derivative is an entity's own equity, then the derivative is referred to as a derivative on own equity in this Discussion Paper.

37 See paragraphs 4.28–4.29 for further discussion on the net amount of a derivative on own equity.

38 See Appendix A of IFRS 9.

39 This description of derivatives is based on paragraphs AG15–AG19 of the Application Guidance of IAS 32.

4.5 Derivatives on own equity can be unconditional (eg a forward contract), or they can be conditional on one or more of the following:

(a) rights within the control of the entity (eg purchased options);

(b) rights within the control of the holder of the claim (eg written options); or

(c) events beyond the control of both the entity and the holder (eg contracts that are exercised automatically if an uncertain future event occurs and the event is outside the control of both the entity and the holder).

4.6 In addition, derivatives on own equity might be settled in various ways. For example, they might be:

(a) settled by exchanging the underlying financial instruments (gross physically settled);

(b) settled net in cash (net-cash settled); or

(c) settled net in equity instruments (net-share settled).

4.7 Finally, derivatives on own equity could exist as standalone derivatives, or could be embedded in another non-derivative host financial instrument (eg a hybrid instrument).

4.8 Sections 4 and 5 set out the Board's discussion on classification of derivatives on own equity. When considering the subject, the Board considered the following two types of exchanges, which may either be gross physically settled or net-settled in cash or shares:

(a) contracts to receive cash or another financial asset in exchange for delivering own equity instruments. In this Discussion Paper, we refer to these types of exchanges as 'asset/equity exchanges'.

(b) contracts to extinguish a financial liability in exchange for delivering own equity instruments and contracts to extinguish own equity instruments in exchange for another obligation that has one or both features of a financial liability in paragraph 3.8.[40] For example, a forward contract to buy back own shares for cash. The obligation to deliver cash in this contract meets the definition of a financial liability. In this Discussion Paper, we refer to these types of exchanges as 'liability/equity exchanges'.

4.9 While the exchanges in paragraph 4.8 may look similar in that they involve delivering or receiving own equity instruments, there is a difference, which is that:

(a) for gross physically settled asset/equity exchanges, neither the underlying financial assets to be received nor the underlying equity to be delivered are existing financial assets or equity instruments of the entity.

40 A contract may extinguish own equity instruments in exchange for delivering cash, ie a gross physically settled contract, or may require delivery of own shares, ie a net-share settled contract. The requirement to transfer cash or a variable number of shares in these contracts has the feature(s) of a financial liability.

Thus, settling gross physically settled asset/equity exchange derivatives results in an increase in both the entity's assets and equity.[41]

(b) for gross physically settled liability/equity exchanges, the financial liabilities or equity instruments that are extinguished on settlement of the derivative are existing financial liabilities or equity instruments of the entity.

4.10 This section discusses the application of the Board's preferred approach to asset/equity derivatives and liability/equity derivatives, but only those liability/equity derivatives that extinguish a financial liability in exchange for delivering equity instruments. The discussion of embedded derivatives on own equity and derivatives that include an obligation to extinguish an entity's own equity instruments is set out in Section 5.

Challenges associated with classification of derivatives on own equity

4.11 The Board observed that classification of derivatives on own equity gives rise to both conceptual and practice challenges when applying IAS 32. The conceptual challenge is that derivatives on own equity combine both an equity leg and an asset or a liability leg. If the two legs existed independently of each other as separate instruments, the financial reporting consequences for the equity leg would be different from that of the asset or liability leg. For example, changes in the asset or liability leg would meet the definition of income and expense and would be recognised as such, while changes in the equity leg would not.

4.12 Any approach to classifying derivatives on own equity requires striking a balance between:

(a) representing the characteristics of the equity leg and asset or liability legs of the derivative consistent with what the classification of those legs would have been had they existed separately; and

(b) the cost and the complexity of depicting the characteristics of the legs separately instead of classifying the derivative as a whole.

4.13 IAS 32 addresses some of the challenges of classifying derivatives on own equity by:

(a) classifying derivatives in their entirety, using the fixed-for-fixed condition,[42] as an equity instrument, a financial asset or a financial liability; and

(b) including additional requirements that identify liability and equity components for compound instruments and for contracts that include an obligation to redeem equity instruments for cash or for another financial asset—for example, a written put option on own shares.

41 Applying IAS 32, an entity's own shares are not recognised as financial assets. If an entity reacquires its own shares (treasury shares), such treasury shares are deducted from equity. This requirement would remain unchanged applying the Board's preferred approach.

42 Applying the fixed-for-fixed condition in IAS 32, a derivative is classified as equity only if it is settled by exchanging a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

4.14 However, the Board is aware of a number of practice challenges in applying the requirements of IAS 32 relating to the classification of derivatives on own equity as stated in paragraph 1.36, including:

(a) practice questions regarding the application of the fixed-for-fixed condition to particular types of instruments;

(b) whether it is appropriate for derivatives that meet the foreign currency rights issue exception to be classified differently from conversion options in foreign currency convertible bonds;[43]

(c) whether it is appropriate that written put options and forward purchase contracts on an entity's own equity instruments are presented grossed-up rather than on a net basis like other derivatives; and

(d) how to account for transactions within equity when an entity has an obligation to extinguish its own equity instruments.

Applying the Board's preferred approach to derivatives on own equity

4.15 The Board considered different ways of applying its preferred approach to derivatives on own equity to address the conceptual challenges identified in paragraph 4.11. In particular, the Board considered:

(a) whether such derivatives should be classified in their entirety (paragraphs 4.16–4.20); and

(b) whether all such derivatives should be classified as financial assets or financial liabilities (paragraphs 4.21–4.24).

4.16 In the Board's preliminary view, consistent with the existing approach in IAS 32 and the approach to accounting for derivatives in IFRS 9, an entity would apply the Board's preferred approach to:

(a) classify derivatives on own equity in their entirety; and

(b) classify derivatives on own equity as equity instruments, financial assets or financial liabilities.

4.17 Classifying derivatives on own equity in their entirety as equity instruments, financial assets or financial liabilities would provide information that is useful in assessing financial positions and financial performance of the entity as described in Section 2 compared with classifying all derivatives on own equity in their entirety as financial assets or liabilities. The Board thinks that such an approach will strike the right balance between representing the characteristics of the individual legs of the derivatives on own equity and the cost and the complexity of doing so.

4.18 One of the consequences of classifying derivatives on own equity in their entirety is that some derivatives with an equity leg may be classified as financial

43 Applying IAS 32, issued 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. The same does not apply to conversion options in convertible bonds with otherwise identical features.

assets or financial liabilities, and vice versa. As described in paragraph 4.11, classifying derivatives on own equity in their entirety as financial assets or financial liabilities would lead to inconsistent classification between the equity leg of the derivatives and a similar obligation to deliver equity instruments in a non-derivative financial instrument. Consider, for example, a derivative to deliver 100 shares of the entity in exchange for receiving 110 units of foreign currency. Applying the Board's preferred approach, if the two legs were considered in isolation, the obligation to deliver 100 units of own shares has the features of equity. However, still applying the Board's preferred approach, if considered in its entirety, the derivative would not be classified as an equity instrument.

4.19 The Board considered whether, instead of classifying a derivative on own equity in its entirety, the entity should separate and classify separately the individual legs of the derivative. For example, a warrant to deliver own shares in exchange for receiving cash would have been classified as an equity component (the obligation to deliver own shares) and an asset component (the right to receive cash). The advantages of classifying the legs of a derivative separately include:

(a) that such classification would have been more consistent with how similar rights and obligations would have been classified if each leg had existed as a non-derivative financial instrument; and

(b) that it would have applied the same classification principle as that for non-derivative financial instruments, thus eliminating the need for developing a separate classification principle that applies to derivative financial instruments and eliminating the need for developing additional requirements for compound instruments and redemption obligations.

4.20 However, the Board rejected separating derivatives into components because of several challenges that it identified. The challenges include:

(a) conceptual challenges about whether the resulting components meet the definitions of assets, liabilities or equity given the interdependence of the rights and obligations of the contract.[44]

(b) the resulting 'gross-up' of the statement of financial position with assets that the entity may not control and equity that has not yet been issued (eg the receipt of assets and issuance of equity that is contingent on the holder exercising an option). This gross-up would have been inconsistent with the underlying objective of the Board's preferred approach, which is to depict whether the entity has sufficient economic resources to meet its obligations by providing information to assess funding liquidity and cash flows and to assess balance-sheet solvency and returns.

(c) practical challenges of separating a derivative into its components and measuring them separately, in particular for option derivatives.

44 As noted in paragraph 4.57 of the *Conceptual Framework* an executory contract establishes a combined right and obligation to the exchange. The right and obligation are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability.

(d) inconsistency with other IFRS Standards such as IFRS 9 because derivatives are not further separated into components in IFRS 9.

(e) in the predecessor FICE project, the Board and the US Financial Accounting Standards Board (the FASB) considered the Reassessed-Expected-Outcomes approach, which would have separated derivatives into components using option pricing techniques. However, the FASB and the Board ultimately decided not to pursue the approach given its complexity and cost.

4.21 The Board also considered whether, instead of classifying derivatives on own equity as equity instruments, financial assets or financial liabilities, it would be more appropriate to classify all derivatives on own equity as financial assets or financial liabilities. In previous consultations, some respondents have suggested that all derivatives on own equity should be classified as such on the grounds that no approach to classifying derivatives in their entirety can completely eliminate the conceptual challenges described in paragraph 4.11.

4.22 However, the Board rejected classifying all derivatives on own equity as financial assets or financial liabilities because it would:

(a) reduce the usefulness of the information provided through classification to make the assessments identified in Section 2.

(b) exacerbate the issue of recognising changes relating to the equity leg as income or expense, because more derivatives with an equity leg would be classified as financial assets or financial liabilities.

(c) have limitations similar to the basic ownership approach considered in the predecessor project. The approach not only classified all derivatives as financial assets or financial liabilities, but also classified all financial instruments other than the most subordinate claim against the entity (eg ordinary shares) as financial liabilities. While a basic ownership approach would eliminate the inconsistency between classification of derivative and non-derivative financial instruments discussed in paragraph 4.11, it would not provide any of the information through classification to make the assessments identified in Section 2.

4.23 Challenges described in paragraph 4.22 might be mitigated through additional presentation and disclosure requirements. However, mitigation through presentation and disclosure requirements would have shifted from classification to presentation and disclosure the challenges of providing useful information to help users of financial statements make the assessments identified in Section 2.

4.24 The Board reached the preliminary view as described in paragraph 4.16. The Board is seeking to address the practice challenges identified (see paragraph 4.14) when applying IAS 32 by:

(a) articulating the classification principle of the Board's preferred approach for derivatives on own equity in their entirety[45] (see paragraphs 4.25–4.66), which would clarify the rationale for distinguishing derivative financial assets or derivative financial liabilities from equity without fundamentally changing the existing classification outcomes of IAS 32; and

(b) improving the requirements and guidance for identifying liability and equity components for compound instruments and derivatives that include an obligation to extinguish own equity instruments (see Section 5).

Classification of derivatives on own equity applying the Board's preferred approach

4.25 As discussed in Section 3, the Board's preliminary view is that the Board's preferred approach would classify a non-derivative financial instrument as a financial liability if it contains:

(a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation (the timing feature); and/or

(b) an unavoidable contractual obligation for an amount that is independent of the entity's available economic resources (the amount feature).

4.26 The Board considered how the classification principle can be applied to derivatives on own equity in their entirety. In the Board's preliminary view, the Board's preferred approach would classify a derivative on own equity as a financial asset or financial liability if:

(a) it is net-cash settled—the derivative could require the entity to transfer cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation (the timing feature); and/or

(b) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources (the amount feature).

Asset/equity exchange derivatives

4.27 This section sets out the Board's discussion on classification of an asset/equity exchange derivative as described in paragraph 4.8(a). The assessment of the timing feature—determining whether a derivative on own equity requires the transfer of cash or another financial asset, and/or contains a right to receive cash, at a specified time other than at liquidation—is relatively straightforward. Applying the Board's preliminary view set out in paragraph 4.26(a):

45 The requirement to separate embedded derivatives in a compound instrument would not change. Application of this requirement would mean that standalone derivatives or embedded derivatives—once separated from the host contract—would not be required to be separated further for the classification purposes.

(a) if a derivative on own equity is net-cash settled and could require the entity to transfer cash at a specified time other than at liquidation, it would be classified as a financial liability;

(b) if a derivative on own equity is net-cash settled and could result in the entity receiving cash, for example, a net-cash settled purchased option on own equity, it would be classified as a financial asset because such a financial instrument represents a contractual right to receive cash; and

(c) if a derivative on own equity is either gross physically settled or net-share settled, the derivative would not oblige the entity to transfer cash or another financial asset at a specified time other than at liquidation; for those derivatives, an entity would consider the amount feature to determine their classification.

4.28 As discussed in paragraph 2.7, the amount of a financial instrument refers to how the financial instrument contract specifies the quantity of cash, other financial assets or own equity instruments that are required to be transferred. A derivative financial instrument represents an exchange contract of two legs. As a consequence of the decision to classify derivatives on own equity in their entirety, an entity would need to consider the combined effects of the two legs to determine the amount of such derivatives. In other words, the amount of a derivative on own equity would be determined as the *net amount* of the two legs of the exchange.

4.29 The Board observed that the net amount of a derivative on own equity is affected by the variables introduced by each leg of the exchange. In order for the net amount of a derivative to be not independent of the entity's available economic resources, all the variables that affect the net amount of the derivative must not be independent of the entity's available economic resources. For example, consider a derivative that requires an entity to deliver 100 ordinary shares of the entity for receiving CU100 in cash. The net amount of the derivative is determined by the combined effect of receiving CU100 and delivering 100 shares. The asset leg does not introduce a variable that affects the net amount because it is a fixed amount of cash in the entity's functional currency. Since the equity leg is a fixed number of ordinary shares to be delivered, the amount of the equity leg is determined by the ordinary shares' right to the pro-rata share of the net assets of the entity (paragraph 2.9). Therefore, the only variable affecting the net amount of the derivative is changes in the entity's available economic resources.[46] The net amount of this derivative is unaffected by any variable that is independent of the entity's available economic resources.

4.30 In assessing the amount feature of a derivative on own equity, the Board therefore considered how various variables, for example, interest rate, foreign currency or share price affect the net amount of the derivative. The variables can be categorised into two types:

46 When such derivatives are valued, a variable such as the entity's share price might be used as a proxy for changes in the entity's available economic resources.

(a) a variable that is independent of the entity's available economic resources ('independent variable'), for example, the receipt of an amount of cash indexed to a commodity index; and

(b) a variable that is not independent of the entity's available economic resources ('dependent variable'), for example, the price of the entity's own share.

4.31 Classification challenges arise for derivatives on own equity whose net amounts are affected by both independent variables and dependent variables. The classification would be clear if variables affecting both legs of a derivative are either all dependent on or all independent of the entity's available economic resources. An entity would classify a derivative on own equity as an equity instrument—if only affected by dependent variables—or as a financial asset or a financial liability—if only affected by independent variables. However, the net amount of many derivatives on own equity will be affected by both types of variables. For convenience, this Discussion Paper refers to these types of derivatives as 'partly independent derivatives'.

4.32 In the Board's preliminary view, partly independent derivatives would be classified as financial assets or financial liabilities for the reasons discussed in paragraphs 4.33–4.34.[47]

4.33 Classifying partly independent derivatives in their entirety as equity instruments would have raised a number of questions. These questions include:

(a) whether an equity classification would have been appropriate when changes in the carrying amounts resulting from independent variables would have been included in profit or loss if they arose from a separate contract that is classified as a financial asset or a financial liability;

(b) whether the presentation requirements for equity instruments that the Board is considering could adequately represent the effects of variables that are independent of the entity's available economic resources (see Section 6); and

(c) if only some such derivatives were to be classified as equity instruments, whether some types of variables, such as foreign currency indexation, should have different treatment from other variables, such as commodity indexation.

4.34 On the other hand, if all partly independent derivatives were classified in their entirety as financial assets or financial liabilities, changes in the carrying amounts of the derivatives resulting from changes in the entity's available economic resources would be recognised as income or expenses. For example, the net amount of a derivative that requires an entity to receive a fixed amount in a foreign currency in exchange for delivering a fixed number of the entity's own shares will change due in part to changes in the entity's available economic resources but also in response to changes in the foreign currency exchange rate. The Board thinks that this consequence can be mitigated by separate

47 Applying the fixed-for-fixed condition in IAS 32, all partly independent derivatives are classified as financial assets or financial liabilities subject to one exception with respect to particular foreign currency rights, options and warrants.

presentation of income and expenses arising from changes in the entity's available economic resources (see Section 6).

4.35 Thus, the Board's preferred approach would classify a standalone asset/equity exchange derivative on own equity, in its entirety, as a financial asset or financial liability if:

(a) it is net-cash settled—the derivative could require the entity to transfer cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or

(b) the net amount of the derivative is affected by an independent variable.[48]

Liability/equity exchange derivatives

4.36 Consistent with asset/equity exchange derivatives, in the Board's preliminary view, the Board's preferred approach would classify a standalone liability/equity derivative that extinguishes a financial liability in exchange for delivering equity instruments as a financial asset or financial liability if:

(a) it is net-cash settled—the derivative could require the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or

(b) the net amount of the derivative is affected by an independent variable.

4.37 A liability/equity exchange derivative typically exists as an embedded derivative in a non-derivative financial instrument (host instrument) and may extinguish existing financial liabilities or equity instruments of the entity as explained in paragraph 4.9. Because of this relationship, in the Board's preliminary view, an entity should consider the rights and obligations of such derivatives together with those of existing financial instruments that will be, or might be, extinguished. In order to consider how the Board's preferred approach could be applied consistently to various arrangements with the same rights and obligations, this Discussion Paper explores liability/equity exchange derivatives, in particular contracts to extinguish equity instruments, further in Section 5.

Summary of preliminary views and questions for respondents

4.38 In the Board's preliminary view, applying the Board's preferred approach, a derivative on own equity, would be:

(a) classified in its entirety; as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and

(b) classified as a financial asset or a financial liability if:

(i) it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or

48 Thus, applying the Board's preferred approach, partly independent derivatives on own equity would be classified as financial assets or financial liabilities.

(ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.

Comparison of preliminary view to IAS 32

4.39 Applying IAS 32, a derivative on own equity is classified as a financial asset or financial liability unless it meets the fixed-for-fixed condition or meets an exception for particular foreign currency derivatives, as described in paragraph 4.13(a).

4.40 The classification of derivatives on own equity applying the Board's preferred approach has many similarities in its requirements with those in IAS 32, including:

(a) classifying derivatives in their entirety;

(b) classifying as financial assets or financial liabilities all derivatives that are net-cash settled; and

(c) classifying as financial assets or financial liabilities[49] all derivative financial instruments with a net amount that is affected by an independent variable, such as a commodity index.

4.41 The classification principle of the Board's preferred approach for derivatives on own equity is based on the timing and the amount features, which are also used for classifying non-derivative financial instruments. As discussed in Section 3, the main difference between IAS 32 and the Board's preferred approach is how the classification principle is articulated with respect to the amount of a financial instrument. Instead of using a specific condition such as the fixed-for-fixed condition, the Board's preferred approach articulates the classification principle by reference to the amount of a financial instrument.

4.42 The Board expects that classification outcomes would remain largely the same for most types of derivatives on own equity. For example, all derivatives that meet the fixed-for-fixed condition applying IAS 32 are expected to be classified as equity instruments applying the Board's preferred approach. However, the classification outcomes for some derivatives on own equity might differ from those under IAS 32 because of the differences arising from clarifying the rationale and rearticulating the amount feature. For example:

(a) net-share settled derivatives to deliver a fixed number of an entity's own shares in exchange for receiving a variable number of its own shares with a total value equal to a fixed amount of the entity's functional currency[50] would be classified as equity instruments under the Board's preferred approach, but are classified as financial assets or financial liabilities under IAS 32. The Board's preferred approach considers whether there is a contractual obligation to transfer economic resources at a specified time other than at liquidation and as a result, gross

49 This is the case under IAS 32 (as a consequence of the fixed-for-fixed condition) except for particular foreign currency derivative financial instruments subject to the 'FX rights issue exception' noted in the footnote to paragraph 4.14(b).

50 The reverse, ie derivatives to deliver a variable number of own shares equal to a fixed amount of cash in exchange for receiving a fixed number of own shares are discussed in Section 5 because the derivatives result in extinguishment of a fixed number of own equity instruments.

physically settled instruments and 'net-share settled' instruments are classified consistently given that neither require the transfer of economic resources. Thus, if both types of instruments also have net amounts that are unaffected by a variable that is independent of the entity's available economic resources, the Board's preferred approach would classify both as equity instruments whereas IAS 32 classifies only 'gross-settled' derivatives as equity instruments.

(b) foreign currency rights issues that meet the exception in IAS 32 would be classified as financial assets or financial liabilities applying the Board's preferred approach. Such classification is consistent with derivatives on own equity whose net amount is affected by other independent variables, including other derivatives in foreign currency[51] such as the embedded conversion option in a foreign currency convertible bond.

4.43 Articulating the classification principle by reference to the amount feature would improve consistency in classification of derivatives on own equity that have similar consequences for the assessments identified in Section 2. Clarifying the underlying principle for classifying derivatives on own equity would also address application issues concerning the fixed-for-fixed condition in IAS 32 without fundamentally changing the classification outcomes of IAS 32. Paragraphs 4.45–4.66 discuss how identifying the underlying principle might help address some of these practical application issues.

4.44 One of the consequences of applying the Board's preferred approach to derivatives on own equity as set out in paragraph 4.38 is that entities would continue to classify partly independent derivatives as financial assets or financial liabilities. This means that changes in such financial assets or financial liabilities would include changes in the entity's available economic resources and those changes would be recognised as income or expense—the same way they are recognised when applying IAS 32. The Board considered whether separate presentation requirements could help alleviate these consequences and improve the information provided to users of financial statements (see Section 6).

51 The Board's preferred approach would include separate presentation requirements for foreign currency derivative financial instruments as discussed in Section 6.

Question 5
The Board's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows: (a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and (b) a derivative on own equity is classified as a financial asset or a financial liability if: (i) it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or (ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources. Do you agree? Why, or why not?

Further guidance on variables that affect the net amount of derivatives on own equity

4.45 This section considers how different variables in derivatives on own equity affect their classification applying the Board's preferred approach, in particular, variables that have resulted in questions and difficulties when applying the fixed-for-fixed condition in IAS 32.[52]

4.46 One application problem that arises when applying the fixed-for-fixed condition in IAS 32 is that IAS 32 does not define the term 'fixed' and is unclear about the rationale for the fixed-for-fixed condition. The Board considered whether its preferred approach would help address the application problems. For example, questions arise as to whether the fixed-for-fixed condition is met if:

(a) the amount of cash or another financial asset an entity will receive changes as a result of variables such as an interest rate.

(b) the unit of financial assets an entity will receive is fixed but the financial assets are exposed to changes in market prices that are independent of the entity's available economic resources. For example, the right to receive 100 ounces of gold is fixed in terms of the unit of gold, but is not fixed in terms of the entity's functional currency, and is exposed to changes in the market price of gold.

(c) the number of equity instruments an entity will deliver changes as a result of:

(i) changes in the number of shares outstanding, such as share splits; and

52 Based on submissions to the Committee and other consultations.

(ii) changes based on dividends paid on existing equity instruments, so that the number of equity instruments to be delivered is adjusted only to reflect the dividend paid.

4.47 The Board considered the following variables and discussed which variables would affect the net amount of a derivative on own equity in a way that is independent of the entity's available economic resources and which would not. Applying the Board's preferred approach, the Board thinks that:

(a) the following variables would be independent variables in all circumstances:

(i) currency—other than the entity's functional currency—and fixed units of financial assets (paragraphs 4.49–4.51); and

(ii) variables that depend on the entity's economic resources—before deducting all other claims against the entity (paragraph 4.52).

(b) on the other hand, the following variables could be considered as dependent variables in some but not all circumstances such that adjustments for these variables might not result in the amount feature being independent of the entity's available economic resources:

(i) time value of money (paragraphs 4.53–4.54);

(ii) dilution (paragraphs 4.55–4.58);

(iii) distributions to holders of equity instruments (paragraphs 4.59–4.61);

(iv) non-controlling interests (paragraph 4.62); and

(v) contingencies (paragraphs 4.63–4.66).

4.48 The discussion in paragraphs 4.49–4.66 is limited to identifying whether a given variable is independent of the entity's available economic resources in order to assess the amount of a derivative on own equity; and does not consider other variables or other features that may be relevant to the classification of the derivative as whole.

Currency or fixed units of financial assets

4.49 An entity's economic resources and claims against the entity, which make up the entity's available economic resources, are measured in the functional currency of the entity. Therefore, in assessing how a particular variable affects the net amount of a derivative on own equity, an entity would consider the net amount of the derivative in the entity's functional currency. If a derivative on own equity includes a foreign currency underlying, for example, the exercise price of an option is set in a foreign currency, the net amount of the derivative, in the entity's functional currency, would be affected by the exchange rate between the foreign currency and the entity's functional currency, which would change in a way that is independent of the entity's available economic resources. If the net amount of a derivative on own equity is affected by foreign currency, the reference to foreign currency is an independent variable and the derivative would be classified as a financial asset or a financial liability.

4.50 In some cases, an entity may enter into a derivative contract on equity instruments of another entity within the same group. The Board considered, in the context of the consolidated group financial statements, which entity's functional currency should be the reference point for assessing whether the net amount of the derivative is affected by a foreign currency variable. The Board thinks that the functional currency of the entity whose equity instruments form the underlying of the derivative should be the reference point. If a derivative represents a claim on the available economic resources of a specific entity within a group, the exposure to a currency other than the functional currency of that entity introduces an independent variable.

4.51 If the net amount of a derivative is affected by a fixed unit of financial assets that are linked to an independent variable (eg receipt of 100 units of a bond that is linked to a commodity index), the reference to the fixed units of financial assets would be an independent variable. Changes in the value of the fixed units of financial assets are independent of the entity's available economic resources.

Dependency on the entity's economic resources before deducting all other claims

4.52 As discussed in paragraphs 3.17–3.24, the entity's available economic resources are the total recognised and unrecognised assets[53] of the entity that remain after deducting all other claims against the entity.[54] Consequently, a variable that depends on the entity's total economic resources or a specific component thereof (ie before deducting *all* other claims against the entity) is an independent variable. The presence of the variable in a derivative on own equity could result in the net amount of the derivative changing independently of potential changes in other claims. For example, some derivative financial instruments might promise a share of total assets of an entity or a share of a performance measure that reflects changes in those assets such as EBIT. For example, consider a derivative that requires a transfer of 1% of EBIT of an entity. The net amount of the derivative would increase as long as the entity's EBIT increases, even when the entity makes a net loss resulting in a decrease in the entity's available economic resources. Such a variable is an independent variable.

Time value of money

4.53 The time value of money, whether implicit or explicit, is an inherent component of any financial instrument and is also inherent in any entity's available economic resources and therefore all equity instruments. Share price, a variable that often acts as a proxy for changes in the entity's available economic resources, also therefore include a time value of money component. Time value of money is an inherent component for derivatives in particular, because the definition of a derivative includes the requirement to be settled at a future date. The right to receive cash or another financial asset or the right to extinguish a financial liability in a derivative on own equity may be specified in terms of a

53 An entity should not need to determine its available economic resources to assess whether the amount of a financial instrument is independent of its available economic resources. This should be clear from the instrument's contractual terms.

54 All other claims against the entity including all liabilities and equity, except the financial instrument in question.

present value or a future value. Therefore, a variable that reflects compensation for the time value of money that is relevant to the derivative, such as an interest rate, could be a dependent variable. However, if a variable that represents the time value of money is leveraged or is unrelated to the derivative instrument (eg the benchmark interest rate of an unrelated currency), such a variable is an independent variable. Such a variable could change the net amount of a derivative independently of the entity's available economic resources.

4.54 For example, a written call option on own shares may have multiple exercise dates and a strike price that increases based solely on a relevant interest rate (in the entity's functional currency) at each exercise date. In a contract such as this, the strike price is specified in terms of the present value. Other contracts may specify the strike price as a fixed amount, in terms of the future value to be transferred at a future date of exercise. Both approaches to specifying the fixed amount can result in a dependent variable.

Dilution

4.55 Many equity instruments, including ordinary shares and derivatives that require delivery of a fixed number of an entity's own ordinary shares, are exposed to the potential dilution of their share in the available economic resources of the entity. For example, if an entity issues other ordinary shares that have a dilutive effect, it reduces the share of the entity's available economic resources attributable to the holders of existing ordinary shares or derivatives to receive a fixed number of ordinary shares. To mitigate the consequences of dilution, some derivatives on own equity, such as conversion options embedded in convertible bonds, may contain an anti-dilution provision. An anti-dilution provision adjusts the terms of exchange, for example, the conversion ratio, in the event of dilution to keep the derivative holder in the same economic position (for example, by entitling the holder to 1% of the ordinary shares in the entity at settlement).

4.56 An entity would need to determine whether an anti-dilution provision introduces another variable that is independent of the entity's available economic resources. If it does not, the anti-dilution provision in itself is not an independent variable. If the net amount of a derivative on own equity is unaffected by any independent variable, adding such an anti-dilution provision to the derivative would not result in the net amount of the derivative being independent of the entity's available economic resources. Given that many equity instruments are exposed to dilution, the presence or the absence of the anti-dilution provision would not change the assessment of the amount feature of a derivative on own equity, as long as the provision does not introduce an independent variable.

4.57 Some anti-dilution provisions are asymmetric, for example, the provisions adjust the number of shares to be delivered either only when there is an increase in the total number of shares (ie in the event of dilution), while others are symmetric—the provisions adjust the number of shares to be delivered for both increases and decreases in the total number of shares outstanding. The symmetric or asymmetric nature of the anti-dilution provision, on its own, does not determine whether the anti-dilution provision introduces an independent variable. Given that the presence or absence of the anti-dilution provision would not preclude equity classification—derivatives could be either fully dilutive or fully protected from any dilution, and could be classified as equity instruments, its presence or absence in particular scenarios would also not preclude equity classification. An example of such a provision is an asymmetric anti-dilution provision triggered for some dilution events, but not others.

4.58 Consider the following examples:

(a) a derivative may require an entity to deliver a variable number of shares that represent a fixed *proportion* of the entity's available economic resources (for example, 25% of issued shares) for a fixed amount of functional currency of the entity. By promising a fixed proportion of the entity's shares in issue, the net amount of the derivative will only be affected by changes in the entity's available economic resources. Such a contractual term does not introduce an independent variable.

(b) a derivative may require an entity to deliver a fixed number of shares subject to an adjustment that will occur in the event of dilution so that the holder receives shares worth at least CU100. Such a contractual term has the effect of the entity promising a delivery of an amount that is independent of the entity's available economic resources, at least in some scenarios in which the fixed number of shares are worth less than CU100, requiring the entity to deliver additional shares totalling CU100.[55] The amount of the obligation to deliver CU100 worth of own shares is independent of the entity's available economic resources because the amount of the obligation does not change in response to changes in the entity's available economic resources.[56]

Distributions to holders of equity instruments

4.59 A contractual term may adjust the amount of a derivative on own equity, such as adjustments in the conversion ratio or strike price, to compensate the holder for missed distributions to which holders of existing equity instruments would be entitled, eg dividends.

4.60 Such contractual terms may be a dependent variable. Although equity instruments contain no contractual obligation to transfer the entity's available economic resources at a specified time other than at liquidation, an entity may choose to distribute part of its available economic resources, for example, in the form of dividends. An entity would make such dividend payments out of the entity's available economic resources; therefore, the amount of dividends depends on the entity's available economic resources. The distribution of an entity's available economic resources to its existing equity instrument holders will reduce the entity's available economic resources available to future equity instrument holders including the derivative holder. From the perspective of the

55 If a derivative on own equity could require the entity to transfer an amount independent of the entity's available economic resources in at least one possible settlement outcome, the derivative would be classified as a financial asset or a financial liability. See paragraphs 4.63–4.66.

56 The amount of the obligation is determined as CU100. The number of equity instruments to be delivered for such an obligation might change in response to changes in the share price, but the amount of the obligation remains unchanged at CU100.

net amount of the derivative on own equity, the distribution has a similar effect to a dilution event, unless there is an adjustment for such distribution.

4.61 Similar to an anti-dilution provision, contractual terms that seek to compensate the holder for missed dividend distributions may be a dependent variable provided that those terms do not introduce another independent variable. Contractual terms that compensate for issued dividends seek to compensate the holder from the reduction in available economic resources resulting from dividend distributions, similar to an anti-dilution provision seeking to protect the holder from dilution resulting from increases in the total number of equity instruments. Similar to an anti-dilution provision, the presence or absence of this type of contractual term does not in itself introduce an independent variable.

Non-controlling interests

4.62 As discussed in paragraph 3.24(c), ordinary shares in a subsidiary held by non-controlling interests are equity instruments of the group. Therefore, an entity would apply the Board's preferred approach to derivatives on non-controlling interests in the same way as for derivatives on other own equity instruments. For example:

(a) the net amount of a written call option to deliver a fixed number of equity instruments of a subsidiary for receipt of a fixed amount of cash in the functional currency of the subsidiary would depend on the subsidiary's available economic resources and therefore would not preclude equity classification in the consolidated financial statements. This applies even if the consolidated group financial statements are presented using another currency or if the parent has another functional currency.[57]

(b) the net amount of a written call option to exchange a fixed number of the parent's own shares for a fixed number of its subsidiary's shares would depend on the available economic resources of the parent and of the subsidiary and therefore would not preclude equity classification in the consolidated financial statements.

Contingencies

4.63 The exercise of derivatives on own equity can be optional or non-optional. The exercise of non-option derivatives such as a forward contract is certain to occur whereas the exercise of option derivatives will be conditional upon the contingencies specified in the contract. The exercise may be at the option of the holder of the instrument or the entity, or contingent on an event beyond the control of both the holder and the entity.

4.64 Consistent with the classification of a non-derivative financial instrument discussed in paragraph 3.10, if an entity does not have the unconditional right to avoid a settlement outcome of a derivative on own equity that has the feature(s) of a financial asset or a financial liability, the derivative in its entirety would be classified as such regardless of whether its exercise is contingent on

57 See paragraph 4.50.

the holder or on an uncertain future event that is beyond the control of both the holder and the entity. A settlement outcome is considered avoidable only if its avoidance is within the control of the entity. From the perspective of the entity, the entity does not have unconditional ability to avoid a settlement outcome that has a feature(s) of a financial liability when exercise is contingent on the holder or on an uncertain future event that is beyond the control of the holder and the entity.

4.65 Applying the Board's preferred approach, contingencies that do not affect either the timing feature or the amount feature of a derivative on own equity[58] would not affect the classification of the derivative. However, if a contingency affects the net amount of a derivative on own equity, the entity would need to determine whether it introduces another variable that is independent of the entity's available economic resources. A contractual term may be such that the occurrence of a specified contingent event would vary the amount of cash receivable, or vary the number of equity instruments to be delivered, in a way that is independent of the entity's available economic resources. In such cases, the contingency introduces an independent variable.

4.66 For example, consider a derivative on own equity that requires the exchange of CU100 for delivering 100 ordinary shares and that is mandatorily exercised if event A occurs. If event A does not occur, the derivative is not exercised similar to an option that lapses if not exercised. The contingency does not affect the net amount of the derivative and does not affect its classification.

Section 5—Compound instruments and redemption obligation arrangements

5.1 As stated in Section 3, the Board developed separate classification principles for non-derivative and derivative financial instruments because of particular challenges arising from classification of derivatives on own equity. As stated in paragraph 4.37, additional requirements would be needed to support the consistent classification of arrangements that include liability/equity exchange derivatives. This section sets out the Board's discussion of the classification of embedded derivatives and derivatives that include an obligation to extinguish own equity instruments.

5.2 To provide comparable information for users of financial statements to make the assessments described in Section 2, classification should be consistent for all similar contractual rights and obligations regardless of how an entity has structured those rights and obligations. Otherwise, the information provided in the financial statements may reflect the form rather than the economic substance of the contractual arrangements. The Board's aim is to achieve consistency between the classification of all arrangements that have the same settlement outcomes but are structured differently as described in paragraphs 5.3–5.7 below.

58 Changes in the probability of the contingent event occurring are likely to affect the *fair value* of derivatives that include such a contingency. However, it does not always affect the net amount of such derivatives.

5.3 The Board observed that the same contractual rights and obligations of two financial instruments, a non-derivative financial liability and a *standalone* derivative to extinguish that financial liability in exchange for issuing equity instruments, can be structured as a compound instrument that combines an *embedded* derivative and a non-derivative financial liability that will be extinguished or converted. For example, an entity can issue a bond to pay CU110 in two years' time and write an option to convert that bond to 100 ordinary shares as part of the same contract, or as a separate option contract. Whichever way those rights and obligations are structured, they result in the entity having an obligation that has the feature(s) of a financial liability (the obligation to pay CU110) and an alternative obligation, at the holders' option, to exchange the obligation to pay CU110 for an obligation to deliver 100 ordinary shares.

5.4 In addition, the Board observed that liability/equity exchange derivatives with the same settlement outcomes could be structured with two different combinations of contracts, either:

(a) a financial liability and a derivative that could result in the extinguishment of that financial liability in exchange for delivering own equity instruments; or

(b) an equity instrument and a derivative that could result in the extinguishment of that equity instrument in exchange for an obligation that meets the definition of a liability.

5.5 For example, an entity could issue 100 ordinary shares and separately write an option for the holder to put the shares back to the entity in exchange for CU110 in two years' time. Alternatively, the entity could issue 100 puttable shares that can be put back to the entity in exchange for CU110 in two years' time. The combination of the ordinary shares and the written put option creates substantially the same contractual rights and obligations as the puttable shares, and both of these arrangements have similar settlement outcomes to the convertible bond example in paragraph 5.3. In all cases, at the end of year two, the entity will either have to pay CU110 or deliver 100 ordinary shares (or have 100 ordinary shares remain outstanding if the written put option is not exercised), but not both. For convenience, this Discussion Paper refers to these types of financial instruments as financial instruments with alternative settlement outcomes.

5.6 The Board also observed that both: (a) financial instruments with alternative settlement outcomes that are contingent on an uncertain future event beyond the control of both the entity and the holder; and (b) those that depend on the holder exercising rights, are beyond the control of the entity (the issuer). In both cases the entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability.

5.7 To reflect the economic substance of contractual arrangements with similar contractual rights and obligations in a consistent manner, the classification of financial instruments with alternative settlement outcomes should be consistent regardless of whether:

(a) the financial instrument to be extinguished is:

(i) a financial liability—that is combined with a derivative that could result in the extinguishment of that financial liability in exchange for delivering own equity instruments; or

(ii) an equity instrument—that is combined with a derivative that could result in the extinguishment of that equity instrument in exchange for an obligation that meets the definition of a financial liability;

(b) the liability/equity exchange derivative is part of the same contract—an embedded derivative—or a separate contract; or

(c) the settlement outcomes are controlled by the holder or are contingent on an uncertain future event beyond the control of both the entity and the holder.

5.8 To achieve consistency in classification, in the Board's preliminary view, the entity would:

(a) for a standalone derivative to extinguish an equity instrument, consider the package of contractual rights and obligations arising from the derivative and the underlying non-derivative equity instrument that will, or may, be extinguished (together referred to as a 'redemption obligation arrangement'). Once identified, the package of the contractual rights and obligations would then be analysed for classification purposes in a similar way as a compound instrument.

(b) for a compound instrument or a redemption obligation arrangement, classify separately the financial liability and equity components. If an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would:

(i) classify that unavoidable contractual obligation as a non-derivative financial liability, applying the non-derivative classification principle of the Board's preferred approach; and

(ii) classify any remaining contractual rights and obligations as an equity instrument, a financial asset or a financial liability, applying the derivative classification principle of the Board's preferred approach.

(c) if an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that have the feature(s) of a financial liability, the financial instrument does not contain a financial liability component.

5.9 This section is structured as follows:

(a) Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer):

(i) Compound instruments (paragraphs 5.12–5.14);

(ii) Redemption obligation arrangements (paragraphs 5.15–5.18);

(b) Further guidance on accounting for compound instruments and redemption obligation arrangements:

(i) Whether the liability component should include the effect of any conditionality (paragraphs 5.20–5.26);

(ii) Accounting within equity (paragraphs 5.27–5.32);

(c) Illustrative Examples of accounting for convertible bonds and written put options on own equity instruments (paragraphs 5.33–5.34);

(d) How the Board's preferred approach would address the challenges identified (paragraphs 5.35–5.42);

(e) Financial instruments with alternative settlement outcomes that are controlled by the entity (the issuer) (paragraphs 5.43–5.47); and

(f) Summary of preliminary views and questions for respondents (paragraph 5.48).

Financial instruments with alternative settlement outcomes that are not controlled by the entity (the issuer)

5.10 The Board first considered the classification of financial instruments with alternative settlement outcomes in which the entity (the issuer) does not control the settlement outcomes. That is because applying the Board's preferred approach as discussed in paragraph 3.10, when classifying a non-derivative financial instrument with alternative settlement outcomes, an entity would consider whether the entity has the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability. If it does not have such a right, the entity would classify that unavoidable contractual obligation as a non-derivative financial liability. Financial instruments with alternative settlement outcomes controlled by the entity are discussed in paragraphs 5.43–5.47.

5.11 To achieve consistency in classifying financial instruments with alternative settlement outcomes as discussed in paragraph 5.7, the Board considered the application of the classification principles in Sections 3 and 4 to the following:

(a) compound instruments—contracts that include both a liability and an equity component, for example, convertible bonds and puttable shares[59] (paragraphs 5.12–5.14).

(b) redemption obligation arrangements—arrangements that contain a non-derivative equity instrument and a standalone derivative to extinguish that equity instrument. An example of this type of arrangement is ordinary shares and a written put option on ordinary shares (paragraphs 5.15–5.18).

Compound instruments

5.12 In the Board's preliminary view, applying the Board's preferred approach, the issuer of a non-derivative financial instrument would evaluate its terms to determine whether it contains both a liability and an equity component. Such

59 The puttable shares discussed in this section are those that are not subject to the puttable exception.

components would be classified separately as financial liabilities, financial assets or equity instruments. This requirement is consistent with the requirement for compound instruments in IAS 32. Examples of compound instruments include convertible bonds and puttable shares.

5.13 Applying the classification principle of the Board's preferred approach for non-derivative financial instruments, if an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would identify that unavoidable contractual obligation first and classify it as a non-derivative financial liability.

5.14 Once the financial liability component has been identified, the entity would consider whether the remaining rights and obligations would be classified as an equity instrument if they existed as a separate contract.[60] Because the remaining rights and obligations would represent a liability/equity exchange derivative, the entity would apply the classification principle for derivative financial instruments as set out in Section 4 to classify those remaining rights and obligations as if they were included in a standalone derivative.

Redemption obligation arrangements

5.15 As discussed in paragraph 4.9, the Board distinguished between asset/equity exchange derivatives and liability/equity exchange derivatives because a liability/equity exchange derivative involves an extinguishment of an existing financial instrument whereas an asset/equity exchange derivative does not. The Board's preliminary view is that for a derivative that may result in an extinguishment of an existing non-derivative equity instrument of the entity, the entity should analyse the package of contractual rights and obligations arising from the derivative together with those arising from the existing equity instrument (ie consider the whole of the redemption obligation arrangement).

5.16 Once an entity identifies the package of contractual rights and obligations that arise from a redemption obligation arrangement as a whole, the entity would apply the compound instrument requirements under the Board's preferred approach as discussed in paragraphs 5.12–5.14. The entity would evaluate the package of contractual rights and obligations of the redemption obligation arrangement as if they were contained in a single compound instrument and would determine whether there are liability and equity components. If so, the entity would classify those components separately as financial liabilities, financial assets or equity instruments.

5.17 The additional requirement in paragraphs 5.15–5.16 to consider the package of contractual rights and obligations arising from a redemption obligation arrangement as a whole would apply only to derivatives that may extinguish own equity instruments in exchange for an obligation that has the feature(s) of a

60 Such an approach would be consistent with the existing compound instrument requirements of IAS 32. The financial liability component that is identified would also be allocated in a manner consistent with IAS 32 with any equity component measured as a residual.

financial liability; the requirement would not apply to derivatives to extinguish a financial liability by delivering own equity instruments[61] and asset/equity exchange derivatives.

5.18 The Board noted that the additional requirement for derivatives to extinguish an equity instrument in exchange for an obligation that has the feature(s) of a financial liability is necessary to achieve consistent classification of similar contractual rights and obligations, and to provide useful information for the assessments identified in Section 2. For example, if an entity had a forward contract to repurchase 100 of its own ordinary shares in exchange for cash equal to CU110 in two years' time, the entity would classify its obligation to pay CU110 as a financial liability. The entity has an unconditional obligation to pay CU110, which has similar consequences for the entity's cash flows and creates similar information needs for users of the entity's financial statements as a simple bond.[62] If the forward contract were accounted for in the same way as other derivative financial instruments, it would be presented as the net amount of the exchange, CU110 net of the fair value of 100 equity instruments. Classifying the forward contract separately on a net basis while continuing to recognise the underlying equity instruments as outstanding would not provide information about the contractual obligation to transfer CU110 in two years' time, which would be useful for the assessments identified in Section 2.

Further guidance on accounting for compound instruments and redemption obligation arrangements

5.19 The Board noted that the application of its preferred approach as discussed in paragraphs 5.12–5.16 would also help address a number of challenges and questions arising from the existing requirements of IAS 32, including:

(a) whether the effect of any conditionality in settlement outcomes should be included in the liability component of a compound instrument or a redemption obligation arrangement (paragraphs 5.20–5.26); and

(b) the lack of clear requirements for the accounting within equity (paragraphs 5.27–5.32).

Whether the liability component should include the effect of any conditionality

5.20 When applying IAS 32, questions arise regarding whether the conditionality in settlement outcomes should be included in:

(a) the non-derivative financial liability component, for example, by probability-weighting the liability component based on the likelihood of the liability settlement outcome occurring; or

61 For arrangements containing a non-derivative financial liability and a standalone derivative to extinguish that financial liability by delivering equity instruments, classifying the package of rights and obligations arising from the arrangement as a whole results in the same classification as classifying the financial liability and the derivative separately.

62 The only difference is that the equity instruments underlying the exchange will remain outstanding for the two years and grant the holder of the equity instruments the rights linked to those shares for that limited time (for example, the receipt of dividends).

(b) the derivative representing the rights and obligations remaining after the non-derivative financial liability component is separately accounted for.

5.21 As stated in paragraph 5.10, applying the Board's preferred approach, if a financial instrument does not give an entity the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, it would give rise to a financial liability of the entity, regardless of whether the settlement outcome is controlled by the holder or is determined by an uncertain future event that is beyond the control of both the entity and the holder. In either case, the entity has an unavoidable contractual obligation that has the feature(s) of a financial liability until that obligation is waived by the holder, or extinguished as a consequence of the occurrence or non-occurrence of the contingent event. Examples of such contingent events include events such as changes in the entity's future revenues, profit or loss, financial position ratios or own share price. Hence, any conditionality would be included in the derivative representing the remaining rights and obligations and not in the non-derivative financial liability (see also paragraphs 4.63–4.66).

5.22 Consider, for example, a mandatorily convertible instrument that requires the entity to deliver a variable number of its own shares with a total value equal to CU100, subject to a cap of 100 shares. The cap will be triggered automatically if the share price falls below CU1 per share. This means that the entity has an obligation to deliver either:

(a) CU100 in shares, if the share price is higher than CU1; or

(b) 100 shares, if the share price is equal to or lower than CU1.

5.23 Applying the Board's preferred approach, the obligation to deliver CU100 in paragraph 5.22 would be classified as a financial liability because of the amount feature—ie the obligation for an amount independent of the entity's available economic resources. The entity has an unavoidable contractual obligation to deliver CU100 of shares unless the share price falls to or below CU1. Such a contingent event is beyond the control of the entity. Therefore, applying the Board's preferred approach, the entity would first classify that obligation to deliver a variable number of its own shares with a total value equal to CU100 as a non-derivative liability component. In identifying the liability component, the entity would not consider the uncertainty that arises from conditionality, ie the likelihood of the share price falling below CU1. Once the liability component is identified, the entity would classify the remaining rights and obligations applying the classification principle of the Board's preferred approach for derivative financial instruments.

5.24 In compound instruments and redemption obligation arrangements, once a financial liability is identified, the remaining obligation would represent an obligation to exchange that financial liability with an equity instrument. Consequently, the effect of any conditionality in settlement outcomes would be part of the obligation to exchange, ie would be part of the derivative. The non-derivative financial liability component would not include the effect of conditionality.

5.25 The consequence of excluding the effect of the conditionality from the non-derivative financial liability component is that the financial liability recognised—reflecting the unavoidable contractual obligation to transfer economic resources—would be the same for the obligation arising from a forward contract and a written option. For example, an entity would recognise the same non-derivative financial liability for a mandatory share repurchase and a written put option on own shares that has the same terms except for the option feature. Any other alternative settlement outcome arising from a written put option would be recognised as a derivative on own equity, which represents a potential exchange of the financial liability for equity instruments.

5.26 The Board also observed that the consequence described in paragraph 5.25 is consistent with the conclusion that there is no carrying amount attributable to the equity component in an obligation to extinguish an equity instrument at its fair value. The liability component would represent the redemption amount—the obligation to pay the fair value of the equity instrument—as if it were unconditional. The remaining obligation for the entity is to exchange that obligation for an equity instrument with the same value. Therefore, the equity component has a zero value regardless of whether the redemption obligation was exercisable at the option of the holder or was contingent on an event beyond the control of both the entity and the holder—or whether the redemption was mandatory. Recognising the redemption obligation for the fair value of the equity instruments as a financial liability[63] provides the information required to help assessments of funding liquidity and cash flows as discussed in Section 2.

Accounting within equity

5.27 When applying IAS 32, questions arise with respect to accounting within equity because IAS 32 does not provide explicit requirements, in particular for obligations to extinguish own equity instruments. For example, if an entity has an obligation to purchase its own equity instruments for cash or another financial asset, paragraph 23 of IAS 32 requires recognition of the present value of the redemption amount as a financial liability and reclassification of the same amount from equity. However, it does not specify how to reclassify that amount.

5.28 Applying the Board's preferred approach to a redemption obligation arrangement, an entity would identify the unavoidable contractual obligation to extinguish its own equity instruments as a liability component and recognise this component as a financial liability by derecognising[64] the existing equity instruments. For a redemption obligation arrangement that includes a written put option,[65] there are remaining rights and obligations that need to be classified—the obligation to exchange the financial liability for own equity

63 Because the amount of the obligation would not be independent of the entity's available economic resources, income and expenses arising from such an obligation would be subject to the separate presentation requirements discussed in Section 6.

64 Although the equity instruments are derecognised on issuance of a written put option, it does not mean that the equity instruments have been extinguished at that point. The presence of a written put option on own equity instruments has changed the characteristics of the equity instruments to those of a financial liability.

65 For a forward contract to repurchase own equity instruments, there will be no other rights and obligations once a financial liability is recognised and own equity instruments derecognised.

instruments in the event that the holder of the put option does not exercise the option. That exchange obligation would be classified as a financial asset, a financial liability, or an equity instrument applying the classification principle of the Board's preferred approach for derivative financial instruments.

5.29 Any written put option on own shares comprises three parts—the strike price of the option (ie the redemption amount) less the fair value of the underlying shares plus the time value of the holder's right to exercise the option. One part of the exchange in the written put option, the obligation to pay the strike price, will be recognised as a financial liability. However, until the option is exercised, the holder has the choice not to exercise the option and, in such an event, the ordinary shares would remain outstanding. To faithfully represent the remaining rights and obligations, the entity would need to recognise a liability/equity exchange derivative representing that option of the holder. Such an option would be similar to a written call option contract to exchange that liability for equity instruments. This similarity is best illustrated by considering a scenario in which the share price of the entity approaches zero at the maturity of the put option. In this scenario, the fair value of the written put option is the strike price. This is already recognised as a financial liability under the Board's preferred approach. The fair value of the written call option, which would be required to be recognised applying the Board's preferred approach, would be worth nothing as the share price of the entity approaches zero at the maturity.[66]

5.30 Therefore, if an entity issues a written put option with a strike price of CU110 on 100 ordinary shares of the entity and receives CU10 as an option premium, the accounting applying the Board's preferred approach would be as follows:

(a) a financial liability would be recognised for the present value of CU110, the put option strike price.

(b) 100 units of the entity's own shares would be derecognised at fair value at the date when the written put option is issued.

(c) the remaining rights and obligations (the difference between the sum of the amounts (a) and (b), and CU10, the premium received for the written put option) would represent the option of the holder to waive their right to exercise the put and receive CU110 recognised in (a) in exchange for the 100 ordinary shares remaining outstanding. Such an option is similar to a written call option or conversion option in a convertible bond. An entity would classify this component as a financial asset or a financial liability, or an equity instrument in accordance with the derivative classification principle.

5.31 If the entity were to derecognise the underlying shares at the redemption amount recognised as a financial liability (ie the present value of CU110), the remaining component as described in paragraph 5.30(c) would equal CU10. This amount would represent the premium received for the written put option

66 The same issue described in this paragraph would apply even if the remaining rights and obligations are classified as derivative financial assets or financial liabilities. The Board's preferred approach clarifies the accounting for the remaining rights and obligations after identifying the financial liability for the redemption amount regardless of whether they are classified as equity or as a financial asset or liability.

contract, even though the remaining obligation represents that of a written call option. By derecognising the equity instrument at fair value, the amount effectively attributed to the option reflects the value of a similar written call option.

5.32 Consistency in accounting between a compound instrument and a redemption obligation arrangement would also be achieved after initial recognition. For example, if the written put option is not exercised and, hence, the holder does not exercise their right to put the entity's own shares to the entity in exchange for receiving the strike price, this outcome would be accounted for in a similar manner to the exercise of a conversion option in a convertible bond. On conversion of the convertible bond, the financial liability and equity components would be derecognised and the ordinary shares would be recognised. The entity would account for non-exercise of the written put by the holder in the same way. Even though the ordinary shares were never physically redeemed or issued, the written put option was issued and expired. The expiry of the written put option gives rise to similar consequences for the entity's financial position and financial performance as would arise in the case of conversion of the convertible bond.

Illustrative examples of accounting for convertible bonds and written put options on own equity instruments

5.33 The following examples illustrate how the Board's preferred approach would apply to contracts for an exchange of a financial liability and equity:

(a) Example 1—convertible bond: the entity issues a bond for CU100,000[67] in cash, which requires the entity to pay the holder an amount equal to CU110,000 in cash, two years from the date of issue. The bond also grants the holder the right to receive 100,000 ordinary shares of the entity instead of the CU110,000 in cash (the conversion option). Assume that:

(i) the bond has no interest payments and early settlement is prohibited;

(ii) the present value of CU110,000 payable in two years' time is CU82,000; and

(iii) the entity's ordinary share price at the end of two years is CU1.25 per share.

(b) Example 2—written put option on own equity: the entity issues 100,000 ordinary shares for CU0.9 each.[68] Simultaneously, the entity issues a written put option on 100,000 ordinary shares at a strike price of CU1.1 each. The put option is exercisable in two years' time and in return the entity received CU10,000 in cash as a premium. The present

67 Currency unit of the entity's functional currency.

68 For purposes of the illustration, the example assumes that the shares and the written put are issued simultaneously. However, the analysis would remain unchanged if the written put option and the shares were issued at different times.

value of the redemption amount (CU110,000) is CU82,000. The entity's ordinary share price at the end of two years is CU1.25 per share.[69]

5.34 In both examples:

(a) the obligation to pay CU110,000 in cash in two years' time would meet the definition of a financial liability applying the Board's preferred approach because it requires the transfer of cash at a specified time other than at liquidation, and it is for an amount independent of the entity's available economic resources. The subsequent accounting for the financial liability, including the unwinding of the discounting effect from CU82,000 to CU110,000, would be in accordance with IFRS 9. In both examples, because the amount of cash to be transferred is independent of the entity's available economic resources, the financial liability would not qualify for separate presentation applying the Board's preferred approach.[70]

(b) the option to exchange the liability in paragraph 5.33(a) for 100,000 ordinary shares is an equity component. The option has the feature of an equity instrument applying the Board's preferred approach as the option represents an exchange of a fixed amount of a financial liability in the entity's functional currency for a fixed number of own shares. The example considers both exercise and non-exercise of the option at the end of two years.

Journal entries

In Currency Units (CU)	Example 1: convertible bond		Example 2: written put option		
Identification of components and initial recognition	Debit (Dr) Cash	100,000	Dr Cash	90,000	
	Credit (Cr) Financial liability	82,000	Cr Equity—Ordinary Shares	90,000	
			On initial recognition of 100,000 ordinary shares @ CU0.9 per share		
	Cr Equity—Conversion option	18,000	Dr Cash	10,000	
	On initial recognition, the convertible bond is separated into its liability and equity components.		Dr Equity—Ordinary Shares	90,000	
			Cr Financial liability		82,000
			Cr Equity—Conversion option		18,000
			On initial recognition of the put option, the entity would derecognise the ordinary shares at fair value at the date the written put is issued, and recognise a liability for the redemption amount and an equity component.		

continued...

69 In our example, the ordinary shares do not pay dividends in the intervening period. The bond is not convertible or redeemable by the holder or the entity before the conversion date at the end of year two (ie it is a European style option) and does not meet the puttable exception.

70 If the amount of the obligation were not independent of the entity's available economic resources—for example, the redemption amount is equal to the fair value of the underlying shares—separate presentation requirements would apply to the financial liability. See Section 6.

...continued

In Currency Units (CU)	**Example 1: convertible bond**	**Example 2: written put option**
Recognition of accretion of interest over the life of the bond/written put option (after initial recognition)	Dr Interest expenses (profit or loss) 28,000 Cr Financial liability 28,000 *Over the period between initial recognition and the end of year 2, interest accrues on the bond and is recognised in profit or loss.*	Dr Interest expenses (profit or loss) 28,000 Cr Financial liability 28,000 *Over the period between initial recognition and the end of year 2, the financial liability accretes to the redemption amount and the accretion is recognised as interest in profit or loss.*
If equity settlement outcome is selected in year 2	Dr Financial liability 110,000 Dr Equity—Conversion option 18,000 Cr Equity—Ordinary shares 128,000 *If the bond is settled by delivering ordinary shares, the financial liability and conversion option shall be derecognised, and ordinary shares would be recognised.*	Dr Financial liability 110,000 Dr Equy—Conversion option 18,000 Cr Equity—Ordinary shares 128,000 *If the written put option is not exercised, the financial liability and conversion option would be derecognised, and ordinary shares would be recognised.*
If liability settlement outcome is selected in year 2[(a)]	Dr Financial liability 110,000 Cr Cash 110,000 Dr Equity—Conversion option 18,000 Cr Equity attributable to ordinary shares 18,000 *If the bond is settled by delivering cash, the financial liability would be derecognised, and the carrying amount of the conversion option would be reclassified within equity.*	Dr Financial liability 110,000 Cr Cash 110,000 Dr Equity—Conversion option 18,000 Cr Equity attributable to ordinary shares 18,000 *If the written put option is exercised and settled by delivering cash, the financial liability would be derecognised, and the carrying amount of the conversion option would be reclassified within equity.*

(a) Any requirements to reclassify amounts within equity will depend on what the Board decides on presentation requirements within equity. For example, if the Board decides to require attribution of total comprehensive income to equity instruments other than ordinary shares (see Section 6), the reclassification within equity would have more significant consequences on presentation.

How would the Board's preferred approach address the challenges identified?

5.35 Although IAS 32 requires similar accounting for a financial liability component in a compound instrument and an obligation to extinguish own equity instruments for cash or another financial asset, it does not discuss the relationship between these accounting requirements. This has resulted in a number of questions, including:

(a) whether the requirements in IAS 32 for an obligation to extinguish own equity instruments apply if a written put option is settled by transfer of a variable number of own shares. This question arises because requirements in paragraph 23 of IAS 32 refer only to obligations to transfer cash or another financial asset and are silent regarding settlement in own shares.

(b) how to account for transactions within equity. For example, IAS 32 requires the initial recognition of a financial liability for the present value of the redemption amount and a reclassification of this amount from equity. However, it does not specify how to reclassify the amount.

5.36 One transaction that illustrates the challenges that arise is accounting for NCI puts. In 2012, the Committee published a draft interpretation that addressed the recognition of changes in the measurement of the liability.[71] However, respondents to that draft interpretation suggested that the Board should address the accounting for NCI puts more comprehensively. The respondents pointed out that other aspects of the accounting for NCI puts have resulted in diversity in practice. The aspects of accounting that raise diversity in practice include:

(a) the account the debit is recognised in when reclassifying the present value of the redemption amount from equity. For NCI puts, in particular, the question is whether the non-controlling interest is derecognised, or a contra-equity account is recognised within parent equity.

(b) how to account within equity for any premium received for NCI puts, and for the expiration or exercise of the NCI puts.

5.37 Answering these questions for NCI puts would have consequences for the accounting for transactions such as dividends or other distributions. Answering these questions would also affect whether a portion of the subsidiary's profit or loss should continue to be attributed to the NCI as required by paragraph B94 of IFRS 10 *Consolidated Financial Statements*, after NCI puts are written.

5.38 As discussed in paragraphs 5.19–5.32 and demonstrated by the illustrative examples set out in paragraphs 5.33–5.34, the Board's preferred approach would require consistent accounting for redemption obligation arrangements, including NCI puts and compound instruments. Consistent accounting for these arrangements would improve the usefulness of the financial statements because both have similar contractual rights and obligations that result in similar liability and equity outcomes. By clarifying the relationship between the requirements for such arrangements, the Board's preferred approach would improve the consistency and completeness of the requirements. The requirement to identify the liability component would also apply to redemption obligation arrangements that require a transfer of a variable number of own shares, if the amount of the contractual obligation to transfer own shares is independent of the entity's available economic resources, thus answering the question described in paragraph 5.35(a).

5.39 The Board's preferred approach would also clarify accounting for equity components. For NCI puts, the accounting in the consolidated financial

71 The redemption obligation requirements in this regard would be carried forward under the Board's preferred approach. The separate presentation requirements under the Board's preferred approach consider the presentation of changes in the measurement of such liabilities.

statements would be the same as that in Example 2 set out in paragraphs 5.33–5.34 except that the underlying equity instruments are shares that represent the NCI. Applying the Board's preferred approach would thus require:

(a) recognition of a liability component at the redemption amount (which will be subsequently measured in accordance with IFRS 9);

(b) derecognition of the NCI—the ordinary shares of the subsidiary that represent the NCI—on which put options are written, at the fair value of the ordinary shares of the subsidiary at the date the put options are issued; and

(c) recognition of an equity component for the—implicit—written call option on the subsidiary's shares.

5.40 Similar entries would be required for the expiry or exercise of the NCI puts as shown in Example 2 set out in paragraphs 5.33–5.34. However, if the puts expire unexercised, instead of ordinary shares of the parent set out in paragraphs 5.33–5.34, the shares of the subsidiary would be recognised.

5.41 Gains or losses, including those arising from subsequent measurement of the liability component, are recognised as income and expense, while changes in the equity components are recognised in the statement of changes in equity.

5.42 If the NCI put is a fair value put, consistent with the discussion in paragraph 5.26, the equity component would be nil. The financial liability would be remeasured in accordance with IFRS 9—reflecting the change in the fair value of the NCI. The returns on the put would be reflected in the liability component with changes in the carrying amount of the liability recognised as income or expenses. The separate presentation requirements might apply to the gains and losses on the financial liability component (see Section 6).

Financial instruments with alternative settlement outcomes that are controlled by the entity (the issuer)

5.43 As stated in paragraph 5.10, the Board considered how the Board's preferred approach would classify a financial instrument with alternative settlement outcomes controlled by the entity.

5.44 Some financial instruments have alternative settlement outcomes and give the entity an unconditional right to choose the settlement outcome. Consider, for example, a so-called reverse convertible bond that grants the entity the unconditional right to settle the bond either by delivering 100 of its own shares at any time, or by paying cash of CU110 at the bond's maturity. The entity has the obligation to settle the bond in one of two ways, but the entity has the unconditional right to avoid the liability settlement outcome by choosing to deliver 100 shares. Such a financial instrument can be analysed as containing an obligation to deliver a fixed number of equity instruments together with a right—not an obligation—of the entity to extinguish that obligation by delivering cash instead. The reverse convertible bond does not contain a financial liability component, unless the bond establishes an obligation that has the feature(s) of a financial liability indirectly (see Section 8). Applying the Board's preferred approach, the entity would classify the bond as an equity instrument reflecting the right to deliver 100 shares and thus avoid cash settlement.

5.45 The Board considered whether, and if so, how the information about the entity's right to choose the alternative settlement outcome—paying CU110 in cash in the example in paragraph 5.44—should be provided in the financial statements. The Board discussed potential ways to provide information about the alternative settlement outcome, including:

(a) separation of embedded derivatives from the equity host instrument; and

(b) presentation and disclosure, such as attribution within equity.

5.46 The entity's right to deliver CU110 instead of 100 shares for the financial instrument described in paragraph 5.44 is an embedded derivative—a purchased call option on own shares. The Board considered whether the embedded derivative should be separated from an equity host instrument. Separation would mean that if the embedded derivative does not have the features of an equity instrument applying the Board's preferred approach, the derivative would be classified as a financial asset. The Board discussed the following as the potential benefits and challenges of such separation:

(a) more information about the alternative settlement outcomes would be provided through classification and the resulting recognition and measurement of the embedded derivative, which would decrease the pressure on the presentation and disclosure requirements in providing information about the embedded derivative. Separation of the embedded derivative would also enhance consistency of classification between different arrangements with similar contractual rights and obligations.

(b) on the other hand, the challenges with separating embedded derivatives from equity host instruments include identifying and defining the host instrument, and specifying the order of separation. There are many possible ways of performing the separation, and clarifying these aspects would be necessary for financial instruments with similar contractual rights and obligations to be classified consistently. The Board also observed that separating embedded derivatives from an equity host instrument would lead to a gross-up of assets and equity in the statement of financial position and that the effect will be more significant for deep out-of-the-money options.[72] Requiring separation may also result in a change in practice.

5.47 The Board observed that the need for the information described in paragraph 5.45 arises not only when applying the Board's preferred approach; it also arises when applying IAS 32. However, the Board is not aware of the extent

72 Consider an example of an issuer-held share conversion option in a reverse convertible bond that is deep out of the money. A deep out-of-the-money share conversion option suggests that the share settlement option is much more expensive than the cash settlement option. This in turn means that the entity's option to pay cash (effectively reflecting the right to call back the shares) instead of delivering shares is highly valuable. If the embedded option were to be separated from the host, the entity would recognise shares as if they are issued and recognise the entity's right to pay cash to call those shares back as a financial asset. Since the entity's option to pay cash (rather than to issue shares) is highly valuable, a high value option asset and a high value equity instrument are recognised although it is unlikely that the entity would actually choose to deliver shares and thus it is unlikely that ultimately the equity would remain outstanding.

of the significance and prevalence of challenges associated with this issue applying IAS 32. In view of the limited information about the significance of the issue and the complexity associated with the potential solutions, the Board did not develop a preliminary view. After receiving feedback on this Discussion Paper, the Board intends to discuss whether to address this issue and if so, how.

Summary of preliminary views and questions for respondents

5.48 In the Board's preliminary view, applying the Board's preferred approach, an entity would:

(a) for a standalone derivative to extinguish an equity instrument, consider the package of contractual rights and obligations arising from the derivative and the non-derivative equity instrument that will, or may, be extinguished. Once identified, the package of the contractual rights and obligations would be analysed for classification purposes consistent with a compound instrument.

(b) for a compound instrument or a redemption obligation arrangement, classify separately the financial liability and equity components. If an entity does not have the unconditional right to avoid a settlement outcome that has the feature(s) of a financial liability, the entity would:

   (i) classify that unavoidable contractual obligation as a non-derivative financial liability, applying the non-derivative classification principle of the Board's preferred approach; and

   (ii) classify any remaining rights and obligations as an equity instrument, a financial asset or a financial liability, applying the derivative classification principle of the Board's preferred approach.

(c) if an entity has the unconditional right to avoid all settlement outcomes of a financial instrument that have the feature(s) of a financial liability, the financial instrument does not contain a financial liability component.

Question 6
Do you agree with the Board's preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity's own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34. For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47. (a) Do you think the Board should seek to address the issue? Why, or why not? (b) If so what approach do you think would be most effective in providing the information, and why?

Section 6—Presentation

6.1 As discussed in Section 2, the Board considered what information is best provided through classification using the distinction between liabilities and equity and what information is best provided through presentation and disclosure requirements. This section sets out the Board's preliminary views on the information that would be provided through presentation applying the Board's preferred approach. This section considers:

(a) presentation of financial liabilities (paragraphs 6.2–6.54); and

(b) presentation of equity instruments (paragraphs 6.55–6.95).

Presentation of financial liabilities

6.2 The Board's preferred approach would classify financial instruments as financial liabilities or derivative financial assets or liabilities[73] if they have either one or both features of a financial liability, because those features are relevant to the assessments that the Board identified in Section 2. Consequently, some financial liabilities and derivatives on own equity that are classified as financial assets or financial liabilities will have features relevant to only one of those assessments. As discussed in paragraph 2.35, to provide information that will help users of financial statements make each of the identified assessments separately, the Board developed presentation requirements that would provide information about financial liabilities and derivative financial assets and liabilities that have only one of the two features. As discussed in paragraph 2.37, this section also considers how information about the secondary distinctions—such as further

73 In this section, derivative financial assets and liabilities refer to derivatives on own equity that are classified as financial assets or financial liabilities applying the Board's preferred approach set out in Section 4.

disaggregated information about the timing and the amount features of financial liabilities and the priority of financial liabilities—could be provided through presentation.

6.3 This section is structured as follows:

(a) assessments of balance-sheet solvency and returns—providing information through presentation about the amount feature, which would be relevant to this assessment (paragraphs 6.6–6.48);

(b) assessments of funding liquidity and cash flows—providing information through presentation about the timing feature, which would be relevant to this assessment (paragraphs 6.49–6.52); and

(c) a summary of preliminary views and questions for respondents (paragraphs 6.53–6.54).

6.4 In the Board's preliminary view, to facilitate assessments of balance-sheet solvency and returns, an entity should, applying the criteria-based approach:[74]

(a) in the statement of financial position, present separately carrying amounts of:

(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

(ii) derivative financial assets and derivative financial liabilities that have net amounts unaffected by any independent variable; and

(iii) partly independent derivatives that meet the criteria in paragraph 6.34.

(b) in the statement of financial performance, present in other comprehensive income (OCI), without subsequent reclassification, income and expenses arising from:

(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

(ii) derivative financial assets and derivative financial liabilities that have net amounts unaffected by any independent variable; and

(iii) partly independent derivatives that meet the criteria in paragraph 6.34.

6.5 In the Board's preliminary view, no presentation requirements need to be developed to provide information about the timing feature of financial liabilities because existing presentation and disclosure requirements in other IFRS Standards provide sufficient information to facilitate assessments of funding liquidity and cash flows.

Assessments of balance-sheet solvency and returns

6.6 This subsection sets out how the Board developed its preferred approach to presentation of financial liabilities—including derivative financial assets and liabilities—and how these presentation requirements would provide further

74 See paragraphs 6.21–6.48.

information about the amount feature of financial liabilities and derivative financial assets and liabilities to facilitate assessment of balance-sheet solvency and returns. The Board considered the following:

(a) statement of financial position (paragraphs 6.7–6.9);

(b) statement of financial performance (paragraphs 6.10–6.15);

(c) financial instruments to which the presentation requirements would apply (paragraphs 6.16–6.20);

(d) how the presentation requirements would apply (paragraphs 6.21–6.41); and

(e) whether the presentation requirements should be achieved using OCI (with or without subsequent reclassification) or using a separate line item within profit or loss (paragraphs 6.42–6.48).

Statement of financial position

6.7 The Board considered whether separate presentation of financial liabilities and derivative financial assets and liabilities using additional line items or subclassifications would provide further disaggregated information about how a financial instrument contract specifies the amount and the priority of the claims on liquidation. As discussed in paragraph 2.30, additional information about these secondary distinctions would help users of financial statements make more detailed assessments of balance-sheet solvency and returns. For example, financial liabilities that do not contain an obligation for an amount that is independent of the entity's available economic resources (eg shares redeemable at fair value) would be presented in a separate line item from those that do contain such an obligation (eg ordinary bonds). This distinction is not currently required under IFRS Standards.

6.8 The Board also considered whether providing information about financial liabilities—and for that matter, equity instruments—that have different priority levels on liquidation of the entity (for example, in order of priority:[75] senior ordinary bonds, unsecured bonds, share-settled debt and cumulative preference shares) should be required on face of the statement of financial position. As discussed in Section 2, arranging claims by priority on liquidation would help users of financial statements assess in more detail how any potential shortfall or surplus in economic resources is allocated among claims.

6.9 In the Board's preliminary view, an entity should:

(a) present, on the face of the statement of financial position, financial liabilities and derivative assets or liabilities that do not contain an obligation for an amount that is independent of the entity's available economic resources separately from those that do. The Board's consideration about the set of financial instruments to which this

75 The order of priority of financial instruments determines how an entity's total economic resources are allocated on liquidation. The order of maturity of financial instruments is determined by the timing of required settlement.

presentation requirement would apply is set out in more detail together with a discussion of the presentation requirements for income and expense in paragraphs 6.10–6.48.

(b) present financial liabilities and equity in order of priority on the face of the statement of financial position, or disclose this information in the notes to the financial statements. If the statement of financial position is presented using a current or non-current presentation, classes of financial liabilities and equity could be arranged by order of priority within those subtotals. Otherwise, the information about the priority of financial liabilities and equity on liquidation would be disclosed in the notes to the financial statements. The Board's considerations about how the information could be provided about the priority of financial instruments through disclosure is outlined in paragraphs 7.4–7.12.

Statement of financial performance

6.10 The Board considered whether it would be useful to present income and expenses that result from changes in the entity's available economic resources separately from other income and expenses, so that users of financial statements would be able to distinguish them for the purposes of making assessments of an entity's financial performance as identified in Section 2.

6.11 Applying the Board's preferred approach to classification, some financial instruments are classified as financial liabilities even though they do not contain an obligation for an amount independent of the entity's available economic resources. Income and expenses that arise from such instruments are affected by changes in the entity's available economic resources. The Board identified the following instruments that would include such effects in income and expenses:

(a) financial liabilities that do not contain an obligation for an amount independent of the entity's available economic resources but are classified as financial liabilities due to their timing feature—a requirement to transfer cash or another financial asset at a specified time other than at liquidation. One example of such an instrument is shares redeemable at fair value that do not meet the puttable exception.

(b) derivative financial assets and liabilities[76] that have net amounts unaffected by any independent variable but are classified as financial assets or financial liabilities due to their timing feature (such as net-cash settled derivatives on own equity).

(c) partly independent derivatives.[77] Income and expenses that arise from such derivatives would include the effects of changes in the entity's available economic resources in addition to the effects of independent variables.

76 Derivative financial instruments that have a net amount that is unaffected by any independent variables would be classified as financial assets or financial liabilities if they are net-cash settled. See Section 4.

77 Applying the Board's preferred approach, all partly independent derivatives (ie derivatives on own equity whose net amounts are affected by both independent and dependent variables) are classified as financial assets or financial liabilities. See Section 4.

6.12 The Board thinks that it would be useful to separately present income and expenses of the financial assets and financial liabilities described in paragraph 6.11. Such separate presentation would be useful because:

(a) such income and expenses are not relevant to the assessments of an entity's financial performance as identified in Section 2; and

(b) recognising changes in the carrying amount of such financial instruments in profit or loss may also appear counter-intuitive due to the accounting mismatch that arises from incomplete recognition of changes in the value of other assets and other liabilities of an entity.

6.13 This apparent counter-intuitive accounting was also one of the concerns that led to the puttable exception, because:

(a) when an entity performs well, the carrying amount of the liabilities increases and a loss would be recognised on those liabilities; and

(b) when an entity performs poorly, the carrying amount of the liabilities decreases and a gain would be recognised on those liabilities.

6.14 However, the concerns regarding the counter-intuitive effects on the income statement are not limited to financial instruments subject to the puttable exception but apply to all financial instruments classified as financial assets or financial liabilities that contain an obligation for an amount that is affected by changes in the entity's available economic resources—the financial instruments identified in paragraph 6.11. Respondents also expressed similar concerns to the May 2012 Draft Interpretation on the accounting for NCI puts,[78] in particular, for written puts with a fair value strike price.

6.15 Consequently, the Board developed presentation requirements that would provide the information in paragraph 6.12 for financial instruments identified in paragraph 6.11. The Board did so considering its preferred approach to classification and the requirements of IFRS 9 because IFRS 9 sets out how financial instruments identified in paragraph 6.11 are accounted for. In particular, the Board considered the following:

(a) financial instruments to which the separate presentation requirements would apply (paragraphs 6.16–6.20);

(b) how the separate presentation requirements should apply (paragraphs 6.21–6.41); and

(c) whether the separate presentation requirements should apply within profit or loss, or using OCI (with or without subsequent reclassification) (paragraphs 6.42–6.47).

Financial instruments to which the separate presentation requirements would apply

6.16 Presentation of income and expenses from financial assets and financial liabilities is affected by how those financial assets and financial liabilities are measured and accounted for under IFRS 9. Consequently, any new or additional

78 See paragraph 5.36 for further detail.

subclass of financial liabilities to which the Board's presentation requirements would apply needs to be considered within the context of the classification and measurement requirements in IFRS 9.

6.17 After initial recognition, IFRS 9 requires that an entity measures a financial liability at either amortised cost or fair value through profit or loss.[79] For particular financial liabilities such as derivatives, measurement at fair value through profit or loss is required,[80] whereas for some others, designation at fair value through profit or loss is permitted, subject to specific conditions (the fair value option).[81]

6.18 IFRS 9 contains specific requirements for accounting for an embedded derivative, which it describes as 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.[82] If the economic characteristics and risks of an embedded derivative are not closely related to those of the host, IFRS 9 requires the entity to separate the embedded derivative from the host unless the hybrid contract is measured at fair value through profit or loss.[83] These requirements apply to hybrid contracts that contain a host that is not an asset within the scope of IFRS 9.[84]

6.19 Paragraph B4.3.5(c) of IFRS 9 states that equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar. Consequently, if a hybrid contract contains an embedded derivative that is not independent of the entity's available economic resources, the embedded derivative would be required to be separated from the host instrument, unless the fair value option is applied to the entire instrument.

6.20 Accordingly, the financial instruments identified by the Board in paragraph 6.11 would be measured at fair value through profit or loss applying IFRS 9. The instruments would be one of the following types of financial instruments:

(a) a standalone derivative on own equity that:

(i) has a net amount that is unaffected by a variable that is independent of the entity's available economic resources; and

(ii) is classified as a financial asset or a financial liability because of the requirement to transfer cash or another financial asset (for example, a net-cash settled derivative on own equity).

(b) a standalone derivative on own equity that:

79 See paragraph 4.2.1 of IFRS 9. We have not considered the classification of financial guarantee contracts and loan commitments, because they are not relevant to this Discussion Paper.

80 See paragraph 4.2.1(a) of IFRS 9.

81 See paragraphs 4.2.2 and 4.3.5 of IFRS 9.

82 See paragraph 4.3.1 of IFRS 9.

83 See paragraph 4.3.3 of IFRS 9.

84 See paragraph 4.3.2 of IFRS 9.

(i) is partly independent of the entity's available economic resources, ie the net amount of the derivative is affected by both independent variables and dependent variables (for example, a contract to deliver a fixed number of the entity's own shares in exchange for a fixed amount of foreign currency); and

(ii) is therefore classified as a financial asset or a financial liability, because applying the Board's preferred approach, all partly independent derivatives are classified as such (see Section 4).

(c) a hybrid instrument that:

(i) contains a non-derivative financial liability and an embedded derivative that has the same features as a standalone derivative in (a) or (b); and

(ii) is designated as measured at fair value through profit or loss as a whole applying the fair value option, ie the embedded derivative is not separated.

(d) an embedded derivative that:

(i) has the same features as a standalone derivative in (a) or (b); and

(ii) is separated from the non-derivative host contract.[85]

How would the separate presentation requirements apply?

6.21 The Board considered applying the following approaches to the presentation requirements to the types of financial instruments described in paragraph 6.20:

(a) disaggregation approach; and

(b) criteria-based approach.

6.22 As far as derivatives on own equity are concerned, the Board observed that the choice of approach would only matter for partly independent derivatives because for derivative financial assets or liabilities that have a net amount that is unaffected by any independent variable (ie standalone or embedded derivatives described in paragraph 6.20(a)), applying either approach in paragraph 6.21 would result in the same presentation.

6.23 Applying the disaggregation approach, an entity would disaggregate, for presentation purposes, income and expenses arising from all partly independent derivatives (ie standalone or embedded derivatives described in paragraph 6.20(b)) into:

(a) the portion of income and expenses that result from the effect of dependent variables, which would be subject to separate presentation; and

(b) the portion of income and expenses that result from the effect of independent variables, which would not be subject to separate presentation. In other words, this portion of the income and expenses

85 The host contract may be a non-financial liability.

would be presented together with income and expenses arising from other derivatives which are affected by independent variables.

6.24 Applying the criteria-based approach, an entity would apply the presentation requirements to the total income and expenses arising from a partly independent derivative, if the derivative meets particular criteria. Unlike the disaggregation approach, the separate presentation requirements would only apply to some partly independent derivatives that meet particular criteria (ie the total income and expenses in respect of those derivatives, including the effect of independent variables).

Relative benefits of the criteria-based approach and the consequences of its application

6.25 In the Board's preliminary view, the criteria-based approach better achieves the objective of the presentation requirements. The criteria-based approach has the following advantages over the disaggregation approach:

(a) applying the criteria-based approach, income and expenses arising from a derivative financial asset or liability are presented in their entirety; therefore, they reflect the effects on the fair value of the derivative of all variables in the instrument, including interdependencies between the variables.

(b) applying the criteria-based approach would be less complex and less costly than the disaggregation approach, both for preparers to implement and users of financial statements to understand. The Board observed that there is no consistent way to disaggregate the income and expenses in a manner that is comparable. The Board considered different ways of disaggregating changes in the fair value of derivatives by keeping constant the independent variables, but concluded that it is often difficult to isolate the effect of a change in particular variables due to their interdependency.

(c) the criteria-based approach could be applied in a consistent manner for the purposes of separate presentation in the statement of financial position (see paragraph 6.9) and statement of financial performance. In contrast, the disaggregation approach would require additional consideration as to how the disaggregation would be applied in the statement of financial position. Applying the disaggregation approach in a consistent manner in the statement of financial position and statement of financial performance would require a disaggregation of the carrying amount of partly independent derivatives. Such a requirement would present additional challenges for derivatives with non-zero fair value at initial recognition such as options.

(d) the criteria-based approach is more consistent with the proposed approach to classifying derivatives on own equity under the Board's preferred approach and the requirements in IFRS 9, in that a derivative is classified and accounted for in its entirety.

6.26 However, applying the criteria-based approach to partly independent derivatives, the income and expenses presented separately would include the effect of some independent variables—to the extent permitted by the criteria selected—reducing the usefulness of the presentation requirements. This is a disadvantage of applying the criteria-based approach, but the Board thinks that this could be mitigated by the criteria selected (see paragraphs 6.28–6.34).

6.27 The Board also noted that applying the criteria-based approach requires additional consideration of how the approach would apply to hybrid instruments with embedded derivatives, whereas the disaggregation approach could be applied to standalone derivatives and hybrid instruments in the same way without the need for further requirements. The Board's discussion on this issue is set out in paragraphs 6.37–6.41.

Developing the criteria-based approach

6.28 In developing the criteria, the Board sought to strike an appropriate balance, bearing in mind the following:

(a) if the criteria are too complicated it would be costly for preparers to apply them and difficult for users of financial statements to understand the resulting information.

(b) if the criteria are too broad, the income and expenses separately presented would include the effects of too many independent variables, which would reduce the usefulness of the separate presentation of income and expenses. Also, broad criteria could lead to opportunities to structure contracts to achieve an accounting result and could also lead to diversity in practice. For example, an entity could avoid presenting in profit or loss the income and expenses arising from a financial instrument by simply including a minor reference to a variable that depends on the entity's available economic resources (for example, share price). The criteria therefore need to be effective at mitigating these risks. The need for stringent criteria is similar to the basis for the accounting requirements for embedded derivatives in IFRS 9, which aim to prevent entities from circumventing the requirements for derivatives by embedding a derivative in a non-derivative host contract using the 'closely-related' concept.

6.29 The Board considered the existing requirements for assessing whether an embedded derivative is closely related to the host in a hybrid instrument. In particular, it examined some of the examples of closely related economic characteristics set out in paragraph B4.3.8 of IFRS 9 and considered whether those examples could be used as the criteria for identifying whether and if so, what type of partly independent derivatives should be subject to the presentation requirements.

6.30 The Board initially identified an interest rate and a foreign currency variable as potential candidates[86] but concluded that the only variable that might be

86 The Board considered other examples of closely related economic characteristics and risks in paragraph B4.3.8 of IFRS 9 but concluded that they are not relevant to derivatives on own equity. Those examples relate to very specific types of contracts and cannot be applied to derivatives on own equity in a meaningful way. These other examples include prepayment features in a principal-only or interest-only strip, unit-linking features and other lease or insurance contract related examples.

relevant in considering the criteria for the presentation requirements is a foreign currency variable. That is because, applying the Board's preferred approach, a derivative on own equity would not typically be classified as a financial asset or a financial liability as a consequence of the presence of an interest rate variable as discussed in paragraphs 4.53–4.54.

6.31 In relation to embedded foreign currency derivatives, paragraph B4.3.8(d) of IFRS 9 does not require separation of embedded foreign currency derivatives in the following circumstances:

> ... an embedded foreign currency derivative... 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 (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

6.32 Some derivatives on own equity may have a foreign currency variable for similar reasons to those described in paragraph B4.3.8(d) of IFRS 9. For example, some entities enter into derivatives on own equity with a strike price denominated in a foreign currency for reasons such as:

(a) the entity's shares are listed on a foreign stock exchange; and

(b) there is no market for convertible bonds denominated in the entity's functional currency, or the costs of issuing convertible bonds in the entity's functional currency are prohibitive.

6.33 The Board noted that in limited circumstances, IFRS 9 does not require separation of embedded foreign currency derivatives (see paragraph 6.31). The Board, therefore, considered whether it would be appropriate to separately present income and expenses arising from some particular derivatives if the independent variable is a foreign currency variable that arises for similar reasons. The Board acknowledged that requiring separate presentation for only some types of foreign currency derivatives would result in two foreign currency exposures with the same economic effect being presented differently by different entities. This risk was incorporated into the Board's considerations in setting the criteria for separate presentation.

6.34 In the Board's preliminary view, in addition to separately presenting income and expenses arising from financial instruments described in paragraphs 6.11(a)–6.11(b), an entity should include all income and expenses arising from a partly independent derivative in the amounts presented separately, if all of the following criteria are met:

(a) the derivative has a net amount that otherwise is unaffected by any other independent variable; the only independent variable is a currency other than the entity's functional currency.

(b) the foreign currency exposure is not leveraged.

(c) the foreign currency exposure does not contain an option feature.

(d) the denomination in the foreign currency is imposed by an external factor. For example, the currency denomination is imposed by law or regulation, or market forces are such that denominating the derivative in the entity's functional currency would not have been practically possible.

6.35 If a derivative that is partly independent does not meet the criteria in paragraph 6.43, an entity would present all income and expenses from that derivative in profit or loss without separate presentation.

6.36 In addition, for presentation in the statement of financial position, an entity would present separately the carrying amount of the partly independent derivatives that meet the criteria. Specifically, the total carrying amount of all such derivatives would be presented as a separate line item on the face of the statement of financial position.

Application of the criteria-based approach to hybrid instruments

6.37 As noted in paragraph 6.27, the Board considered the application of the criteria-based approach to hybrid instruments. A hybrid instrument may contain an embedded derivative with a net amount that is unaffected by any independent variables. For example, a bond may include an 'equity kicker' that, at maturity, obliges the entity to pay cash equal to the difference between the value of a fixed number of the entity's ordinary shares and the contractual amount of the bond.[87] Other hybrid instruments may contain embedded derivatives that are partly independent of the entity's economic resources.

6.38 If an embedded derivative in a hybrid contract is separated from the host (ie embedded derivatives described in paragraph 6.20(d)), the separate presentation requirements using the criteria-based approach discussed in paragraphs 6.21–6.36 would apply. However, some embedded derivatives may not have been separated from the host because the hybrid instrument as a whole is measured at fair value through profit or loss (ie hybrid instruments described in paragraph 6.20(c)).[88] For such instruments, the Board considered the following two alternatives:

(a) Alternative A—apply these separate presentation requirements only to embedded derivatives that are separated from the host and hybrid instruments that, as a whole, do not contain any obligation for an amount independent of the entity's available economic resources, for example, shares redeemable at fair value.

87 A derivative with these features, even if it had existed on its own, would be not be classified as an equity instrument because the entity is required to transfer cash at maturity of the instrument, ie at a specified time other than at liquidation.

88 Derivatives embedded in a hybrid contract described in paragraph 6.20(c) would not be closely related to the host contract for the reason discussed in paragraph 6.19.

(b) Alternative B—apply these separate presentation requirements to all embedded derivatives regardless of whether they are separated from the host. Under this alternative, the entity would be required to separate all embedded derivatives for purposes of applying the presentation requirements even though the entity measures the hybrid contract as a whole at fair value through profit or loss.

6.39 The choice between the two alternatives does not affect how the separate presentation requirements would apply to embedded derivatives that are separated from the host. Under either alternative, they would be subject to the separate presentation requirements discussed in paragraphs 6.21–6.36.

6.40 The Board observed that making a decision between the two alternatives would need to consider striking a balance between:

(a) maximising the benefits of improved comparability by applying the criteria in paragraph 6.34 to both standalone and embedded derivatives—whether separated or not from the host contract—in the same way; and

(b) minimising the costs and complexity of the requirements. One of the reasons for allowing an entity to designate a hybrid instrument as a whole at fair value through profit or loss is to reduce the costs and complexity of separating embedded derivatives from the host.

6.41 The Board did not reach a preliminary view on the application of the criteria-based approach to hybrid instruments, and decided to seek feedback using this Discussion Paper.

Whether the separate presentation requirements should apply within profit or loss, or using OCI

6.42 The Board considered whether income and expenses that meet the criteria for the separate presentation requirements should be presented as a separate line item in profit or loss, or as a separate line item in OCI. If presented in OCI, the question also arises whether those amounts should be subsequently reclassified to profit or loss. In the Board's preliminary view:

(a) an entity should separately present in OCI income and expenses arising from financial liabilities and derivative financial assets and liabilities described in paragraphs 6.11(a)–6.11(b) as well as from partly independent derivatives that meet the criteria in paragraph 6.34; and

(b) an entity should not reclassify these amounts presented in OCI to profit or loss.

6.43 The Board's preliminary view is that using OCI would be a more effective way of applying the separate presentation requirements to income and expenses. The relative advantages of applying these presentation requirements using OCI over separate presentation within profit or loss include:

(a) separate presentation using OCI would provide a clearer distinction between income and expenses that result from changes in the entity's available economic resources, and income and expenses presented in profit or loss;

(b) separate presentation using OCI would enhance the relevance of profit or loss[89] for the purpose of assessing whether the entity has produced a sufficient return on its economic resources to satisfy the return that its claims oblige the entity to achieve; and

(c) separate presentation using OCI would alleviate the concern over the accounting mismatch described in paragraph 6.14.

6.44 The relative disadvantages of applying these presentation requirements using OCI include:

(a) doing so would expand the use of OCI to a new type of income or expenses, which adds additional complexity to OCI. The default requirement for presenting income and expenses—in the *Conceptual Framework*—is to present them in profit or loss.

(b) profit or loss will not include some recognised changes in the value of financial assets or financial liabilities. These gains or losses are economic gains or losses on claims against the entity.

(c) entities might have stronger incentives to try to structure financial instruments that would be presented in OCI to avoid presenting income and expenses in profit or loss.

6.45 The fact that changes in the value of financial instruments that do not contain an obligation for an amount independent of the entity's available economic resources might be volatile had no bearing on the Board's preliminary view that separate presentation should be in OCI.

6.46 The Board considered whether the amounts presented in OCI should be subsequently reclassified (recycled) to profit or loss. In the Board's preliminary view, an entity should not reclassify these amounts separately presented in OCI to profit or loss, because the nature of these income and expenses will not be different in the future and will therefore not be relevant to assessments of performance at a future date. In reaching this preliminary view, the Board acknowledged the points set out in paragraphs 6.47–6.48.

6.47 One of the consequences of separate presentation using OCI without subsequent recycling into profit and loss is that changes in the value of some financial liabilities will never be included in profit or loss. For example, consider a share redeemable for its fair value. As share price increases over time, the value of the financial liability will increase, and so will the amount of cash the entity has to pay on redemption. The information about the increase in the amount of the future cash outflow will not be presented in profit or loss, even when the payment is made.

6.48 The Board compared the income and expenses arising from financial instruments that do not contain an obligation for an amount independent of the

89 Paragraph 7.17 of the *Conceptual Framework* states that '[...] all income and expenses are, in principle, included in [the statement of profit or loss]. However, in developing Standards, the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period.'

entity's available economic resources with gains and losses arising from changes in own credit risk of financial liabilities designated as measured at fair value through profit or loss. Such income and expenses:

(a) are similar in the sense that both are affected by changes in the available economic resources of the entity. Therefore, presenting such gains and losses similarly in OCI, without recycling, would help users of financial statements in making the assessments of balance sheet solvency and returns.

(b) are however different in the following way—if the entity repays the contractual amount, the cumulative effect over the life of the financial instrument of any changes in the liability's credit risk will net to zero because its fair value will ultimately equal the contractual amount.[90] This is one reason why IFRS 9 requires presentation of such gains or losses in OCI without recycling. In contrast, changes in the fair value of financial instruments that do not contain an obligation for an amount independent of the entity's available economic resources will not be reversed over the instrument's life.

Assessments of funding liquidity and cash flows

6.49 The Board considered whether separate presentation of financial liabilities and derivative financial assets and liabilities using additional line items or subclassifications would be helpful in providing further disaggregated information about the timing feature—the required transfer of economic resources at different specified times other than at liquidation. As discussed in paragraph 2.23, information about these secondary distinctions would help users of financial statements make more detailed assessments of funding liquidity and cash flows. For example, additional subclassifications within liabilities might be useful to show:

(a) financial liabilities that are specified as payable on demand (eg demand deposits, shares redeemable at fair value at any time);

(b) financial liabilities payable at specified times other than liquidation (eg ordinary bonds, trade payables); and

(c) financial liabilities that require a transfer of economic resources only at liquidation (eg irredeemable cumulative preference shares).

6.50 IAS 32 sets out requirements for classifying financial instruments as liabilities or equity while IAS 1 and IFRS 7 *Financial Instruments: Disclosure* sets out presentation and disclosure requirements for financial liabilities and other financial instruments. Some IAS 1 requirements provide information relevant to assessments of funding liquidity and cash flows. IAS 1 requires entities to present current and non-current liabilities separately, or to present the liabilities in the order of liquidity thus:[91]

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90 See paragraph BC5.53 of Basis for Conclusions on IFRS 9.
91 See paragraph 60 of IAS 1.

(a) applying the current or non-current presentation[92] requirements, for example:

(i) shares redeemable at fair value on demand would be classified as current liabilities; and

(ii) irredeemable cumulative preference shares would be classified as non-current liabilities.

(b) applying an order of liquidity presentation, different classes of liabilities are presented, ranked based on maturity. Under this presentation, for example, shares redeemable at fair value on demand would be presented before irredeemable cumulative preference shares.

6.51 The Board considered but rejected requiring separate presentation of financial liabilities that have a contractual obligation to transfer cash or another financial asset only at liquidation from other non-current liabilities. Distinctions between longer maturities are less relevant for assessments of funding liquidity and cash flows than are distinctions between shorter maturities. In addition, IFRS 7 already requires a maturity schedule for financial liabilities in the notes to the financial statements.

6.52 Therefore, in the Board's preliminary view, the requirements in existing IFRS Standards are sufficient for providing the information necessary for making assessments of funding liquidity and cash flows when considered together with the information that would be provided through classification of financial instruments applying the Board's preferred approach.

Summary of preliminary views and questions for respondents

6.53 In the Board's preliminary view, to facilitate assessments of balance-sheet solvency and returns, an entity, applying the criteria-based approach, should:

(a) in the statement of financial position, present separately carrying amounts of:

(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

(ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

(iii) partly independent derivatives that meet the criteria in paragraph 6.34.

(b) in the statement of financial performance, present in OCI, without subsequent reclassification, income and expenses arising from:

(i) financial liabilities that contain no obligation for an amount that is independent of the entity's available economic resources;

92 See paragraph 69 of IAS 1.

(ii) derivative financial assets and derivative financial liabilities that have net amounts that are unaffected by any independent variable; and

(iii) partly independent derivatives that meet the criteria in paragraph 6.34.

6.54 In the Board's preliminary view, no presentation requirements need to be developed to provide information about the timing feature because presentation and disclosure requirements in other IFRS Standards provide sufficient information to facilitate assessments of funding liquidity and cash flows.

Question 7
Do you agree with the Board's preliminary views stated in paragraphs 6.53–6.54? Why, or why not? The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

Separate presentation of equity instruments

6.55 Currently, IFRS Standards require more useful information to be presented and disclosed by the issuing entity for financial instruments classified as financial liabilities than for those classified as equity instruments. One objective of the FICE project is to consider how to improve the information provided about equity instruments by issuing entities.

6.56 Applying the Board's preferred approach, financial instruments classified as equity instruments would contain neither an obligation for the entity to transfer economic resources, nor an obligation for an amount independent of the entity's available economic resources. However, different equity instruments may have differences between their rights and obligations. These differences may result in the allocation of different amounts of the residual return to different classes of equity instruments based on features that are not reflected by their classification as equity. These different features could include differences in:

(a) the priority of the claim on liquidation (eg non-cumulative preference shares and ordinary shares);

(b) pay-offs (eg warrants with different exercise prices) and contingencies (eg options and forwards); and

(c) restrictions on dividends, buy-backs or other distributions.

6.57 Information about the different features of equity instruments would be useful for users of financial statements in assessing the distribution of returns among those equity instruments. Existing IFRS Standards do not specifically require entities to provide information about different equity instruments, even if some equity instrument features are similar to those of financial liabilities.

6.58 The Board considered requiring entities to provide information about equity instruments using one or more of the following methods:

(a) enhancing the presentation requirements for different classes of equity through the statement of changes in equity and providing information about the distribution of returns by expanding the attribution of total comprehensive income to equity instruments other than ordinary shares (see paragraphs 6.60–6.86); and/or

(b) improving disclosure requirements about equity instruments, in particular, providing better information about the potential dilution of ordinary shares from financial liabilities and equity instruments (see Section 7) and better information about the fair value of derivative equity instruments (see paragraphs 6.87–6.90).

6.59 Requiring entities to provide more information through presentation and disclosure would respond to the requests from users of financial statements for information about classes of equity other than ordinary shares. Doing so should also reduce the differences in information that financial statements provide about financial liabilities and equity instruments, thus mitigating one of the consequences of classification (see paragraph 2.13).

Statement of changes in equity and attribution of total comprehensive income

6.60 Requirements in IAS 1 include principles for the presentation of equity on the face of the statement of financial position and the statement of financial performance as well as in the statement of changes in equity, including:

(a) profit or loss and OCI are allocated between amounts attributable to non-controlling interests and owners of the parent (holders of equity instruments of the parent);[93]

(b) total equity in the statement of financial position and statement of changes in equity is disaggregated into classes, at a minimum between non-controlling interests and parent equity interests;[94] and

(c) the statement of changes in equity includes information about changes resulting from:[95]

(i) the amounts of total comprehensive income attributable to non-controlling interests and parent equity interests; and

(ii) transactions with owners in their capacity as owners, such as contributions and distributions.

6.61 In addition to the requirements of IAS 1, basic earnings per share and diluted earnings per share, calculated applying the requirements in IAS 33, provide

93 See paragraph 81B of IAS 1.
94 See paragraph 54(q)–54(r) of IAS 1.
95 See paragraph 106 of IAS 1.

some information about the effects of equity instruments other than ordinary shares on the returns on ordinary shares. However, that information is limited because:

(a) both basic and diluted earnings per share calculations include the effect of some, but not all, equity instruments other than ordinary shares, for example, these calculations do not include the effect of antidilutive equity instruments;

(b) the workings of the calculation of earnings per share are not presented on the face of the statement of financial performance and the carrying amounts of equity instruments are not updated; and

(c) only a few disclosure requirements provide information about attributing total comprehensive income between different types of equity instruments.

6.62 In the Board's preliminary view, the information required by IAS 1 should be improved to require total equity and changes in equity to be disaggregated between ordinary shares and equity instruments other than ordinary shares. In particular, expanding the attribution of total comprehensive income to other equity instruments would improve the information provided about the effects that different features of equity instruments have on the distribution of returns between equity instruments. The residual total comprehensive income would be allocated to ordinary shares after the attribution to all other equity instruments. For these purposes, an ordinary share is the class of equity that:[96]

(a) is the most subordinate claim; and

(b) requires the entity to transfer economic resources only at liquidation and the amount of economic resources to be transferred at liquidation is equal to a pro rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.[97]

6.63 The advantage of expanding attribution to other equity instruments is that such attribution would present, in a single place, the effect on ordinary shares of having other classes of equity instruments outstanding. As a result, the attribution of returns to all equity instruments would provide a complete picture of how equity instruments affect each other's returns. The attribution of returns would also result in the carrying amounts for each class of equity being updated for the amount of total comprehensive income attributed to it, and presenting such changes in carrying amounts in the statement of changes in equity, similar to non-controlling interests. Such a requirement, together with the improvements to the identification of different equity components as discussed in Section 5, would improve the information provided about equity instruments and the consistency, completeness and clarity of the requirements for equity instruments.

96 Ordinary shares may include two or more classes that present the same priority and rights at liquidation, but that could have different rights such as voting rights.

97 Similar characteristics were identified in the definition of a Basic Ownership Instrument in the predecessor FICE project.

6.64 In the Board's preliminary view, attribution of total comprehensive income to all equity instruments should be presented on the face of the statement of financial performance.

6.65 In considering how total comprehensive income should be attributed to various equity instruments, the Board considered the existing requirements of IAS 33 as a starting point.

6.66 This project is not reconsidering the requirements in IAS 33. Therefore, entities would continue to disclose basic and diluted earnings per share as currently required by IAS 33. Furthermore, the objectives of the proposed attribution requirements in this Discussion Paper are similar to, but not the same as, the objectives of IAS 33. Nevertheless:

(a) the distinction between liabilities and equity is related to the requirements in IAS 33—hence this project could lead to consequential amendments to IAS 33; and

(b) preparers will incur costs to provide the information required; however, using IAS 33 as the starting point would both reduce the cost of applying the attribution requirements and limit the implications for IAS 33.

Determining the amount to attribute to classes of equity

6.67 The Board considered the attribution of total comprehensive income to:

(a) non-derivative equity instruments other than ordinary shares (see paragraphs 6.68–6.69); and

(b) derivative equity instruments (see paragraphs 6.70–6.91).

Non-derivative equity instruments other than ordinary shares

6.68 In the Board's preliminary view, the attribution of total profit or loss and OCI to non-derivative equity instruments (for example, non-cumulative preference shares and participating equity instruments) should follow the existing calculation for basic earnings per share in IAS 33. Applying IAS 33, the numerator for basic earnings per share is calculated by adjusting profit or loss attributable to the parent entity for the after-tax amounts of preference dividends, the differences arising on the settlement of preference shares and other similar effects of preference shares classified as equity instruments. In addition, for the purposes of calculating basic and diluted earnings per share, IAS 33 has requirements for 'participating equity instruments' (paragraphs A13–A14 of IAS 33).

6.69 Thus, the attribution requirements for non-derivative equity instruments would be for an entity to present on the face of the statements of financial performance the calculation of basic earnings per share applying IAS 33. Doing so would align the attribution requirements with the calculation of basic earnings per share, which would reduce the costs of these attribution requirements.

Derivative equity instruments

6.70 Applying IAS 33, diluted earnings per share is calculated by adjusting basic earnings per share for the effects of all dilutive potential ordinary shares.[98] However, IAS 33 requires only limited information about various equity instruments of the entity because there is no specific requirement to disclose the effect of options or warrants that are antidilutive. Some written options that are out-of-the-money and all purchased options are antidilutive under IAS 33.

6.71 As mentioned in paragraphs 6.62–6.63, the objective of the attribution requirements is to provide information about the distribution of returns among all equity instruments. Therefore, attributing total comprehensive income to all equity instruments would provide useful information regardless of whether those equity instruments are currently dilutive or antidilutive.

6.72 The Board discussed the following three approaches for calculating the attribution of total comprehensive income to derivative equity instruments:

(a) a full fair value approach—total profit or loss and OCI would be attributed to derivative equity instruments based on changes in their fair value, with the residual being attributed to ordinary shares (see paragraphs 6.74–6.78).

(b) an average-of-period approach—total profit or loss and OCI would be attributed to derivative equity instruments using relative average fair values through the period (see paragraphs 6.79–6.82).

(c) an end-of-period approach—total profit or loss and OCI would be attributed to derivative equity instruments indirectly. This would be calculated by first using relative fair values at the end of the period to attribute the carrying amounts of derivative equity instruments and ordinary shares at the end of the period. The attribution amount would then be based on the changes in the carrying amounts attributed from one period to another (see paragraphs 6.83–6.86).

6.73 The Board acknowledges that any approach to attribution would entail additional costs to prepare the information. In particular, all three approaches would require the entity to measure the fair value of equity derivatives, which could be difficult if those fair values are not observable. Therefore, the Board also considered whether a better balance between the benefits and costs would be achieved if preparers were required to provide information about such equity instruments only through disclosure and the requirements of IAS 33 (see paragraphs 6.87–6.90).

Full fair value approach

6.74 Applying this approach, each derivative equity instrument would be measured at fair value at the end of each reporting period and total comprehensive income attributed to the derivative would equal the change in fair value of that

98 IAS 33 defines *potential ordinary shares* as a financial instrument or other contract that may entitle its holder to ordinary shares. Potential ordinary shares are dilutive when their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.

instrument in the period. Ordinary shares would receive the residual amount of total comprehensive income after attributing portions to each derivative equity instrument.

6.75 The advantages of attribution based on full fair value would be that:

(a) it would provide similar information as is provided for derivatives classified as liabilities. Thus, the information would be similar to that provided by applying a classification approach in which all derivatives are classified as financial assets or financial liabilities, such as approaches that classify only ordinary shares as equity instruments.

(b) the fair value of an option contract would reflect the probability that the ordinary shares will be issued. In contrast, applying IAS 33, the calculation of diluted earnings per share reflects only the intrinsic value of the option (ie it effectively assumes that the option will be exercised immediately).

(c) the fair value measurement would be an understandable measurement basis for the carrying amount of the derivative equity instruments.

6.76 Users of financial statements could also use information about the fair value of derivative equity instruments for estimating the value of an entity's ordinary shares. For example, this information could be used by equity investors and analysts to estimate the value of an entity's ordinary shares by first estimating the value of total equity and then deducting from that total the fair value of derivative equity instruments.

6.77 The disadvantages of attribution based on fair value are that:

(a) the change in a derivative equity instrument's fair value is unlikely to have significant predictive value for returns on the instrument unless the entity also discloses the inputs to that valuation (for example, the strike price);

(b) total changes in the fair value of derivative equity instruments may exceed total comprehensive income, which would result in a negative amount being attributed to ordinary shares, even when the economic returns on both derivative equity instruments and ordinary shares are positive (also see similar challenges in 6.12(b)); and

(c) it could distort an entity's price-to-earnings ratio and price-to-book ratio for ordinary shares (see illustrative example after paragraph 6.91).

6.78 Unlike the full fair value approach, the average-of-period approach (see paragraphs 6.79–6.82) and the end-of-period approach (see paragraphs 6.83–6.86) are both based on relative fair values. Thus, they would mitigate the consequences of incomplete recognition and mixed measurement because they would be based on the recognised net assets of the entity or on changes in the recognised net assets, alleviating the concerns about a fair value-based attribution approach (see paragraph 6.77(b)).

Average-of-period approach

6.79 Applying the average-of-period approach, the entity would calculate the amount of total comprehensive income attributed to a derivative equity instrument as follows:

(a) calculate the ratio for the derivative equity instrument as its average fair value for the period compared with the average fair value of all derivative equity instruments and ordinary shares for the period; and

(b) apply the ratio in (a) to the total comprehensive income of the period.

6.80 The rationale behind the average-of-period approach is to use the average-of-period fair value ratio to apportion the entity's total comprehensive income for the period. The objective would be to achieve an attribution amount that could be used by users of financial statements in a similar way as diluted earnings per share calculated by applying IAS 33. Similar to earnings per share calculations, the amount attributed to derivative equity instruments and ordinary shares applying this approach would be proportionate to their fair values; therefore, it would not be possible to attribute a negative amount in the case of a positive total comprehensive income (and vice versa).

6.81 The average-of-period approach might better depict the returns in the period on ordinary shares and derivative equity instruments than other approaches to attribution, because this approach would treat the derivative equity instruments as common share equivalents based on their relative average fair value during the period (see comments in the illustrative example after paragraph 6.91). Such an approach is similar to calculating the additional dilutive shares required for calculating diluted earnings per share applying IAS 33. However, the average-of-period approach uses the fair value of the derivative equity instruments instead of their strike price, and is not limited to instruments that are dilutive at the reporting date.

6.82 The amount attributed to ordinary shares after applying the average-of-period approach could be used as an input to frequently used earnings ratios, similar to diluted earnings per share, and as an input for the purposes of calculating earnings multiples, for example, the price-to-earnings multiple of ordinary shares. In the illustrative example after paragraph 6.91, the price-to-earnings ratio for ordinary shares calculated using the average-of-period approach arguably accurately reflects the ratio of the price of the ordinary shares to the total comprehensive income that is attributable to ordinary shares because this approach would take into account both the dilutive and anti-dilutive effects, unlike diluted earnings per share. However, the average-of-period approach might not provide useful information about the end-of-period carrying amounts.

End-of-period approach

6.83 Applying the end-of-period approach, the entity would calculate the amount of total comprehensive income attributed to a derivative equity instrument as follows:

(a) calculate the ratio for each derivative equity instrument as its fair value at the end of the period compared to the fair value of all derivative equity instruments and ordinary shares at the end of the period;

(b) apply the ratio in (a) to the total carrying amount of equity attributed to all derivative equity instruments and ordinary shares (ie excluding other non-derivatives) to calculate the carrying amount to be allocated to the derivative; and

(c) calculate the amount of attribution required to update the carrying value of the derivative equity instrument to equal the amount in (b).

6.84 The rationale of the end-of-period approach is to reallocate the end-of-period carrying amount of equity among the various derivative equity instruments and ordinary shares so as to reflect the end-of-period fair value ratio. Thus, the end-of-period approach might better depict the relative carrying amounts of the total of the different components of equity at the end of the period than would the other approaches.

6.85 Users of financial statements could use such information for calculating book ratios of ordinary shares, for example, the price-to-book ratio of ordinary shares. In the illustrative example set out in paragraph 6.91, the price-to-book ratio for ordinary shares that is calculated using this approach represents the ratio of the price of the ordinary shares to the carrying value attributed to ordinary shares on a relative fair value basis.

6.86 However, the end-of-period approach may not accurately depict the distribution of returns during the period because the changes in the carrying amounts of derivative equity instruments would include catch-up and other adjustments. These would arise because equity instruments other than ordinary shares would be issued at fair value whereas the carrying amount of equity prior to the issuance would typically be different to the fair value of the equity instruments. This results in a catch-up adjustment to the issued equity instruments in the period they are issued (see further comments in the illustrative example after paragraph 6.91).

Disclosure only

6.87 Given the costs and complexity of any approach to attribute total comprehensive income to equity derivatives, the Board considered whether sufficient information about the effect of derivative equity instruments on ordinary shares could be provided by diluted earnings per share and other disclosures. This Discussion Paper discusses disclosures about potential dilution in paragraphs 7.13–7.25 of Section 7. Those disclosures would apply to all potentially dilutive financial instruments and could provide some of the information requested by users of financial statements.

6.88 In addition, to respond to users' requests for more information about equity instruments, the disclosure requirements related to the fair value of financial liabilities in IFRS 7 could be extended to equity instruments other than ordinary shares. This information could help users of financial statements understand the distribution of returns among different equity claims. It would also result in similar information being provided about derivatives on own equity regardless of whether they are classified as financial assets, financial liabilities or equity instruments.

6.89 Any new disclosures would impose costs because preparers would need to collect and prepare the fair value information. However, the Board observed that:

(a) IFRS 7 currently requires disclosures about the fair value of financial liabilities that have similar risks to derivative equity instruments (such as cash-settled derivatives on own equity). Therefore, determining the fair value of equity derivatives should not be more difficult or costly than financial liabilities with similar risks.

(b) the disclosure would be similar to the disclosures required by IFRS 2 for equity settled share-based payments and other disclosures about fair value required by IFRS 13.

6.90 However, some of the disadvantages of a disclosure-based approach are that:

(a) disclosure would provide information on the fair value of derivatives classified as equity instruments, but would not show the full effect of such derivatives on the distribution of returns among equity instruments.

(b) disclosures would not be as responsive as the other approaches discussed in paragraphs 6.74–6.86 to requests from users of financial statements for better information about the effect of other classes of equity on ordinary shares. Disclosure about dilutive earnings per share and fair value would not provide information as complete as attribution. As noted in paragraph 2.43 the Board thinks that one reason some users of financial statements favour a narrow equity approach is because applying the approach would provide the same information for all claims other than ordinary shares. In particular, users of financial statements are interested in an analysis of claims down to ordinary shares on the face of the financial statements. A disclosure-only approach is unlikely to provide the information requested by such users.

Illustrative example of attribution approaches for derivatives

6.91 The following example illustrates the different attribution approaches discussed in paragraphs 6.74–6.86:

At 1 January 20X0 an entity has recognised net assets of CU149,266. The entity's equity consists of:

- 100,000 ordinary shares that were issued for total proceeds of CU100,000 and retained earnings of CU18,667
- 100,000 warrants that were issued for proceeds of CU30,599 on 1 January 20X0 that are classified as equity.

The warrants have the following terms:

- exercise date 31 December 20X1 (cannot be exercised earlier)
- exercisable by the warrant holder
- strike price of CU1.70 per share
- 100,000 shares to be delivered if exercised

During the year ending 31 December 20X0, the entity recognised total comprehensive income of CU16,419.

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Other relevant information:	
Market price of shares on 1 January 20X0	CU1.78 per share
Market price of shares on 31 December 20X0	CU1.95 per share
Fair value of warrants on 1 January 20X0	CU30,599
Fair value of warrants on 31 December 20X0	CU34,719

In CU	Fair value approach	Average-of-period approach	End-of-period approach
Total comprehensive income for year ended 31 December 20X0	**16,419**	**16,419**	**16,419**
Attributed to:			
Warrants [(a)]	4,120	2,447	(5,558)
Ordinary shares [(b)]	12,299	13,972	21,977
Carrying amount of equity attributable to ordinary shares at 1 January 20X0	118,667	118,667	118,667
Carrying amount of equity attributable to ordinary shares at 31 December 20X0	130,966	132,639	140,644
Price-to-book ratio	149% (CU1.95 per share × 100,000 shares / CU130,966)	147% (CU1.95 per share × 100,000 shares / CU132,639)	139% (CU1.95 per share × 100,000 shares / CU140,644)
Amount attributed to ordinary shares/total number of shares	0.123 per share (12,299 / 100,000)	0.140 per share (13,972 / 100,000)	0.220 per share (21,977 / 100,000)
Price-to-earnings ratio	15.9	13.9	8.9
Diluted earnings per share applying IAS 33 [(c)]	0.151 per share (16,419 / 108,847)		
Price-to-earnings ratio (diluted earnings per share)	12.9		

[(a)] Calculated as the difference between total profit for the period and the amount attributed to the warrants.

[(b)] The amounts attributed have been calculated as follows under each approach:

Fair value approach
Warrants: based on the change in the fair value of the warrant (CU34,719 – CU30,599 = CU4,120)

Average-of-period approach	
Average fair value of warrants and ordinary shares for the period (for convenience, based on simple average)	
Ordinary shares (100,000 × (1.78 + 1.95) / 2)	CU186,500
Warrants ((30,599 + 34,719) / 2)	CU32,659
Total fair value	CU219,159
Relative average fair value of warrants = 32,659 / 219,159	
Total profit	CU16,419
Total profit attributable to warrants based on relative average fair value (CU16,419 × 32,659 / 219,159)	CU2,447
Commentary The CU2,447 amount attributed to the warrants is the same amount that would have been attributed to 17,512 (32,659 / 1.865) additional ordinary shares, if they, instead of the warrants, had been outstanding. The 17,512 additional shares would be the number of shares issued in exchange for the average fair value of the warrants during the period. The updated carrying amount of the warrants after the attribution under the average-of-period approach would be CU33,046 (CU30,599 + CU2,447). This amount would have no meaning on its own, or in relation to the carrying amount of ordinary shares.	

End-of-period approach	
Fair value of warrants and ordinary shares at the end of the period	
Ordinary shares (100,000 × CU1.95)	CU195,000
Warrants	CU34,719
Total fair value	CU229,719
Relative fair value of warrants = 34,719 / 229,719	
Net assets attributable at end of period (118,667 + 30,599 + 16,419)	CU165,685
Net assets attributable to warrants based on relative fair value (CU165,685 × 34,719 / 229,719)	CU25,041
Beginning carrying amount of warrants	CU30,599
Total profit attributed to warrants	(CU5,558)

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End-of-period approach
Commentary The amount attributed to the derivative equity instrument is (CU5,558), which is the amount required to adjust the carrying amount from CU30,599 to CU25,041. The beginning carrying amount of the warrant, the CU30,599, is the fair value of the warrant on issue, not the relative fair value. So, the (CU5,558) update to the carrying amount includes an amount that results from readjusting the carrying amount to get to a relative fair value, in addition to any other changes in the period.

(c) Diluted earnings per share applying IAS 33 are calculated as follows:

Diluted earnings per share applying IAS 33	
Weighted-average shares	100,000
Add: dilutive potential ordinary shares from assumed conversions of warrants	8,847
Adjusted weighted-average shares	108,847
Dilutive potential ordinary shares from exercising warrants = 100,000 – 91,153 = 8,847 CU1.70 (exercise price) × 100,000 shares = CU170,000 CU170,000 / CU1.865 (average share price) = 91,153 shares	

Summary of preliminary views and questions for respondents

6.92 The Board thinks that attributing profit or loss and OCI to all equity instruments other than ordinary shares could provide useful information to users of financial statements. In the case of non-derivative equity instruments other than ordinary shares, the attribution should follow the existing calculation for basic earnings per share in IAS 33 but present these amounts on the face of the statement of financial performance. However, in the case of derivative equity instruments, the Board does not have a preliminary view about which of the three approaches would best balance the costs and benefits of improving information provided to users of financial statements.

6.93 If the attribution calculation were consistent with the calculation of earnings per share in IAS 33, the incremental costs of preparing such information about the distribution of returns would be minimal. However, users of financial statements have requested better information about derivative equity instruments than that provided by the current requirements of IAS 33, which would entail additional costs.

6.94 In the Board's preliminary view:

(a) a full fair value approach would provide information about derivative equity instruments that is equivalent to the information provided by a narrow equity approach to classification. It would provide understandable information about the derivative equity instruments.

However, one disadvantage of this approach would be that it would amplify the consequences of incomplete recognition and mixed measurement on the amount ultimately attributed to ordinary shares (see paragraphs 6.77(b)).

(b) possible approaches to calculating attribution based on relative fair values alleviate some of the disadvantages of the full fair value approach. However, these approaches would also be costlier, because the fair value of ordinary shares would be needed as an input, and the average-of-period approach would be costlier than the end-of-period approach because of the requirements for additional data to calculate the average.

(c) performing a calculation based on relative fair values would result in carrying values and amounts attributed that would not represent a specific measurement attribute of individual equity instruments in isolation.

(d) a relative fair value approach, depending on the approach used for the calculation, however, would provide users of financial statements with better information to calculate price-to-book ratios and calculate earnings multiples, such as price-to-earnings.

6.95 Given the costs and complexity of any approach to attribution for equity derivatives, the Board considered whether it should instead continue to focus on providing information about the effect of derivative equity instruments through diluted earnings per share and improve other disclosures (see paragraphs 7.13–7.25). In the Board's view, improving disclosures would entail extending the fair value disclosure requirements in IFRS 7 to derivative equity instruments. Additional disadvantages of such an approach are that:

(a) the disclosure would not show the full effect of derivatives and non-derivatives classified as equity instruments on the income attributable to ordinary shares of derivatives and non-derivatives classified as equity; and

(b) the approach would not be a sufficient response to calls from users of financial statements for better information about the effect on ordinary shares of other classes of equity.

Question 8

The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?

The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:

(a) a full fair value approach (paragraphs 6.74–6.78);

(b) the average-of-period approach (paragraphs 6.79–6.82);

(c) the end-of-period approach (paragraphs 6.83–6.86); and

(d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25.

Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

Section 7—Disclosure

7.1 In response to various consultations, users of financial statements have consistently requested that preparers be required to provide more information about equity instruments and about the priority of financial liabilities and equity instruments on liquidation.

7.2 In developing preliminary views about how to improve disclosures about financial liabilities and equity instruments, the Board:

(a) reviewed the information requested by users of financial statements about liabilities and equity in their responses to other Board consultations;

(b) considered what information can be communicated through disclosure to meet user information needs and to support the classification and presentation requirements of the Board's preferred approach; and

(c) considered disclosure requirements in IFRS Standards to see whether they can be improved, or removed if they are not providing useful information; for example, the potential attribution requirements for equity instruments might reduce the need for some disclosures about dividends on preference shares, such as the disclosures required by paragraph 137 of IAS 1.

7.3 Based on the activities described in paragraph 7.2, the Board identified the following potential improvements to the disclosure requirements for financial liabilities and equity instruments:

(a) priority on liquidation (paragraphs 7.4–7.12);

(b) potential dilution of ordinary shares (paragraphs 7.13–7.25); and

(c) contractual terms and conditions (paragraphs 7.26–7.29).

Priority on liquidation

7.4 As discussed in Section 2 (paragraph 2.30), information about the priority of financial liabilities and equity instruments on liquidation would help users of financial statements make more detailed assessments of balance-sheet solvency and returns, for example, to determine how any potential surplus or deficit in economic resources and returns will be allocated among claims (typically referred to as the waterfall). IFRS Standards currently do not require any particular information about the priority of financial liabilities and equity instruments.

7.5 Users of financial statements have asked for more information about the priority of financial liabilities and equity instruments on liquidation of an entity. For example, many user respondents to earlier consultations have suggested a disclosure requirement similar to the 'capitalisation table' required by the Securities and Exchange Commission in Form S-1 for the initial listing of securities in the US market. Such a disclosure provides information about an entity's capital structure in a single place (a table, unless another format would be more appropriate), which alleviates the need for users of financial statements to compile this information from multiple sources.

7.6 As discussed in paragraphs 6.8–6.9, the Board's preliminary view is that it would be useful to provide financial liabilities and equity instruments in their order of priority. The Board thinks that an entity could elect to provide this information on the face of the statement of financial position, or in the notes to the financial statements.

7.7 An entity would be permitted to group financial instruments together if the contractual terms and conditions of the financial instruments indicate that the instruments have the same level of priority. The objective would be to provide information to users of financial statements about the relative ranking of financial liabilities and equity instruments. The objective would not be to depict the value of those financial liabilities and equity instruments in a hypothetical liquidation.

7.8 The information provided might include:

(a) a list of all financial liabilities and equity instruments in the order of their priority;

(b) for each group or category of financial liability and equity instrument, information about:

(i) terms and conditions that indicate the priority within the entity's capital structure (eg liquidation preference, the existence of guarantees, collateral, and other payment conditions that might establish a priority between contracts);

(ii) terms and conditions that could lead to changes in priority (eg conversion features and contingent features);

(iii) terms and conditions that indicate any promised returns and/or rights to dividends or other distributions; and

(iv) any other contractual features that could affect holders' rights to share in an entity's economic resources and returns; and

(c) if there is any change in the priority of any group of financial instruments, information about the reason(s) for the change (eg any changes in relevant terms and conditions or circumstances).

7.9 Providing the information in paragraph 7.8(a) in a table would result in a presentation that is similar to the capitalisation table discussed in paragraph 7.5, for example:

Order of priority	**As of 1 January 20XX in CU million**
Senior secured loan	X
Junior secured loan	X
Subordinated notes	X
Total liabilities	**XX**
Non-cumulative preference shares	X
Ordinary shares	X
Total equity	**XX**
Total capitalisation	**XXX**

7.10 In order to provide the information described in paragraph 7.8, entities would need to analyse the terms and conditions of their financial instruments to determine each instrument's priority relative to other financial instruments. The Board identified a number of challenges in determining the priority of financial instruments, for example:

(a) the priority of a particular financial instrument may be determined by a combination of its own terms and conditions and the terms and conditions of other financial instruments;

(b) the priority might be affected by the group structure of the entity, for example, when a claim is against a particular subsidiary;

(c) the priority of a financial instrument might be contingent on uncertain future events; and

(d) limiting this disclosure to financial instruments and not applying the same to non-financial liabilities beyond the scope of IAS 32 might reduce the usefulness of the disclosure.

7.11 Despite such challenges, the Board observed that, in the absence of information about the priority of financial liabilities and equity instruments, users of financial statements would need to perform their own assessments, which would require making assumptions based on limited information. Information about the priority of an entity's financial liabilities and equity instruments would be useful to users of financial statements, even if such information is prepared with some limitations. Those limitations could include simplifying assumptions or requiring the provision of this information only for a particular set of financial instruments (such as limiting it to financial liabilities and equity instruments of, or against, the parent entity).

7.12 The Board discussed but did not reach a preliminary view on whether the amounts included for financial liabilities should be the carrying amounts presented in the statement of financial position, the fair value amounts required by IFRS 7, or both. The Board noted that different measurement bases might be useful for different purposes.

Potential dilution of ordinary shares

7.13 Some information about dilution is currently provided in the disclosure of diluted earnings per share required by IAS 33. However, users of financial statements have indicated that such information is not useful for particular assessments because IAS 33 defines dilution narrowly. Specifically, users of financial statements say the definition of dilution in IAS 33 is incomplete because potential ordinary shares are considered dilutive only if the potential ordinary shares decrease earnings (or increase loss) per share from continuing operations.[99] The Board also observed that IAS 33 has other limitations; in particular, it only considers the effect of equity instruments that are in-the-money. Hence, users of financial statements are not able to determine how many potential ordinary shares might be issued if equity instruments that are out-of-the-money at the reporting date become in-the-money.

7.14 Furthermore, users of financial statements noted a lack of information around the calculation of the weighted average number of ordinary shares applying IAS 33. For example, the following information is not specifically required to be disclosed:

(a) the total number of ordinary shares potentially outstanding at the end of the period; and

(b) the number of ordinary shares that could be issued to settle instruments that could dilute basic earnings per share in the future, but were excluded from the calculation because they are antidilutive for the period(s) presented.

7.15 IAS 1 requires an entity to disclose, for each class of share capital, a reconciliation of the number of shares outstanding at the beginning and at the end of the period. However, neither IAS 1 nor IAS 33 require an entity to provide information about potential changes in the number of shares outstanding at the end of the period arising from existing rights and obligations of the entity.

7.16 Given the limitations of IAS 1 and IAS 33, in the Board's preliminary view more information about the potential dilution of ordinary shares should be provided

99 As per paragraph 42 of IAS 33, an entity uses profit or loss from continuing operations attributable to the parent entity as the control number to establish whether potential ordinary shares are dilutive or antidilutive.

to meet the needs of users of financial statements.[100] Such information would help users of financial statements understand the distribution of returns to ordinary shares, how the entity has financed its operations in the past, and how the entity's capital structure might change in the future. Information about such potential dilution is useful for existing and potential investors in the entity's ordinary shares.

7.17 One way the Board has considered addressing some of these information needs is through improving presentation on the face of the financial statements, including the statement of changes in equity. As discussed in Section 6 paragraphs 6.60–6.95, the potential attribution approaches for equity instruments other than ordinary shares would result in the entity attributing the remaining total comprehensive income to ordinary shares; therefore, ordinary shares will be the ultimate residual after applying the attribution. Information about potential dilution would be even more important if the Board does not proceed with those attribution requirements. As discussed in Section 6, disclosure in the notes to the financial statements can complement, or be a substitute for, the potential attribution requirements for equity instruments other than ordinary shares.

7.18 In addition to information about potential dilution, users of financial statements also requested information about the effect of new issues of ordinary shares on the voting rights of existing shareholders. Such information about voting rights could be provided along with information about dilution.

7.19 Based on paragraphs 7.13–7.18, in the Board's preliminary view, additional disclosure in the notes to the financial statements about potential dilution would be useful. Users of financial statements have expressed various preferences on the form of a dilution analysis. The Board has not considered the merits of those various forms but instead focused on identifying the specific information that would be useful.

7.20 Applying the Board's preferred approach, derivatives to deliver ordinary shares could be classified as financial assets, financial liabilities or as equity instruments. Therefore, the return to ordinary shares could be diluted by instruments classified as assets or liabilities or equity instruments. The potential dilution of a financial liability settled by delivering a variable number of shares equal to a fixed cash amount is unlimited. In contrast, the potential dilution of an equity instrument settled by delivering a fixed number of shares (such as a fixed-for-fixed warrant) is limited.

7.21 The objective would be for an entity to provide information to help users of financial statements assess the potential dilution of ordinary shares arising from financial instruments that could be settled by issuing ordinary shares. To address the limitations of IAS 33, these disclosures in the notes to the financial statements would provide information about dilution that could arise from any potential increase in the number of issued ordinary shares.

7.22 The information to meet the disclosure objective might include:

100 In this Discussion Paper, potential dilution is any actual or potential increase in the number of issued ordinary shares as the result of settling a financial instrument.

(a) a list at the end of each reporting period of all financial instruments that could dilute the ordinary shares;

(b) the following information for each group of potentially dilutive financial instruments:

   (i) terms and conditions, including how the number of ordinary shares required for settlement is determined;

   (ii) dates of share settlement; and

   (iii) number of shares to be delivered at settlement, based on the current conditions at the end of reporting period;

(c) a reconciliation of the movement in the number of ordinary shares outstanding, and in the maximum number of additional potential ordinary shares,[101] during the period, including:

   (i) the total number of ordinary shares and additional potential ordinary shares outstanding at the beginning and end of the reporting period;

   (ii) sources of changes in the number of ordinary shares, and additional potential ordinary shares (eg rights issues, stock splits, warrant issues etc);

   (iii) settlement dates which led to changes in the number of ordinary shares outstanding; and

   (iv) the details of any share repurchase plans.

Illustrative example of dilution disclosure

7.23 The following example illustrates the disclosures discussed in paragraph 7.22:

The following table illustrates a reconciliation of changes in the number of ordinary shares outstanding and in the maximum number of additional potential ordinary shares that could be issued during the period:

	Ordinary shares outstanding	**Maximum additional number of potential ordinary shares**
1 January 20X1	5,000,000	900,000[(a)]
1 January 20X1		
Issue of warrants	–	600,000
1 March 20X1		
Issue of ordinary shares for cash	200,000	–
1 June 20X1		
Conversion of bonds	20,000	(20,000)[(b)]

continued...

101 Assuming the conversion of all financial instruments that require share settlement.

...continued

1 September 20X1		
Exercise of warrants	400,000	(400,000)[(c)]
31 December 20X1	5,620,000	1,080,000

(a) Includes 800,000 related to convertible preference shares issued in the second quarter of 20X0, and 100,000 related to convertible bonds issued in the last quarter of 20X0.
(b) Bonds converted are no longer a source of potential dilution. Therefore, the conversion of bonds reduces the number of potential ordinary shares.
(c) Warrants exercised are no longer a source of potential dilution. Therefore, the exercise of warrants reduces the number of potential ordinary shares.

7.24 Most of the information needed for the disclosures discussed in paragraph 7.22 is already required for calculating earnings per share (for entities applying IAS 33). Additionally, the Board thinks that the disclosures discussed in paragraph 7.22 could be integrated with existing disclosures, for example, with the disclosures regarding outstanding shares required by IAS 1. These disclosures should be useful as a complement to any of the attribution alternatives considered in Section 6. These disclosures would become more essential as a substitute for attribution if the Board does not proceed with one of the attribution alternatives.

7.25 The disclosures would provide a summary of all potentially dilutive financial instruments. Such information would help users of financial statements to assess the distribution of returns among equity instruments and how this may change in the future.

Contractual terms and conditions

7.26 Information about terms and conditions of financial liabilities and equity instruments would help a user of financial statements make both assessments identified in Section 2 as well as other assessments such as the distribution of returns under different future scenarios.

7.27 In the Board's preliminary view, additional information should be provided about the terms and conditions of financial liabilities and equity instruments that affect the amount and timing of cash flows. Such information might include:

(a) terms and conditions that are relevant to determining the settlement amount. Such terms and conditions might include information about the financial instrument's principal amount, interest rate, indices and whether and how the settlement amount depends on the entity's available economic resources (such as indexation to share price) and the effect of any options and contingencies; and

(b) the timing of settlements, including the effect of any options and contingencies.

7.28 In this Discussion Paper (see paragraphs 7.8 and 7.22), the Board has identified particular information that should be disclosed about terms and conditions that affect a financial instrument's priority or its potential to dilute ordinary shares. User feedback indicates that disclosures about terms and conditions should be provided in a single place in the notes to the financial statements.

7.29 The Board acknowledges that aggregating this information could be challenging when an entity has a large number of financial instruments that fall within the scope of the disclosure. The Board notes that there are possible approaches to arranging this information, such as stratifying the set of financial instruments depending on their possible effect on an entity's prospects for future cash flows and requiring different disclosures based on the significance of those possible effects. If the Board decides to finalise this disclosure requirement, the Board will consider information that entities are already required to provide by other requirements.

Questions for respondents

Question 9

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).

(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).

(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

Section 8—Contractual terms

8.1 The focus of this project is limited to financial instruments within the scope of IAS 32. As mentioned in paragraph 3.3, all financial instrument definitions in IFRS Standards, including those of financial assets, financial liabilities and equity instruments, refer to rights or obligations arising from contracts. Paragraph 13 of IAS 32 states that:

In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

8.2 However, determining whether rights and obligations arise from the contractual terms or from some other mechanism can sometimes be challenging. The Board considered:

(a) economic compulsion and indirect obligations (paragraphs 8.4–8.26); and

(b) the relationship between contracts and law (paragraphs 8.27–8.36).

8.3 In the Board's preliminary view, the Board's preferred approach should be applied to the rights and obligations established by the *contractual terms* of a financial instrument, including obligations that are established indirectly through the terms of the contract. This is consistent with the requirements of IAS 32. Economic incentives that might influence the issuer's decision to exercise its rights would not be considered when classifying a financial instrument as a financial liability or equity instrument.

Economic compulsion and indirect obligations

8.4 Some financial instruments grant the entity (the issuer) the right to choose between alternative settlement outcomes, instead of granting that right to the holder. For example, the terms might grant the entity the right to settle the financial instrument in a way that would have met the definition of a liability if it were the only possible outcome.

8.5 In classifying such financial instruments as financial liabilities or equity instruments, challenges include determining whether the financial instrument, in substance, establishes an obligation that would meet the definition of a financial liability.

8.6 The Committee and the Board have considered and resolved some of these challenges in the past. Some types of financial instruments considered included:

(a) issued preference shares the entity is allowed to redeem on specific dates. However, if the entity does not redeem the preference shares, the dividend rate and resulting redemption amount increases at an increasing rate over time (in 2006 the Committee considered a similar type of instrument, 'callable preferred shares with a 'step-up' dividend clause').

(b) instruments that can be converted to a fixed number of ordinary shares at the issuer's option (the Committee considered a type of this instrument in 2013).

8.7 If an entity has settlement options, economic incentives may prompt the entity to exercise the liability settlement outcome even though it has the right to select the equity settlement outcome (or vice versa). The strength of the economic incentive will depend on the entity's rights and obligations and other facts and circumstances.

8.8 In some circumstances, the incentives may be so strong that some would view the entity as being 'economically compelled' to exercise a particular outcome, eg a liability settlement outcome. Interested parties disagree whether the classification of financial liabilities and equity instruments should consider economic incentives and, if so, how strong those economic incentives need to be to equate to economic compulsion.

Does application of the Board's preferred approach address these challenges?

8.9 The Board's preferred approach is based not only on whether the financial instrument requires the entity to transfer economic resources, but also on how the amount of the obligation is determined. In particular, if the obligation is for an amount independent of the available economic resources of the entity (such as a non-derivative financial instrument with contractual cash flows based on interest rates), the financial instrument would be classified as a liability. This would be the case even if the entity has the right to defer payment indefinitely until liquidation (for example, callable preference shares with a step-up dividend clause) or the right to settle the obligation by issuing a variable number of shares with a total value equal to that independent amount.

8.10 As noted in paragraph 3.23, applying the Board's preferred approach, an entity would classify as financial liabilities claims such as callable preference shares with a step-up dividend clause and cumulative preference shares without considering whether the entity is obliged to transfer economic resources. That is, because the Board's preferred approach also considers how the amount of the obligation is determined, it would classify as financial liabilities financial instruments that contain an obligation for an amount independent of the entity's available economic resources but allow the entity to defer payment indefinitely. For such claims, the amount of the payment is known, even though the timing of the payment is unknown. Therefore, the Board's preferred approach would address the classification concerns about the callable preference shares with a step-up dividend clause without the need to consider economic incentives and compulsion.

8.11 Nevertheless, applying the Board's preferred approach, there would be other types of financial instruments with alternative liability and equity settlement outcomes within the control of the entity for which the Board considered the questions regarding economic incentives and economic compulsion.

8.12 For example, a reverse convertible bond is convertible at the issuing entity's option. The issuer has the option to deliver either a specified amount of cash or a fixed number of its own shares.[102] Effectively, the entity's right to choose how to settle the claim means the amount of the entity's obligation is limited to the lower of the value of the specified number of shares and the specified amount of cash.

8.13 When classifying the reverse convertible bond in paragraph 8.12 as a financial liability or as an equity instrument, the question is whether economic compulsion should be considered, and, if so, how strong economic incentives to settle the claim in a particular way need to be to equate to economic compulsion.

8.14 To help illustrate the issue, the Board first considered a 'typical' convertible bond. A typical convertible bond is denominated in the issuer's functional currency and convertible at the holder's option. The holder has the option to receive either a specified amount of cash, or a fixed number of shares. Effectively, a typical convertible bond obliges the entity to deliver an amount that is equal to the higher of the value of the specified number of shares and the specified amount of cash.

8.15 The Board then compared typical and reverse convertible bonds, applying the Board's preferred approach:

(a) the component of the typical convertible bond in paragraph 8.14 under which the entity could be obliged to transfer cash at the option of the holder would be a liability component measured at the present value of the cash settlement alternative. The right of the holder to convert to shares would be a separate equity component. This separate classification of the two components would apply even if the conversion option is highly likely to be exercised by the holder (for instance because the value of the shares is higher than the cash payment amount). If the holder did not exercise the conversion right, the entity would be obliged to transfer economic resources.

(b) the reverse convertible bond in paragraph 8.12 would be equity in its entirety because the entity has the right to settle the financial instrument by issuing a fixed number of ordinary shares, instead of transferring cash. This instrument would be classified as equity even if it is highly likely that the entity will not issue shares but pay cash instead (for instance, because the value of the shares is higher than the cash payment amount). Contractually, the entity does not have an unavoidable contractual obligation to transfer economic resources.

102 Other instruments would have similar alternative settlement outcomes, including (a) a callable share—an ordinary share that includes an unconditional right of the entity to repurchase the share for a fixed amount of cash (the share would be equivalent to an ordinary share but for the embedded call option) and (b) a purchased call option—a derivative that is gross physically settled that grants the right to the entity to repurchase a fixed number of ordinary shares, for a fixed amount of cash. Such an instrument is the standalone equivalent to the embedded derivative in the callable share. As noted in paragraphs 5.43–5.47, the Board has not discussed the details of possible separation methods for such embedded derivatives and will do so in the light of the feedback on the proposals in this Discussion Paper.

8.16 There are two views about these classification outcomes:

(a) View A—the classification results in paragraph 8.15 faithfully represent the different rights and obligations of the entity. For the typical convertible bond, the entity has no right to decide whether to transfer economic resources. That right is controlled by the holder and hence it is an obligation of the entity to transfer economic resources until the holder decides not to exercise that right. For the reverse convertible bond, the entity has a right to decide whether to transfer economic resources or to transfer a fixed number of shares, hence it is not an obligation to transfer economic resources until the entity waives its equity settlement right and commits to make the transfer of cash.

(b) View B—the classification results in paragraph 8.15 are counter-intuitive. They can result in a convertible bond that is highly likely to be converted to shares being classified as a liability for the present value of the cash settlement alternative. Similarly, they can result in a reverse convertible bond that is highly likely to be settled in cash being classified as equity. Holders of this view suggest that to avoid the counter-intuitive result, the requirements of IAS 32 should be amended. In the case of the reverse convertible bond, they think that the entity should consider the economic incentive for settling the bond by transferring cash to determine whether the financial instrument has a liability component. In other words, they think that the economic incentive should be regarded as creating an unavoidable settlement outcome.

8.17 An entity typically has the right to satisfy in whole or in part all claims against it, including those of ordinary shares, by transferring economic resources at some point in time, for example, by repurchasing the claim on the market, paying a dividend, or making some other distribution. If there is no possibility of transferring economic resources, the entity may not have a claim against it at all.

8.18 The Board thinks that, when considering whether a financial instrument should be classified as a financial liability or an equity instrument:

(a) the fact that the entity can waive its right to the equity settlement outcome and settle the financial instrument by transferring economic resources prior to liquidation is not relevant to the analysis. What is relevant is whether the entity has an unavoidable obligation to transfer economic resources at a specified time other than at liquidation, not whether it has the right to do so. The entity has the right to settle most claims against it, in whole or in part, by transferring economic resources at different points in time prior to liquidation (for example, by making discretionary distributions).

(b) economic incentives are not rights or obligations, but are factors that impact the likelihood of an entity or holder exercising particular rights, which may change over time. Classifying a financial instrument as a financial liability or an equity instrument based on economic incentives might represent the likely outcome, but it would not provide information about whether the entity has an unavoidable contractual obligation with the feature(s) of a financial liability.

8.19 The Board agreed with its previous conclusions in AG26 of IAS 32 that:[103]

> ... The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
>
> (a) a history of making distributions;
>
> (b) an intention to make a distribution;
>
> (c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
>
> (d) the amount of the issuer's reserves;
>
> (e) an issuer's expectations of a profit or loss for a period; or
>
> (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

8.20 A reverse convertible bond is a claim against the entity. However, its features differ from that of a typical convertible bond.[104] Because the entity has the right to settle a reverse convertible bond by delivering a fixed number of its own ordinary shares, classifying it as equity shows that:

(a) it would not affect a user's assessment of whether the entity has sufficient economic resources to meet its obligations. Similar to ordinary shares, the amount of the financial instrument will depend on the entity's available economic resources because the entity always has the right to settle the claim by issuing a fixed number of its own ordinary shares.

(b) because the financial instrument can be settled with a fixed number of the entity's own ordinary shares it would not affect a user's assessment of whether the entity will be able to meet its requirements to transfer economic resources as and when they fall due because the entity has the unconditional right to avoid transferring economic resources by choosing to settle with a fixed number of shares.

8.21 Attempting to consider economic incentives in the analysis may raise more questions than it answers. A broad range of facts and circumstances could affect an entity's decision to exercise the liability settlement option instead of the

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103 This is also referred to in paragraph BC12 of IFRIC 2. The Committee observed '...that a history of redemptions may create a reasonable expectation that all future requests will be honoured. However, holders of many equity instruments have a reasonable expectation that an entity will continue a past practice of making payments. For example, an entity may have made dividend payments on preference shares for decades. Failure to make those payments would expose the entity to significant economic costs, including damage to the value of its ordinary shares. Nevertheless, as outlined in IAS 32 paragraph AG26, a holder's expectations about dividends do not cause a preferred share to be classified as a financial liability.'

104 The Board has also developed presentation and disclosure requirements that would require entities to provide information about claims with alternative settlement outcomes. This includes requirements to attribute amounts within equity to classes of equity other than ordinary shares.

equity settlement option. Therefore, a number of follow-on questions arise if economic incentives are to be considered in identifying a financial liability, including:

(a) how significant does an economic incentive need to be for the entity to be economically compelled to transfer economic resources? And, therefore, what is the effect on classification of that threshold?

(b) that market changes will result in the extent of the economic incentive changing from period to period. Therefore, should the assessment of economic compulsion be performed only when classifying the claim at initial recognition, or would the assessment need to be performed continuously to take into consideration changing facts and circumstances?

(c) whether effects on the entity's other economic resources (such as a change of control provision), or claims (such as additional interest on other debt or covenant breaches), or other business factors should influence an entity's decision to exercise a liability settlement option. Should the assessment of economic compulsion consider economic consequences beyond those of the alternatives in the contract and if so, should changes in those circumstances be considered subsequently?

(d) should the assessment be limited to the current economic consequences at the assessment date (ie an 'intrinsic value' assessment)? Alternatively, should the possible future economic consequences from a possible future settlement be considered in the assessment as well? If so, what future scenarios should be assessed? Options that are subject to risk are typically always *potentially* favourable in the future.

8.22 However, the Board observed that sometimes the entity's stated right to settle a financial instrument by delivering a fixed number of ordinary shares is 'structurally out-of-the-money' (ie always 'out-of-the-money', or always unfavourable). This means it is always favourable for the entity to pay cash or another financial asset or to deliver a variable number of its own shares for an amount independent of the entity's available economic resources, or otherwise settle it in a way that would meet the definition of a financial liability under the Board's preferred approach. That is, the fair value of the liability settlement outcome is always less than the fair value of the equity settlement outcome.

8.23 IAS 32 includes some requirements to help assess whether a financial instrument establishes an obligation that would meet the definition of a financial liability indirectly through its terms and conditions. Paragraph 20 of IAS 32 states that:

> Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option.

8.24 In the Board's preliminary view, the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained. The Board noted that retaining these requirements reduces structuring opportunities to achieve desired outcomes when classifying financial instruments, in circumstances in which the contractual terms make exercising a certain option always favourable. By focusing on the contractual terms of financial instruments, the requirements in paragraph 20 of IAS 32 do not conflict with the general principle in this section of excluding economic incentives when classifying a financial instrument. However, they would need to be updated to reflect the features that result in liability classification applying the Board's preferred approach.

8.25 For example, consider a financial instrument that contains an obligation to pay cash equal to the fair value of a specified number of own shares (say X number of shares), but grants the entity a right to settle the instrument by physically delivering a different specified number of shares that is greater than X. Because the value of the equity settlement outcome is always greater than the value of the liability settlement outcome, the entity would always settle in cash. Applying the Board's preliminary view set out in paragraph 8.24, such a financial instrument would be classified as a financial liability.

Summary of preliminary views and questions for respondents

8.26 In the Board's preliminary view, economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument. Thus, under the Board's preferred approach, classification would be based on the rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract. This is consistent with the current approach in paragraph 20 of IAS 32.

Question 10
Do you agree with the Board's preliminary view that: (a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument? (b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained? Why, or why not?

Relationship between contracts and law

8.27 Assets and liabilities that are not contractual, for example rights and obligations that arise from statutory requirements imposed by government, are not financial liabilities or financial assets (for example, income taxes). Paragraph AG12 of IAS 32 states that:

> Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in IAS 12 *Income Taxes*. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

8.28 However, the Board is aware of questions about the effect of law on the rights and obligations of an existing contract (other than just their enforceability). The question is whether classification of a contract as a financial liability or an equity instrument should be based solely on the contractual terms or whether classification should also consider the law, regulation or any other legal instrument issued by an authority in a particular jurisdiction that might affect the rights and obligations set out in a contract.

8.29 Two transactions that demonstrate the challenges include:

(a) bonds that are contingently convertible to ordinary shares as a result of legal or regulatory requirements. Questions have been raised about whether laws that impose contingent conversion features on particular types of claims issued by an entity should be considered in classifying such instruments as financial liabilities or equity instruments. Paragraph B4.1.13 of IFRS 9 includes an example (Instrument E) illustrating contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. In that example, the effect of the regulation that introduces different contractual cash flows is not considered when assessing whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

(b) mandatory purchases of non-controlling interests that arise as a result of legal or regulatory requirements for acquisitions (mandatory tender offers or MTOs). The Committee received a submission regarding whether a liability should be recognised for the MTO at the date the acquirer obtains control of the acquiree. A small majority of Committee members expressed the view that a liability should be recognised for the MTO in a manner that is consistent with IAS 32 at the date that the acquirer obtains control of the acquiree. Other Committee members expressed the view that an MTO is not within the scope of IAS 32 (because they are non-contractual) or IAS 37 (because they are executory) and that a liability should, therefore, not be recognised.

8.30 Classification based on an assessment of contractual terms consistent with IFRS 9 would ensure consistent consideration of contingent convertible bonds that are affected by law for both the holder (as a financial asset) and the issuer (as a financial liability or an equity instrument). However, doing so would result in, for example, the obligations that arise in MTOs, which have similar consequences as those that arise from written put options, not being considered for the purpose of classification because they are beyond the scope of IAS 32. Other IFRS Standards might have specific guidance for issues that arise when an entity accounts for rights and obligations arising from law (such as IAS 37). However, the Board did not design other IFRS Standards to address the classification of liabilities and equity.

8.31 Alternatively, if the treatment of rights and obligations that arise from law were considered as equivalents of contractual terms under IAS 32 then MTOs might be accounted for consistently with written put options. However, such a fundamental change to the scope of IAS 32 and IFRS 9 to include rights and obligations that arise from law could have consequences beyond the distinction between liabilities and equity. In particular, it would extend the scope of the financial instruments literature in general to encompass rights and obligations arising outside contracts. This would likely have consequences beyond those in paragraph 8.29 that the Board is aware of, and for transactions beyond the scope of the FICE project. Those consequences would give rise to additional challenges that will need to be resolved, including challenges related to the recognition, derecognition and reclassification requirements that are specific to the effect of law and regulation,[105] which are beyond the scope of this project.

Summary of preliminary view and questions for respondents

8.32 The consequences to an entity of the rights and obligations of any financial instrument are the same regardless of whether those rights and obligations arise from a contract or from the law. Therefore, the comparability and usefulness of financial statements would be increased if an entity accounted for similar consequences in the same way. However, there are many assets and liabilities that share similar characteristics or consequences. Nevertheless, different IFRS Standards apply different requirements and the Board has decided on the scope of each IFRS Standard that specifies the accounting for the transactions within its scope.

8.33 The IFRS requirements to account for financial instruments have been designed around the concept of a contract. This includes the recognition, derecognition, classification and measurement requirements. The Board has not designed these requirements to account for rights and obligations arising from law.

8.34 IFRIC 2 does refer to relevant local laws and regulations in effect at the date of classification. However, the Board noted that IFRIC 2 was developed for a very specific fact pattern with limited effect in practice, therefore it does not think that it should reconsider that interpretation, nor apply the analysis in that interpretation more broadly.

8.35 In developing IFRS 9, the Board acknowledged that, as a result of legislation, some governments or other authorities have the power in particular circumstances to impose losses on the holders of some financial instruments. The Board has already decided in IFRS 9 that when an entity assesses the classification of a contingent convertible financial asset it should limit the analysis to the terms and conditions in the contract. The Board noted that IFRS 9 requires the holder to analyse the *contractual terms* of a financial asset to determine whether the asset gives rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. In other words, the holder would not include the payments that arise only as a result of the government or other authority's legislative power as cash flows in its analysis. That is because that power and the related payments are not covered by the contractual terms of the financial instrument.[106]

8.36 In the Board's preliminary view, an entity would apply the Board's preferred approach to the contractual terms of a financial instrument consistently with

105 For example, the requirements in IAS 32 are based on the assumption that transactions occur based on agreement between parties to a contract, whereas law and regulation can be changed unilaterally by an authority by without agreement from the counterparties.

106 See paragraph BC4.191 of Basis for Conclusions on IFRS 9.

IAS 32 and IFRS 9. The Board will consider whether it should take any action to address the accounting for mandatory tender offers, including potential disclosure requirements, following its analysis of responses to this Discussion Paper.

Question 11
The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

Appendix A—Alternative approaches to classification and presentation

A1 The Board considered the following alternative approaches to the Board's preferred approach:

(a) Approach A—classification based only on whether there is a contractual obligation to transfer economic resources at a specified time other than at liquidation (paragraph A4).

(b) Approach B—classification based only on whether the obligation is for an amount independent of the entity's economic resources (paragraph A5).

A2 The overall analysis in this Discussion Paper would remain similar between all three approaches, including in many cases its application to derivative financial instruments. The difference between the approaches is how the primary distinctions identified in Section 2 (see paragraphs 2.32–2.42) are depicted through a combination of classification and presentation. The same distinctions as those made in the Board's preferred approach are required to provide relevant information for users of financial statements to make the assessments identified in Section 2. However, the approaches differ in how they affect the structure of the statement of financial position and the statement of profit or loss.

A3 For each approach, we summarise the difference between it and the Board's preferred approach. This Discussion Paper illustrates the classification and presentation consequences of all three approaches in Appendix C.

Approach A

A4 Approach A captures the following features through classification and presentation:

Classification

(a) Approach A would classify claims as liabilities if (and only if) the entity has an obligation to transfer economic resources at a specified time other than at liquidation, regardless of the amount of the obligation.

(b) Approach A would not classify as liabilities claims that the entity can settle by transferring other equity claims, nor claims for which the entity has the unconditional right to defer payment until liquidation, regardless of how the amount of the obligation is determined.

(c) Applying Approach A to derivative financial instruments using the same unit of account as the Board's preferred approach would result in the classification of net-cash settled derivatives on own equity as financial liabilities, regardless of how any variables might affect the net amount of the derivatives.

(d) The compound instrument and redemption obligation requirements would still apply in the Approach A. However, the liability leg would include only obligations to transfer cash and other financial instruments.

(e) Approach A might continue to need the puttable exception in IAS 32, since it is possible for all the claims against the entity to meet the definition of a liability.

Presentation

(a) Approach A would distinguish between liabilities that are for an amount independent of the entity's available economic resources and those that are not. The requirements would be the same as those required for liabilities applying the Board's preferred approach (see Section 5), in order to help a user make assessments of balance-sheet solvency and returns.

(b) Approach A would distinguish between equity claims that are for an amount independent of the entity's available economic resources and those that are not. The requirements would be different to those required for equity claims under the Board's preferred approach. In particular, not only would the entity need to provide more information about classes of equity other than ordinary shares, it also would have to present prominently on the face of the financial statements the effect of equity instruments that promise a specified return in order to help a user make assessments of balance-sheet solvency and returns. This is because Approach A would not consider the amount of the claim for classification.

Approach B

A5 Approach B would capture the following features through classification and presentation:

Classification

(a) Approach B would classify claims as liabilities if (and only if) the entity has an obligation for an amount that is independent of the entity's available economic resources, regardless of whether the entity is required to transfer economic resources at a specified time other than at liquidation.

(b) Approach B would not classify as liabilities claims that depend on the available economic resources of the entity, even if the entity is required to settle the claim by transferring economic resources at a specified time other than at liquidation.

(c) Applying Approach B to derivative financial instruments using the same unit of account as the Board's preferred approach would result in the classification of derivatives on own equity as financial liabilities if the net amount is affected by a variable that is independent of the available economic resources of the entity, regardless of the form of settlement.

(d) The compound instrument and redemption obligation requirements would still apply in Approach B. However, the liability leg would include only obligations for an amount independent of the entity's available economic resources.

(e) Depending on how it would be applied to financial instruments, Approach B might not need the puttable exception in IAS 32, because there would always be a claim that depends on the available economic resources of the entity.

Presentation

(a) Approach B would distinguish between liabilities that require the transfer of economic resources at a specified time other than at liquidation and those that do not. The requirements would be the same as those required for liabilities applying the Board's preferred approach (see Section 5), in order to help a user make assessments of funding liquidity and cash flows.

(b) Approach B would distinguish between equity claims that require the transfer of cash or another financial asset at a specified time other than at liquidation and those that do not. The requirements would be different to those required for equity claims applying the Board's preferred approach. In particular, not only would the entity need to provide more information about classes of equity other than ordinary shares, it also would have to present prominently the effect of instruments that require the transfer of resources in order to help a user make assessments of funding liquidity and cash flows. This is because Approach B would not consider the timing of required resource transfers for classification.

Appendix B—Implications for the *Conceptual Framework* and for other IFRS Standards

The *Conceptual Framework for Financial Reporting*

B1 The effects of the distinction between liabilities and equity are fundamental aspects of accounting that can be traced back to definitions of the elements in the *Conceptual Framework*.

B2 The Board added the FICE project to its research agenda in 2012 in response to feedback it received on its *2011 Agenda Consultation*. That feedback included requests for improvements to IAS 32, to the *Conceptual Framework* or both. Consistent with the Board's statement in its *2012 Agenda Consultation* Feedback Statement, the Board began discussing some of the challenges related to distinguishing between liabilities and equity in its Conceptual Framework project.

B3 In the Conceptual Framework project, the Board decided that the *Conceptual Framework* should continue to make a binary distinction between liabilities and equity. The Board considered suggestions either to increase the number of elements representing claims or to define claims without making a distinction. However, the Board observed that:[107]

(a) the recognition and measurement processes will result in the carrying amount of at least one claim being calculated as a residual, that is, as a result of the recognition and measurement of the entity's assets and other claims; and

(b) information about additional classes of liabilities and equity could be provided even if there are only two classes of claims defined as elements of financial statements.

B4 In March 2018, the Board issued the revised *Conceptual Framework*, which includes a revised definition of a liability and new supporting guidance. The changes to the definition of a liability were not intended to address challenges relating to the application of that definition to distinguish liabilities from equity. Hence, the new *Conceptual Framework* definition of a liability is not used to distinguish liabilities from equity in this Discussion Paper.

B5 The scope of the FICE project is focused on financial instruments and its aim is to investigate, and suggest solutions to, the specific challenges of distinguishing financial liabilities from equity instruments when applying IAS 32. If the Board ultimately decides to implement the preliminary views in this Discussion Paper, the Board might consider possible implications for the *Conceptual Framework*.

B6 The Board has acknowledged that one possible outcome of the research is a recommendation to add a project to amend the *Conceptual Framework* in relation to distinguishing between liabilities and equity. Nevertheless, the Board expects

107 For further details, see paragraphs BC4.90–BC4.91 of the *Basis for Conclusions on the Conceptual Framework for Financial Reporting*.

that none of the potential changes arising from this Discussion Paper will result in changes to the supporting guidance in paragraphs 4.28–4.35 of the *Conceptual Framework*. That guidance was not designed to help to distinguish liabilities from equity.[108] Any decision to add a project to amend the *Conceptual Framework* would be made only after considering feedback on the preliminary views in this Discussion Paper and would be subject to the Board's due process.

B7 IAS 32 is one of the IFRS Standards that includes requirements for the classification of claims as liabilities or equity. The other IFRS Standard that deals with similar classification issues is IFRS 2.

B8 At present, the distinction between liabilities and equity in IFRS 2 is consistent with the *Conceptual Framework*. If the Board does ultimately decide to add a project to propose changes to the *Conceptual Framework* to be consistent with the preliminary views in this Discussion Paper, it might need to consider the implications for a future revision to IFRS 2. Any decision to add a project on IFRS 2 to its agenda would be subject to the Board's due process.

Other IFRS Standards and Board projects

B9 Some other IFRS Standards contain requirements that depend on the requirements in IAS 32. Hence, the outcomes of this research project could have implications for those IFRS Standards. Affected IFRS Standards might include:

(a) other financial instruments standards and interpretations, including IFRS 9 *Financial Instruments*;

(b) standards on presentation and disclosure of financial performance, including IAS 33 *Earnings per Share*; and

(c) business combinations and consolidation standards, including IFRS 3 *Business Combinations* and IFRS 10 *Consolidated Financial Statements*.

B10 When relevant, this Discussion Paper includes a brief discussion of possible consequences for other IFRS Standards. The Board will discuss possible consequential amendments to other IFRS Standards in more detail if it decides to add a project to amend or replace IAS 32 to its agenda.

B11 The Board is also considering particular aspects of financial reporting in other projects that overlap with the matters it is considering as part of this project. The Board will consider those matters on an ongoing basis. These projects include:

(a) the Principles of Disclosure project, which is considering presentation and disclosure requirements across a broad range of IFRS Standards; and

(b) the Primary Financial Statements project, which is considering the structure of the statement of financial position and the statement of financial performance.

B12 Further information about all of the Board's projects is available on our website: https://www.ifrs.org/projects/.

108 See paragraph BC4.92 of the *Basis for Conclusions on the Conceptual Framework for Financial Reporting*.

Appendix C—Brief summary of classification outcomes applying various approaches

Claim	Approach A	Approach B	Board's preferred approach	IAS 32	2018 CF
Simple bonds	Liability				
Ordinary shares	Equity				
Shares redeemable for their fair value[(a)]	Liability	Equity	Liability	Liability	Liability
Irredeemable cumulative preference shares	Equity	Liability	Liability	Equity	Equity
Obligation to deliver a variable number of shares equal to a fixed amount of cash	Equity	Liability	Liability	Liability	Equity

(a) Assumes that the shares redeemable for their fair value do not meet the puttable exception in IAS 32.

Appendix D—Comparison of the Board's preferred approach and IAS 32

Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Simple bonds	Liability classified with income or expense presented in profit or loss *(See Section 3—Obligation to transfer cash or another financial asset at a specified time other than at liquidation and obligation for an amount independent of the entity's available economic resources)*	Liability classified with income or expense presented in profit or loss
Ordinary shares	Equity *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation and no obligation for an amount independent of the entity's available economic resources)*	Equity
Shares redeemable for their fair value (assume they do not meet the puttable exception in IAS 32)	Liability classified with income or expense resulting from changes in fair value presented separately in OCI *(See Section 3—Obligation to transfer cash or another financial asset at a specified time other than at liquidation, but no obligation for an amount independent of the entity's available economic resources and Section 6)*	Liability classified with income or expense presented in profit or loss
Shares redeemable for their fair value (assume they meet the puttable exception)	Equity, carrying amount is not updated for subsequent changes in the amount of cash required to be transferred (but additional disclosure in IAS 1) *(See Section 3—The puttable exception might continue to be required under the Board's preferred approach)*	Equity, carrying amount is not updated for subsequent changes in the amount of cash required to be transferred (but additional disclosure in IAS 1)

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Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Irredeemable cumulative preference shares	Liability classified with income or expense presented in profit or loss *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation, but an obligation for an amount independent of the entity's available economic resources)*	Equity
Irredeemable non-cumulative preference shares	Equity with attribution of total comprehensive income to this class of equity consistent with IAS 33 *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation and no obligation for an amount independent of the entity's available economic resources)*	Equity
Obligation to deliver a variable number of shares equal to a fixed amount of cash	Liability classified with income or expense presented in profit or loss *(See Section 3—No obligation to transfer economic resources at a specified time other than at liquidation, but an obligation for an amount independent of the entity's available economic resources)*	Liability classified with income or expense presented in profit or loss
Compound instruments with non-derivative components (see Section 3)		
Obligation to pay a fixed amount of cash in four years' time and to pay discretionary dividends equal to any dividends paid on ordinary shares for four years	Liability component = obligation to pay a fixed amount of cash in four years' time *(Similar to ordinary bond—accounted for in accordance with IFRS 9)*	Liability component = obligation to pay a fixed amount of cash in four years' time
	Equity component = discretionary dividend payments for four years. Measured as a residual on initial recognition *(Similar to ordinary shares—measured as residual)*	Equity component = discretionary dividend payments for four years. Measured as a residual on initial recognition

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Claim	Board's preferred approach[a]	IAS 32[a]
Irredeemable non-cumulative preference shares to pay discretionary dividends with an obligation to pay a fixed amount at liquidation	Liability component = obligation to pay a fixed amount of cash at liquidation *(However, present value will be negligible on a going-concern basis. See paragraph 3.24)*	No liability component
	Equity component = discretionary dividend payments. Measured as a residual on initial recognition. *(Similar to irredeemable non-cumulative preference shares)*	Equity in its entirety
Derivatives (see Section 4)		
Forward contract, or written option, to: (a) receive fixed amount of cash (in functional currency); and (b) deliver variable number of ordinary shares, indexed to the value of the gold index.		
Gross physically settled (exchange cash and shares) and net-share settled	Liability classified with income or expense presented in profit or loss *(See Section 4—neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, but net amount of derivative affected by a variable independent of the entity's available economic resources)*	Liability classified with income or expense presented in profit or loss
Net-cash settled	Liability classified with income or expense presented in profit or loss *(See Section 4—obligation to transfer cash or another financial asset, or right to receive cash for the net amount, and net amount of derivative affected by a variable independent of the entity's available economic resources)*	Liability classified with income or expense presented in profit or loss
Forward contract, or written option, to: (a) receive fixed amount of cash (in functional currency); and (b) deliver fixed number of ordinary shares.		

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Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Gross physically settled (exchange cash and shares)	Equity (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 4— neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, and net amount of derivative unaffected by a variable independent of the entity's available economic resources)*	Equity
Net-share settled	Equity (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 4—neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, and net amount of derivative unaffected by a variable independent of the entity's available economic resources)*	Liability classified with changes reported in profit or loss
Net-cash settled	Liability classified with income or expense resulting from changes in fair value presented separately in OCI *(See Section 4—obligation to transfer cash or another financial asset or right to receive cash for the net amount, but net amount of derivative unaffected by a variable independent of the entity's available economic resources)*	Liability classified with changes reported in profit or loss

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Claim	Board's preferred approach[a]	IAS 32[a]
Gross physically settled (exchange cash and shares) forward contract, or written option, to: (a) receive a fixed amount of cash in a foreign currency; and (b) deliver fixed number of ordinary shares	Liability classified with income or expense resulting from changes in fair value presented separately in OCI if the contract meets the specific criteria *(See Section 4—neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, but net amount of derivative affected by a variable independent of the entity's available economic resources)* *(See Section 6—the net amount of the derivative is affected by a foreign currency variable and not by any other variable that is independent of the entity's available economic resources)*	Liability, unless it meets the foreign currency rights issue exception, in which case it is classified as equity
Gross physically settled (exchange liability and shares) forward contract, or written option, to: (a) extinguish an existing liability for the transfer of a fixed amount of cash in the entity's functional currency; and (b) deliver fixed number of ordinary shares.	Equity (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 4—neither an obligation to transfer cash or another financial asset, nor a right to receive cash for the net amount, and net amount of derivative unaffected by a variable independent of the entity's available economic resources)*	Equity

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Claim	Board's preferred approach[a]	IAS 32[a]
Compound instruments with derivative components (see Section 5)		
Bond to transfer a fixed amount of cash in four years' time, that is convertible to a fixed number of ordinary shares at the option of the bondholder	Liability component = obligation to pay a fixed amount of cash in four years' time *(Similar to ordinary bond—accounted for in accordance with IFRS 9)*	Liability component = obligation to transfer fixed amount of cash in four years' time (classified consistent with an ordinary bond)
	Equity component = obligation to convert the bond to a fixed number of ordinary shares at the option of the holder. Measured as a residual on initial recognition *(Similar to gross physically settled, ie exchange liability and shares, written option to receive/extinguish/convert an existing liability for the transfer of a fixed amount of cash and deliver fixed number of ordinary shares—measured as residual.)*	Equity component = obligation to convert the bond to a fixed number of ordinary shares at the option of the holder. Measured as a residual on initial recognition
Bond to transfer a fixed amount of cash in four years' time, that is convertible to a fixed number of ordinary shares at the option of the issuing entity	Equity in its entirety (different approaches to attribution of total comprehensive income to this class of equity are being considered) *(See Section 5—no obligation to transfer cash or another financial asset at a specified time other than at liquidation and no obligation for an amount independent of the entity's available economic resources)*	Equity in its entirety

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Claim	Board's preferred approach[(a)]	IAS 32[(a)]
Bond to transfer a fixed amount of foreign currency in four years' time that is convertible to a fixed number of ordinary shares at the option of the bondholder	Liability classified in its entirety with income or expense resulting from changes in fair value of foreign currency conversion option potentially presented separately in OCI depending on whether the contract meets the specific criteria *(See Section 4—obligation to transfer cash or another financial asset and net amount of derivative affected by a variable independent of the entity's available economic resources)* *(See Section 6—the net amount of the derivative is affected by a foreign currency variable and not by any other variable that is independent of the entity's available economic resources)*	Liability classified in its entirety. Under IFRS 9, an entity can choose to bifurcate the conversion option and measure it at fair value through profit or loss, or to designate the entire financial instrument as at fair value through profit or loss
	No equity component	No equity component

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Claim	**Board's preferred approach**[(a)]	**IAS 32**[(a)]
Redemption obligations (see Section 5)		
Written option to: (a) receive/extinguish/convert a fixed number of ordinary shares; and	Liability component = obligation to pay a fixed amount of cash in four years' time *(Similar to ordinary bond—accounted for in accordance with IFRS 9)*	Recognise present value of redemption amount (ie obligation to pay a fixed amount of cash in four years' time) as a financial liability and reclassify from equity
(b) deliver a fixed amount of cash in four years	Equity component = obligation to exchange a fixed amount of cash for delivering the fixed number of ordinary shares at the option of the holder and any right to discretionary dividend payments for four years *(Similar to gross physically settled, ie exchange liability and shares, written option to receive/extinguish/convert an existing liability for the transfer of a fixed amount of cash and deliver fixed number of ordinary shares)*	

(a) If a financial instrument is classified as a financial liability and is designated as at fair value through profit or loss, the effect of changes in the liability's credit risk is presented in other comprehensive income in accordance with IFRS 9.

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