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

Issued March 2019 and incorporates amendments to 31 January 2022 other than consequential amendments resulting from early adoption of PBE IFRS 17 *Insurance Contracts* and *Amendments to PBE IFRS 17*

This Standard was issued on 28 March 2019 by the New Zealand Accounting Standards Board of the External Reporting Board pursuant to section 12(a) of the Financial Reporting Act 2013.

This 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 25 April 2019.

Reporting entities that are subject to this Standard are required to apply it in accordance with the effective date, which is set out in paragraph 156–156.4.

In finalising this 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 as a result of a new International Public Sector Accounting Standard – IPSAS 41 *Financial Instruments*.

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

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

PBE IPSAS 41 FINANCIAL INSTRUMENTS

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PBE IPSAS 41 FINANCIAL INSTRUMENTS

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The following is available on the XRB website as additional material:

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.

Objective

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

Scope

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

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

   (a) **Those interests in controlled entities, associates and joint ventures that are accounted for in accordance with 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 of this Standard. Entities shall also apply this Standard to derivatives on an interest in a controlled entity, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in PBE IPSAS 28 *Financial Instruments: Presentation*.**

   (b) **Rights and obligations under leases to which PBE IPSAS 13 *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 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 *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 paragraphs 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).**

   (e) **Rights and obligations arising under:**

      (i) **An insurance contract, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9; or**

      (ii) **A contract that is within the scope of 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 47–53 and paragraphs AG99–AG106 of this Standard). An entity applies this Standard to financial guarantee contracts, but shall apply PBE IFRS 4 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 contract between an acquirer and a selling shareholder to buy or sell an acquired operation that will result in a PBE combination within the scope of PBE IPSAS 40 *PBE Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.**

(g) **Loan commitments other than those loan commitments described in paragraph 4. However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan commitments are subject to the derecognition requirements of this Standard.**

(h) **Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share-based payment applies, except for contracts within the scope of paragraphs 5–8 of this Standard to which this Standard applies.**

(i) **Rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with PBE IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, 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, 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. **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 for the purposes of recognising impairment gains or losses.**

4. **The following loan commitments are within the scope of this Standard:**

(a) **Loan commitments that the entity designates as financial liabilities at fair value through surplus or deficit (see paragraph 46). An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.**

(b) **Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in 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(d)).**

5. **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through surplus or deficit in accordance with paragraph 6.**

6. **A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through surplus or deficit even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard (see paragraph 5).**

7. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) When the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 5 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

8. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 7(a) or 7(d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Definitions

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

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

The 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.

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), 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).

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.

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), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

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

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

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

(a) **It meets the definition of held for trading.**

(b) **Upon initial recognition it is designated by the entity as at fair value through surplus or deficit in accordance with paragraph 46 or 51.**

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

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 or loss is recognised in surplus or deficit in accordance with paragraph 80 and arises from applying the impairment requirements in paragraphs 73–93.

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

A modification gain or loss is the amount arising from adjusting the gross carrying amount of a financial asset to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original effective interest rate (or the original credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 139. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the expected credit losses, unless the financial asset is a purchased or originated credit-impaired financial asset, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original credit-adjusted effective interest rate.

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

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

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

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

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph AG163). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

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,[1] currency risk, liquidity risk, market risk, equity instrument, financial asset, financial instrument, financial liability and puttable instrument.

Recognition and Derecognition

Initial Recognition

10. **An entity shall 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 and AG16). When an entity first recognises a financial asset, it shall classify it in accordance with paragraphs 39–44 and measure it in accordance with paragraphs 57 and 59. When an entity first recognises a financial liability, it shall classify it in accordance with paragraphs 45 and 46 and measure it in accordance with paragraph 57.**

Regular Way Purchase or Sale of Financial Assets

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

Derecognition of Financial Assets

12. In consolidated financial statements, paragraphs 13–20, AG15, AG15 and AG21–AG38 are applied at a consolidated level. Hence, an entity first consolidates all controlled entities in accordance with PBE IPSAS 35 and then applies those paragraphs to the resulting economic entity.

13. **Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 14–20, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.**

    (a) **Paragraphs 14–20 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.**

        (i) **The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 14–20 are applied to the interest cash flows.**

        (ii) **The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 14–20 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each**

[1] 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).

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 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 proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.**

(b) **In all other cases, paragraphs 14–20 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 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 are applied to the financial asset (or a group of similar financial assets) in its entirety.**

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

14. **An entity shall 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 and 16 and the transfer qualifies for derecognition in accordance with paragraph 17.**

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

15. **An entity transfers a financial asset if, and only if, it either:**

(a) **Transfers the contractual rights to receive the cash flows of the financial asset, or**

(b) **Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 16.**

16. **When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.**

(a) **The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.**

(b) **The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.**

(c) **The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in PBE IPSAS 2 *Cash Flow Statements*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.**

17. **When an entity transfers a financial asset (see paragraph 15), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:**

    (a) **If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall 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).**

18. The transfer of risks and rewards (see paragraph 17) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g., because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (e.g., because the entity has sold a financial asset subject only to an option to buy it back at its *fair value* at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 16).

19. Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison are made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.

20. Whether the entity has retained control (see paragraph 17(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

Transfers that Qualify for Derecognition

21. **If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall 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.**

22. **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. **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.

24. **If the transferred asset is part of a larger financial asset (e.g., when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 13(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be 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.

25. 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. **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 on the transferred asset and any expense incurred on the financial liability.**

Continuing Involvement in Transferred Assets

27. **If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to 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).**

    (c) **When the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.**

28. **When an entity continues to 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. **The entity shall continue to recognise any revenue arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.**

30. **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 101, and shall not be offset.**

31. **If an entity's continuing involvement is in only a part of a financial asset (e.g., when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to 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 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 surplus or deficit.

32. 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 is not applicable to the associated liability.

All Transfers

33. **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 arising from the transferred asset with any expense incurred on the associated liability (see paragraph 47 of PBE IPSAS 28).**

34. **If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:**

    (a) **If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.**

    (b) **If the transferee sells collateral pledged to it, it shall 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.**

Derecognition of Financial Liabilities

35. **An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—i.e., when the obligation specified in the contract is discharged, waived, cancelled or expires.**

36. **An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.**

37. **The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in surplus or deficit. Where an obligation is waived by the lender or assumed by a third party as part of a non-exchange transaction, an entity applies PBE IPSAS 23.**

38. If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be 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 surplus or deficit.

Classification

Classification of Financial Assets

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

    (a) **The entity's management model for financial assets and**

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

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

    (a) **The financial asset is held within a management model whose objective is to hold financial assets in order to collect contractual cash flows and**

    (b) **The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

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

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

    (a) **The financial asset is held within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets and**

    (b) **The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

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

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

    (a) **Principal is the fair value of the financial asset at initial recognition. Paragraph AG64 provides additional guidance on the meaning of principal.**

    (b) **Interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. Paragraphs AG63 and AG67–AG71 provide**

additional guidance on the meaning of interest, including the meaning of the time value of money.

43. **A financial asset shall be measured at fair value through surplus or deficit unless it is measured at amortised cost in accordance with paragraph 40 or at fair value through other comprehensive revenue and expense in accordance with paragraph 41. However, an entity may make an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through surplus or deficit to present subsequent changes in fair value in other comprehensive revenue and expense (see paragraphs 106–107).**

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

44. **Despite paragraphs 39–43, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through surplus or deficit if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs AG91–AG94).**

Classification of Financial Liabilities

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

    (a) **Financial liabilities at fair value through surplus or deficit. Such liabilities, including derivatives that are liabilities, shall be subsequently measured at fair value.**

    (b) **Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 26 and 28 apply to the measurement of such financial liabilities.**

    (c) **Financial guarantee contracts. After initial recognition, an issuer of such a contract shall (unless paragraph 45(a) or (b) applies) subsequently measure it at the higher of:**

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

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

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

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

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

    (e) **Contingent consideration recognised by an acquirer in a PBE combination to which PBE IPSAS 40 applies. Such contingent consideration shall subsequently be measured at fair value with changes recognised in surplus or deficit.**

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

46. **An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through surplus or deficit when permitted by paragraph 51, or when doing so results in more relevant information, because either:**

    (a) **It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs AG91–AG94); or**

(b) **A group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in PBE IPSAS 20 *Related Party Disclosures*), for example, the entity's governing body and chief executive officer (see paragraphs AG95–AG98).**

Embedded Derivatives

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

Hybrid Contracts with Financial Asset Hosts

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

Other Hybrid Contracts

49. **If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:**

(a) **The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs AG103 and AG106);**

(b) **A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and**

(c) **The hybrid contract is not measured at fair value with changes in fair value recognised in surplus or deficit (i.e., a derivative that is embedded in a financial liability at fair value through surplus or deficit is not separated).**

50. **If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the statement of financial position.**

51. **Despite paragraphs 49 and 50, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through surplus or deficit unless:**

(a) **The embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or**

(b) **It is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.**

52. **If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through surplus or deficit.**

53. If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the

embedded derivative using this method, paragraph 52 applies and the hybrid contract is designated as at fair value through surplus or deficit.

Reclassification

54. **When, and only when, an entity changes its management model financial assets it shall reclassify all affected financial assets in accordance with paragraphs 39–43. See paragraphs 94–100, AG111–AG113 and AG220–AG221 for additional guidance on reclassifying financial assets.**

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

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

    (a) An item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;

    (b) An item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and

    (c) Changes in measurement in accordance with paragraphs 152–155.

Measurement

Initial Measurement

57. **Except for short-term receivables and payables within the scope of paragraph 60, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.**

58. **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.**

59. 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).

60. Despite the requirement in paragraph 57, at initial recognition, an entity may measure short-term receivables and payables at the original invoice amount if the effect of discounting is immaterial.

Subsequent Measurement of Financial Assets

61. **After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 39- 44 at:**

    (a) **Amortised cost;**

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

    (c) **Fair value through surplus or deficit.**

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

63. **An entity shall apply the hedge accounting requirements in paragraphs 137–143 (and, if applicable, paragraphs 99–105 of PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* for the fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial asset that is designated as a hedged item.**[2]

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

Subsequent Measurement of Financial Liabilities

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

65. **An entity shall apply the hedge accounting requirements in paragraphs 137–143 (and, if applicable, paragraphs 99–105 of PBE IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial liability that is designated as a hedged item.**

Fair Value Measurement Considerations

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.

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.

Amortised Cost Measurement

Financial Assets

Effective Interest Method

69. **Interest revenue shall be calculated by using the effective interest method (see paragraphs 9 and AG156–AG162). 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. 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(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(b) were applied (such as an improvement in the borrower's credit rating).

Modification of Contractual Cash Flows

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

Changes in the Basis for Determining the Contractual Cash Flows as a Result of Interest Rate Benchmark Reform

72.1 An entity shall apply paragraphs 72.2–72.5 to a financial asset or financial liability if, and only if, the basis for determining the contractual cash flows of that financial asset or financial liability changes as a result of interest rate benchmark reform. For this purpose, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark as described in paragraph 155.2.

72.2 The basis for determining the contractual cash flows of a financial asset or financial liability can change:

(a) By amending the contractual terms specified at the initial recognition of the financial instrument (for example, the contractual terms are amended to replace the referenced interest rate benchmark with an alternative benchmark rate);

(b) In a way that was not considered by—or contemplated in—the contractual terms at the initial recognition of the financial instrument, without amending the contractual terms (for example, the method for calculating the interest rate benchmark is altered without amending the contractual terms); and/or

(c) Because of the activation of an existing contractual term (for example, an existing fallback clause is triggered).

72.3 As a practical expedient, an entity shall apply paragraph AG160 to account for a change in the basis for determining the contractual cash flows of a financial asset or financial liability that is required by interest rate benchmark reform. This practical expedient applies only to such changes and only to the extent the change is required by interest rate benchmark reform (see also paragraph 72.5). For this purpose, a change and only if, both these conditions are met:

(a) The change is necessary as a direct consequence of interest rate benchmark reform; and

(b) The new basis for determining the contractual cash flows is economically equivalent to the previous basis (i.e., the basis immediately preceding the change).

72.4 Examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis (i.e., the basis immediately preceding the change) are:

(a) The replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate—or the implementation of such a reform of an interest rate benchmark by altering the method used to calculate the interest rate benchmark—with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate;

(b) Changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

(c) The addition of a fallback provision to the contractual terms of a financial asset or financial liability to enable any change described in (a) and (b) above to be implemented.

72.5 If changes are made to a financial asset or financial liability in addition to changes to the basis for determining the contractual cash flows required by interest rate benchmark reform, an entity shall first apply the practical expedient in paragraph 72.3 to the changes required by interest rate benchmark reform.

The entity shall then apply the applicable requirements in this Standard to any additional changes to which the practical expedient does not apply. If the additional change does not result in the derecognition of the financial asset or financial liability, the entity shall apply paragraph 71 or paragraph AG161, as applicable, to account for that additional change. If the additional change results in the derecognition of the financial asset or financial liability, the entity shall apply the derecognition requirements.

Impairment

Recognition of Expected Credit Losses

General Approach

73. **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 , a lease receivable, or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2(g), 45(c) or 45(d).**

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

75. **Subject to paragraphs 85–88, 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. 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. **Subject to paragraphs 85–88, 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. 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. 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 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. An entity shall recognise in surplus or deficit, as an impairment gain or loss, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with this Standard.

Determining Significant Increases in Credit Risk

81. 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. 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).

83. 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. 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 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. **Despite paragraphs 75 and 77, 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. At each reporting date, an entity shall recognise in 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 Receivables

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

    (a) **Receivables that result from exchange transactions that are within the scope of PBE IPSAS 9 and non-exchange transactions within the scope of PBE IPSAS 23.**

    (b) **Lease receivables that result from transactions that are within the scope of PBE IPSAS 13, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all lease receivables but may be applied separately to finance and operating lease receivables.**

88. An entity may select its accounting policy for trade receivables and lease receivables 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. **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. 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. 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. However, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For such financial instruments, and only those financial instruments, the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

Reclassification of Financial Assets

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

95. **If an entity reclassifies a financial asset out of the amortised cost measurement category and into the fair value through surplus or deficit measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in surplus or deficit.**

96. **If an entity reclassifies a financial asset out of the fair value through 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 for guidance on determining an effective interest rate and a loss allowance at the reclassification date.)**

97. **If an entity reclassifies a financial asset out of the amortised cost measurement category and into the fair value through other comprehensive revenue and expense 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. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph AG220.)**

98. **If an entity reclassifies a financial asset out of the fair value through other comprehensive revenue and expense 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 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 but does not affect surplus or deficit and therefore is not a reclassification adjustment (see PBE IPSAS 1 *Presentation of Financial Reports*). The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph AG220.)**

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

100. **If an entity reclassifies a financial asset out of the fair value through other comprehensive revenue and expense measurement category and into the fair value through surplus or deficit measurement category, the financial asset continues to be measured at fair value. The cumulative gain or loss**

previously recognised in other comprehensive revenue and expense is reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see PBE IPSAS 1) at the reclassification date.

Gains and Losses

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

    (a) **It is part of a hedging relationship (see paragraphs 137–143 and, if applicable, paragraphs 99- 105 of PBE IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk);**

    (b) **It is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive revenue and expense in accordance with paragraph 106;**

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

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

102. Dividends or similar distributions are recognised in surplus or deficit only when:

    (a) The entity's right to receive payment of the dividend is established;

    (b) It is probable that the economic benefits associated with the dividend will flow to the entity; and

    (c) The amount of the dividend can be measured reliably.

103. **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 and, if applicable, paragraphs 99–105 of PBE IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognised in surplus or deficit when the financial asset is derecognised, reclassified in accordance with paragraph 95, through the amortisation process or in order to recognise impairment gains or losses. An entity shall apply paragraphs 95 and 97 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 and, if applicable, paragraphs 99–105 of PBE IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognised in surplus or deficit when the financial liability is derecognised and through the amortisation process. (See paragraph AG224 for guidance on foreign exchange gains or losses.)**

104. **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 and, if applicable, paragraphs 99–105 of PBE IPSAS 29 for the fair value hedge accounting for a portfolio hedge of interest rate risk.**

105. **If an entity recognises financial assets using settlement date accounting (see paragraphs 11, AG17 and AG20), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets measured at amortised cost. For assets measured at fair value, however, the change in fair value shall be recognised in surplus or deficit or in other comprehensive revenue and expense, as appropriate in accordance with paragraph 101. The trade date shall be considered the date of initial recognition for the purposes of applying the impairment requirements.**

Investments in Equity Instruments

106. **At initial recognition, an entity may make an irrevocable election to present in other comprehensive 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 PBE combination to which PBE IPSAS 40 applies. (See paragraph AG226 for guidance on foreign exchange gains or losses.)**

107. If an entity makes the election in paragraph 106, it shall recognise in surplus or deficit dividends or similar distributions from that investment in accordance with paragraph 102.

Liabilities Designated as at Fair Value Through Surplus or Deficit

108. **An entity shall present a gain or loss on a financial liability that is designated as at fair value through surplus or deficit in accordance with paragraph 46 or paragraph 51 as follows:**

(a) **The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive revenue and expense (see paragraphs AG236–AG243), and**

(b) **The remaining amount of change in the fair value of the liability shall be presented in surplus or deficit**

unless the treatment of the effects of changes in the liability's credit risk described in (a) would create or enlarge an accounting mismatch in surplus or deficit (in which case paragraph 109 applies). Paragraphs AG228–AG230 and AG233–AG235 provide guidance on determining whether an accounting mismatch would be created or enlarged.

109. **If the requirements in paragraph 108 would create or enlarge an accounting mismatch in surplus or deficit, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in surplus or deficit.**

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

Assets Measured at Fair Value Through Other Comprehensive Revenue and Expense

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

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

Hedge Accounting

Objective and Scope of Hedge Accounting

113. The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect surplus or deficit (or other comprehensive revenue and expense, 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 in accordance with paragraph 106). 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. An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in accordance with paragraphs 116–128 and AG244–AG274. 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 and AG294–AG321. When the hedged item is a group of items, an entity shall comply with the additional requirements in paragraphs 146–151 and AG333–AG348.

115. 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 instead of those in this Standard. In that case, the entity must also apply the specific requirements for the fair value hedge accounting for a portfolio hedge of interest rate risk and designate as the hedged item a portion that is a currency amount (see paragraphs 91, 100 and AG157–AG175 of PBE IPSAS 29).

Hedging Instruments

Qualifying Instruments

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

117. **A non-derivative financial asset or a non-derivative financial liability measured at fair value through surplus or deficit may be designated as a hedging instrument unless it is a financial liability designated as at fair value through surplus or deficit for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive revenue and expense in accordance with paragraph 108. 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 revenue and expense in accordance with paragraph 106.**

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

Designation of Hedging Instruments

119. 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 and AG322–AG326);

    (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 and AG327–AG332); 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. 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. 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). 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).

Hedged Items

Qualifying Items

122. **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 and AG333–AG348).**

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

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

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

125. **An aggregated exposure that is a combination of an exposure that could qualify as a hedged item in accordance with paragraph 122 and a derivative may be designated as a hedged item (see paragraphs AG252–AG253). 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. **For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting entity can be designated as hedged items. Hedge accounting can be applied to transactions between entities in the same economic entity only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the economic entity, except for:**

    (a) **The consolidated financial statements of an investment entity, as defined in PBE IPSAS 35, where transactions between an investment entity and its controlled entities measured at fair value through surplus or deficit will not be eliminated in the consolidated financial statements; or**

    (b) **The consolidated financial statements of a controlling entity of an investment entity, as defined in 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. However, as an exception to paragraph 126, the foreign currency risk of a monetary item within an economic entity (for example, a payable/receivable between two controlled entities) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with PBE IPSAS 4 *The Effects of Changes in Foreign Exchange Rates*. In accordance with PBE IPSAS 4, foreign exchange rate gains and losses on monetary items within an economic entity are not fully eliminated on consolidation when the monetary item is transacted between two entities within the economic entity that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated surplus or deficit.

Designation of Hedged Items

128. 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). 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).

Qualifying Criteria for Hedge Accounting

129. **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);**

(ii) **The effect of credit risk does not dominate the value changes that result from that economic relationship (see paragraphs AG281–AG282); 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).**

Accounting for Qualifying Hedging Relationships

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

131. **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 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 surplus or deficit.**

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

132. If the hedged item is 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, the hedged exposure referred to in paragraph 131(a) must be one that could affect other comprehensive revenue and expense. In that case, and only in that case, the recognised hedge ineffectiveness is presented in other comprehensive revenue and expense.

133. 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. **If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio (see paragraph 129(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).**

135. **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. An entity shall apply:

    (a) Paragraph 139 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 when it discontinues hedge accounting for cash flow hedges.

Fair Value Hedges

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

    (a) **The gain or loss on the hedging instrument shall be recognised in surplus or deficit (or other comprehensive 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 revenue and expense in accordance with paragraph 106).**

    (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 surplus or deficit. If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41, the hedging gain or loss on the hedged item shall be recognised in surplus or deficit. However, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive revenue and expense in accordance with paragraph 106, those amounts shall remain in other comprehensive 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 surplus or deficit.**

138. 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. Any adjustment arising from paragraph 137(b) shall be amortised to 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 revenue and expense in accordance with paragraph 41, amortisation applies in the same manner but to the amount that represents the cumulative gain or loss previously recognised in accordance with paragraph 137(b) instead of by adjusting the carrying amount.

Cash Flow Hedges

140. **As long as a cash flow hedge meets the qualifying criteria in paragraph 129, 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 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 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) and hence it does not affect other comprehensive 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 surplus or deficit as a reclassification adjustment (see PBE IPSAS 1) in the same period or periods during which the hedged expected future cash flows affect surplus or deficit (for example, in the periods that interest revenue or interest expense is 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 surplus or deficit as a reclassification adjustment (see PBE IPSAS 1).**

141. When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 135 and 136(b)) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 140(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(d)(iii) applies. When the future cash flows occur, paragraph 140(d) applies.

(b) If the hedged future cash flows are no longer expected to occur, that amount shall be immediately reclassified from the cash flow hedge reserve to surplus or deficit as a reclassification adjustment (see PBE IPSAS 1). A hedged future cash flow that is no longer highly probable to occur may still be expected to occur.

Hedges of a Net Investment in a Foreign Operation

142. **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 shall be recognised in other comprehensive revenue and expense (see paragraph 140); and**

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

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

Accounting for the Time Value of Options

144. 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(a)), it shall account for the time value of the option as follows (see paragraphs AG322–AG326):

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

(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 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) and hence does not affect other comprehensive 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 surplus or deficit as a reclassification adjustment (see PBE IPSAS 1) in the same period or periods during which the hedged expected future cash flows affect surplus or deficit (for example, when a forecast sale occurs).

(iii) However, if all or a portion of that amount is not expected to be recovered in one or more future periods, the amount that is not expected to be recovered shall be immediately reclassified into surplus or deficit as a reclassification adjustment (see PBE IPSAS 1).

(c) The change in fair value of the time value of an option that hedges a time-period related hedged item shall be recognised in other comprehensive 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 surplus or deficit (or other comprehensive 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 revenue and expense in accordance with paragraph 106). Hence, in each reporting period, the amortisation amount shall be reclassified from the separate component of net assets/equity to surplus or deficit as a reclassification adjustment (see PBE IPSAS 1). However, if hedge accounting is discontinued for the hedging relationship that includes the change in intrinsic value of the option as the hedging instrument, the net amount (i.e., including cumulative amortisation) that has been accumulated in the separate component of net assets/equity shall be immediately reclassified into surplus or deficit as a reclassification adjustment (see PBE IPSAS 1).

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

145. 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(b)), the entity may apply paragraph 144 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.

Hedges of a Group of Items

Eligibility of a Group of Items as the Hedged Item

146. **A group of items (including a group of items that constitute a net position; see paragraphs AG333–AG340) is an eligible hedged item only if:**

    (a) **It consists of items (including components of items) that are, individually, eligible hedged items;**

    (b) **The items in the group are managed together on a group basis for risk management purposes; and**

    (c) **In the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting risk positions arise:**

        (i) **It is a hedge of foreign currency risk; and**

        (ii) **The designation of that net position specifies the reporting period in which the forecast transactions are expected to affect surplus or deficit, as well as their nature and volume (see paragraphs AG339–AG340).**

Designation of a Component of a Nominal Amount

147. 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. 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).

Presentation

149. 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 comprehensive 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) remains unaffected.

150. 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(b).

Nil Net Positions

151. 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.

Option to Designate a Credit Exposure as Measured at Fair Value Through Surplus or Deficit

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

152. **If an entity uses a credit derivative that is measured at fair value through surplus or deficit to manage the credit risk of all, or a part of, a financial instrument (credit exposure) it may designate that financial instrument to the extent that it is so managed (i.e., all or a proportion of it) as measured at fair value through surplus or deficit if:**

(a) **The name of the credit exposure (for example, the borrower, or the holder of a loan commitment) matches the reference entity of the credit derivative ('name matching'); and**

(b) **The seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.**

An entity may make this designation irrespective of whether the financial instrument that is managed for credit risk is within the scope of this Standard (for example, an entity may designate loan commitments that are outside the scope of this Standard). The entity may designate that financial instrument at, or subsequent to, initial recognition, or while it is unrecognised. The entity shall document the designation concurrently.

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

153. If a financial instrument is designated in accordance with paragraph 152 as measured at fair value through 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

surplus or deficit. For financial assets measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41, the cumulative gain or loss previously recognised in other comprehensive revenue and expense shall immediately be reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see PBE IPSAS 1).

154. An entity shall discontinue measuring the financial instrument that gave rise to the credit risk, or a proportion of that financial instrument, at fair value through surplus or deficit if:

(a) The qualifying criteria in paragraph 152 are no longer met, for example:

(i) The credit derivative or the related financial instrument that gives rise to the credit risk expires or is sold, terminated or settled; or

(ii) The credit risk of the financial instrument is no longer managed using credit derivatives. For example, this could occur because of improvements in the credit quality of the borrower or the loan commitment holder or changes to capital requirements imposed on an entity; and

(b) The financial instrument that gives rise to the credit risk is not otherwise required to be measured at fair value through surplus or deficit (i.e., the entity's management model has not changed in the meantime so that a reclassification in accordance with paragraph 54 was required).

155. When an entity discontinues measuring the financial instrument that gives rise to the credit risk, or a proportion of that financial instrument, at fair value through surplus or deficit, that financial instrument's fair value at the date of discontinuation becomes its new carrying amount. Subsequently, the same measurement that was used before designating the financial instrument at fair value through surplus or deficit shall be applied (including 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 surplus or deficit.

Temporary Exceptions from Applying Specific Hedge Accounting Requirements

155.1 An entity shall apply paragraphs 155.4–155.12 and paragraphs 156.3 and 184(d) to all hedging relationships directly affected by interest rate benchmark reform. These paragraphs apply only to such hedging relationships. A hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about:

(a) The interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk; and/or

(b) The timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

155.2 For the purpose of applying paragraphs 155.4–155.12, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the Financial Stability Board's July 2014 report 'Reforming Major Interest Rate Benchmarks'.[3]

155.3 Paragraphs 155.4–155.12 provide exceptions only to the requirements specified in these paragraphs. An entity shall continue to apply all other hedge accounting requirements to hedging relationships directly affected by interest rate benchmark reform.

Highly Probable Requirement for Cash Flow Hedges

155.4 For the purpose of determining whether a forecast transaction (or a component thereof) is highly probable as required by paragraph 124, an entity shall assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

Reclassifying the Amount Accumulated in the Cash Flow Hedge Reserve

155.5 For the purpose of applying the requirement in paragraph 141 in order to determine whether the hedged future cash flows are expected to occur, an entity shall assume that the interest rate benchmark on which

[3] The report, 'Reforming Major Interest Rate Benchmarks', is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

Assessing the Economic Relationship Between the Hedged Item and the Hedging Instrument

155.6 For the purpose of applying the requirements in paragraphs 129(c)(i) and AG278–AG280, an entity shall assume that the interest rate benchmark on which the hedged cash flows and/or the hedged risk (contractually or non-contractually specified) are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, is not altered as a result of interest rate benchmark reform.

Designating a Component of an Item as a Hedged Item

155.7 Unless paragraph 155.8 applies, for a hedge of a non-contractually specified benchmark component of interest rate risk, an entity shall apply the requirement in paragraphs 128(a) and AG257—that the risk component shall be separately identifiable—only at the inception of the hedging relationship.

155.8 When an entity, consistent with its hedge documentation, frequently resets (ie discontinues and restarts) a hedging relationship because both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long), the entity shall apply the requirement in paragraphs 128(a) and AG257—that the risk component is separately identifiable—only when it initially designates a hedged item in that hedging relationship. A hedged item that has been assessed at the time of its initial designation in the hedging relationship, whether it was at the time of the hedge inception or subsequently, is not reassessed at any subsequent redesignation in the same hedging relationship.

End of Application

155.9 An entity shall prospectively cease applying paragraph 155.4 to a hedged item at the earlier of:

(a) When the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) When the hedging relationship that the hedged item is part of is discontinued.

155.10 An entity shall prospectively cease applying paragraph 155.5 at the earlier of:

(a) When the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based future cash flows of the hedged item; and

(b) When the entire amount accumulated in the cash flow hedge reserve with respect to that discontinued hedging relationship has been reclassified to surplus or deficit.

155.11 An entity shall prospectively cease applying paragraph 155.6:

(a) To a hedged item, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk or the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) To a hedging instrument, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedging instrument.

If the hedging relationship that the hedged item and the hedging instrument are part of is discontinued earlier than the date specified in paragraph 155.11(a) or the date specified in paragraph 155.11(b), the entity shall prospectively cease applying paragraph 155.6 to that hedging relationship at the date of discontinuation.

155.12 When designating a group of items as the hedged item, or a combination of financial instruments as the hedging instrument, an entity shall prospectively cease applying paragraphs 155.4–155.6 to an individual item or financial instrument in accordance with paragraphs 155.9, 155.10, or 155.11, as relevant, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of the interest rate benchmark-based cash flows of that item or financial instrument.

155.13 An entity shall prospectively cease applying paragraphs 155.6 and 155.8 at the earlier of:

(a) When changes required by interest rate benchmark reform are made to the non-contractually specified risk component applying paragraph 155.14; or

(b) When the hedging relationship in which the non-contractually specified risk component is designated is discontinued.

Additional Temporary Exceptions Arising from Interest Rate Benchmark Reform

155.14 As and when the requirements in paragraphs 155.4–155.8 cease to apply to a hedging relationship (see paragraphs 155.9–155.13), an entity shall amend the formal designation of that hedging relationship as previously documented to reflect the changes required by interest rate benchmark reform, i.e., the changes are consistent with the requirements in paragraphs 72.2–72.4. In this context, the hedge designation shall be amended only to make one or more of these changes:

(a) Designating an alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

(b) Amending the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged; or

(c) Amending the description of the hedging instrument.

155.15 An entity also shall apply the requirement in paragraph 155.14(c) if these three conditions are met:

(a) The entity makes a change required by interest rate benchmark reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument (as described in paragraph 72.2);

(b) The original hedging instrument is not derecognised; and

(c) The chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument (as described in paragraphs 72.3 and 72.4).

155.16 The requirements in paragraphs 155.4–155.8 may cease to apply at different times. Therefore, in applying paragraph 155.14, an entity may be required to amend the formal designation of its hedging relationships at different times, or may be required to amend the formal designation of a hedging relationship more than once. When, and only when, such a change is made to the hedge designation, an entity shall apply paragraphs 155.20–155.25 as applicable. An entity also shall apply paragraph 137 (for a fair value hedge) or paragraph 140 (for a cash flow hedge) to account for any changes in the fair value of the hedged item or the hedging instrument.

155.17 An entity shall amend a hedging relationship as required in paragraph 155.14 by the end of the reporting period during which a change required by interest rate benchmark reform is made to the hedged risk, hedged item or hedging instrument. For the avoidance of doubt, such an amendment to the formal designation of a hedging relationship constitutes neither the discontinuation of the hedging relationship nor the designation of a new hedging relationship.

155.18 If changes are made in addition to those changes required by interest rate benchmark reform to the financial asset or financial liability designated in a hedging relationship (as described in paragraphs 72.2–72.4) or to the designation of the hedging relationship (as required by paragraph 155.14), an entity shall first apply the applicable requirements in this Standard to determine if those additional changes result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, an entity shall amend the formal designation of the hedging relationship as specified in paragraph 155.14.

155.19 Paragraphs 155.20–155.26 provide exceptions to the requirements specified in those paragraphs only. An entity shall apply all other hedge accounting requirements in this Standard, including the qualifying criteria in paragraph 129, to hedging relationships that were directly affected by interest rate benchmark reform.

Accounting for Qualifying Hedging Relationships

Cash Flow Hedges

155.20 For the purpose of applying paragraph 140, at the point when an entity amends the description of a hedged item as required in paragraph 155.14(b), the amount accumulated in the cash flow hedge reserve shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

155.21 For a discontinued hedging relationship, when the interest rate benchmark on which the hedged future cash flows had been based is changed as required by interest rate benchmark reform, for the purpose of applying paragraph 141 in order to determine whether the hedged future cash flows are expected to occur, the amount accumulated in the cash flow hedge reserve for that hedging relationship shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

Groups of Items

155.22 When an entity applies paragraph 155.14 to groups of items designated as hedged items in a fair value or cash flow hedge, the entity shall allocate the hedged items to subgroups based on the benchmark rate being hedged and designate the benchmark rate as the hedged risk for each subgroup. For example, in a hedging relationship in which a group of items is hedged for changes in an interest rate benchmark subject to interest rate benchmark reform, the hedged cash flows or fair value of some items in the group could be changed to reference an alternative benchmark rate before other items in the group are changed. In this example, in applying paragraph 155.14, the entity would designate the alternative benchmark rate as the hedged risk for that relevant subgroup of hedged items. The entity would continue to designate the existing interest rate benchmark as the hedged risk for the other subgroup of hedged items until the hedged cash flows or fair value of those items are changed to reference the alternative benchmark rate or the items expire and are replaced with hedged items that reference the alternative benchmark rate.

155.23 An entity shall assess separately whether each subgroup meets the requirements in paragraph 146 to be an eligible hedged item. If any subgroup fails to meet the requirements in paragraph 146, the entity shall discontinue hedge accounting prospectively for the hedging relationship in its entirety. An entity also shall apply the requirements in paragraphs 137 and 140 to account for ineffectiveness related to the hedging relationship in its entirety.

Designation of Risk Components

155.24 An alternative benchmark rate designated as a non-contractually specified risk component that is not separately identifiable (see paragraphs 128(a) and AG257) at the date it is designated shall be deemed to have met that requirement at that date, if, and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within 24 months. The 24-month period applies to each alternative benchmark rate separately and starts from the date the entity designates the alternative benchmark rate as a non-contractually specified risk component for the first time (i.e., the 24month period applies on a rate-by-rate basis).

155.25 If subsequently an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months from the date the entity designated it as a non-contractually specified risk component for the first time, the entity shall cease applying the requirement in paragraph 155.24 to that alternative benchmark rate and discontinue hedge accounting prospectively from the date of that reassessment for all hedging relationships in which the alternative benchmark rate was designated as a noncontractually specified risk component.

155.26 In addition to those hedging relationships specified in paragraph 155.14, an entity shall apply the requirements in paragraphs 155.24 and 155.25 to new hedging relationships in which an alternative benchmark rate is designated as a non-contractually specified risk component (see paragraphs 128(a) and AG257) when, because of interest rate benchmark reform, that risk component is not separately identifiable at the date it is designated.

Effective Date and Transition

Effective Date

156. **An entity shall apply this Standard for annual periods beginning on or after 1 January 2022. Earlier application is permitted. If an entity elects to apply this Standard early, it must disclose that fact and apply all of the requirements in this Standard at the same time (but see also paragraphs 173 and 179). It shall also, at the same time, apply the amendments in Appendix D.**

156.1 **PBE IPSAS 40 *PBE Combinations*, issued in July 2019, amended paragraphs 2, 45, 106, AG110 and AG250. An entity shall apply those amendments when it applies PBE IPSAS 40.**

156.2 [See PBE IFRS 17 *Insurance Contracts* and *Amendments to PBE IFRS 17*]

156.3 ***PBE Interest Rate Benchmark Reform*, which amended PBE IPSAS 41, PBE IPSAS 29 and PBE IPSAS 30, issued in February 2020, added paragraphs 155.1–155.12 and amended paragraphs 157.7, 157.8, 179 and 184. If an entity has applied PBE IPSAS 41 for annual periods beginning on or before 1 January 2020 it shall apply these amendments for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact. If an entity has not applied PBE IPSAS 41 for annual periods beginning on or before 1 January 2020, it shall apply these amendments when it first applies PBE IPSAS 41.**

156.4 ***PBE Interest Rate Benchmark Reform—Phase 2*, which amended PBE IPSAS 41, [PBE IFRS 9], PBE IPSAS 29 and PBE IPSAS 30, issued in November 2020, added paragraphs 72.1–72.5, 155.13, 155.14–155.26 and 157.12–157.15 and amended paragraphs 157.7, 157.8 and 179. If an entity has early adopted PBE IPSAS 41 it shall apply these amendments for annual periods beginning on or after 1 January 2021. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact. If an entity has not early adopted PBE IPSAS 41, it shall apply these amendments when it first applies PBE IPSAS 41.**

157. [Not used.]

Transition

157.1. An entity that has previously applied PBE IFRS 9 *Financial Instruments* shall apply the transition provisions in paragraphs 157.3–157.11. 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 the 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 the revised requirements in the opening accumulated comprehensive revenue and expense (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 113–155.26 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 113–155.26 of this Standard in accordance with paragraphs 179–184A 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. 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 paragraph 87 in the opening accumulated comprehensive revenue and expense (or other component of net assets/equity, as appropriate) of the annual reporting period that includes the date of initial 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. 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 Appendix C in the opening accumulated comprehensive revenue and expense (or other component of net assets/equity, as appropriate) of the annual reporting period that includes the date of initial application of Appendix C.

Transition for PBE Interest Rate Benchmark Reform—Phase 2

157.12 An entity shall apply *PBE Interest Rate Benchmark Reform—Phase 2* retrospectively in accordance with PBE IPSAS 3, except as specified in paragraphs 157.13–157.15.

157.13 An entity shall designate a new hedging relationship (for example, as described in paragraph 155.26) only prospectively (i.e., an entity is prohibited from designating a new hedge accounting relationship in prior periods). However, an entity shall reinstate a discontinued hedging relationship if, and only if, these conditions are met:

(a) The entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging relationship if these amendments had been applied at that time; and

(b) At the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (after taking into account these amendments).

157.14 If, in applying paragraph 157.13, an entity reinstates a discontinued hedging relationship, the entity shall read references in paragraphs 155.24 and 155.25 to the date the alternative benchmark rate is designated as a non-contractually specified risk component for the first time as referring to the date of initial application of these amendments (i.e., the 24-month period for that alternative benchmark rate designated as a non-contractually specified risk component begins from the date of initial application of these amendments).

157.15 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. 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 comprehensive revenue and expense (or other component of net assets/equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.

Entities Transitioning from PBE IPSAS 29

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

159. [Not used]

Transition for Classification and Measurement

160. At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraphs 40(a) or 41(a) on the basis of the facts and circumstances that exist at that date. The resulting classification shall be applied retrospectively irrespective of the entity's management model in prior reporting periods.

161. If, at the date of initial application, it is impracticable (as defined in PBE IPSAS 3) for an entity to assess a modified time value of money element in accordance with paragraphs AG68–AG70 on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the requirements related to the modification of the time value of money element in paragraphs AG68–AG70. (See also paragraph 49R of PBE IPSAS 30.)

162. If, at the date of initial application, it is impracticable (as defined in PBE IPSAS 3) for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraph AG74(c) on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph AG74. (See also paragraph 49S of PBE IPSAS 30.)

163. If an entity measures a hybrid contract at fair value in accordance with paragraphs 41, 43 or 44 but the fair value of the hybrid contract had not been measured in comparative reporting periods, the fair value of the hybrid contract in the comparative reporting periods shall be the sum of the fair values of the components (i.e., the non-derivative host and the embedded derivative) at the end of each comparative reporting period if the entity restates prior periods (see paragraph 173).

164. If an entity has applied paragraph 163 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 comprehensive revenue and expense (or other component of net assets/equity, as appropriate) of the reporting period that includes the date of initial application.

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

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

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

    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. At the date of initial application an entity:

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

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

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

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

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

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

(c) May revoke its previous designation of a financial liability as measured at fair value through surplus or deficit if such designation was made at initial recognition in accordance with the condition now in paragraph 46(a) and such designation satisfies that condition at the date of initial application.

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

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

(a) The fair value of the financial asset or the financial liability at the end of each comparative period presented as the gross carrying amount of that financial asset or the 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. If an entity previously accounted at cost (in accordance with PBE IPSAS 29), for an investment in an equity instrument that does not have a quoted price in an active market for an identical instrument (i.e., a Level 1 input) (or for a derivative asset that is linked to and must be settled by delivery of such an equity instrument) it shall measure that instrument at fair value at the date of initial application. Any difference between the previous carrying amount and the fair value shall be recognised in the opening accumulated comprehensive revenue and expense (or other component of net assets/equity, as appropriate) of the reporting period that includes the date of initial application.

169.1 Despite the requirements in paragraphs 45(c) and AG136, an entity that was previously unable to determine a reliable measure of the fair value of a financial guarantee contract issued through a non-exchange transaction shall, at the date of initial application, measure the contract at the higher of:

(a) The loss allowance determined in accordance with paragraphs 73–93; and

(b) The previous carrying amount determined in accordance with PBE IPSAS 29.

Any difference between the amount determined at the date of initial application and the previous carrying amount shall be recognised in the opening accumulated comprehensive revenue and expense of the reporting period that includes the date of initial application. The amount recognised at the date of initial application becomes the amount initially recognised in accordance with this Standard.

170. 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, 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 accumulated comprehensive revenue and expense of the reporting period that includes the date of initial application.

171. At the date of initial application, an entity shall determine whether the treatment in paragraph 108 would create or enlarge an accounting mismatch in surplus or deficit on the basis of the facts and circumstances that exist at the date of initial application. This Standard shall be applied retrospectively on the basis of that determination.

172. At the date of initial application, an entity is permitted to make the designation in paragraph 6 for contracts that already exist on the date but only if it designates all similar contracts. The change in the net assets resulting from such designations shall be recognised in net assets/equity at the date of initial application.

173. Despite the requirement in paragraph 158, 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) shall provide the disclosures set out in paragraphs 49L–49O of PBE IPSAS 30 but need not restate prior periods. The entity may restate prior periods if, and only if, it is possible without the use of hindsight. If an entity does not restate prior periods, the entity shall 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 comprehensive revenue and expense (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.

174. 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).

Impairment

175. An entity shall apply the impairment requirements in paragraphs 73–93 retrospectively in accordance with PBE IPSAS 3 subject to paragraphs 173 and 176–178.

176. 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) and compare that to the credit risk at the date of initial application of this Standard.

177. 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 and AG186–AG188; and

(b) The rebuttable presumption in paragraph 83 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. 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(a) applies).

Transition for Hedge Accounting

179. 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 instead of the requirements in paragraphs 113–155.26 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.

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

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

183 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; and

(b) Shall consider the hedge ratio in accordance with PBE IPSAS 29 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship, if applicable. Any gain or loss from such a rebalancing shall be recognised in surplus or deficit.

184. 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 retrospectively if, in accordance with PBE IPSAS 29, only the change in an option's intrinsic value was designated as a hedging instrument in a hedging relationship. This retrospective application

applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.

(b) May apply the accounting for the forward element of forward contracts in accordance with paragraph 145 retrospectively if, in accordance with PBE IPSAS 29, only the change in the spot element of a forward contract was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. In addition, if an entity elects retrospective application of this accounting, it shall be applied to all hedging relationships that qualify for this election (i.e., on transition this election is not available on a hedging-relationship-by-hedging-relationship basis). The accounting for foreign currency basis spreads (see paragraph 145) 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 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.

(d) Shall apply the requirements in paragraphs 155.1–155.12 retrospectively. This retrospective application applies only to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements.

Transition for PBE Interest Rate Benchmark Reform—Phase 2

184A An entity shall apply *PBE Interest Rate Benchmark Reform—Phase 2* retrospectively in accordance with PBE IPSAS 3, except as specified in paragraphs 157.13–157.15.

Withdrawal of PBE IFRS 9

184.1 This Standard supersedes PBE IFRS 9. *Effective Date of PBE IFRS 9*, issued in March 2019, limited the early adoption of PBE IFRS 9 to annual periods beginning before 1 January 2020.

Appendix A

Application Guidance

This Appendix is an integral part of PBE IPSAS 41.

Scope

AG1. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.) If those contracts are not insurance contracts, they are within the scope of this Standard.

AG2. This Standard does not change the requirements relating to employee benefit plans that comply with the relevant international or national accounting standard on accounting and reporting by retirement benefit plans and royalty agreements based on the volume of sales or service revenues that are accounted for under PBE IPSAS 9 *Revenue from Exchange Transactions*.

AG3. Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the management model of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor or joint venturer entity uses PBE IPSAS 36 *Investments in Associates and Joint Ventures* to determine whether the equity method of accounting shall be applied to such an investment.

AG4. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under insurance contracts. 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. 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 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, an entity may elect, under certain circumstances, to treat financial guarantee contracts as insurance contracts using PBE IPSAS 28 if the issuer has previously adopted an accounting policy that treated financial guarantee contracts as insurance contracts and has used accounting that is applicable to insurance contracts; the issuer may elect to apply either this Standard or PBE IFRS 4 *Insurance Contracts* to such financial guarantee contracts. If this Standard applies, paragraph 57 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 surplus or deficit or unless paragraphs 26–34 and AG32–AG38 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) The amount determined in accordance with paragraphs 73–93; and

(ii) The amount initially recognised less, when appropriate, the cumulative amortisation recognised in accordance with the principles of PBE IPSAS 9 (see paragraph 45(c)).

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in this Standard, and are not insurance contracts. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies PBE IPSAS 9 in determining when it recognises the revenue from the guarantee and from the sale of goods.

AG6. Rights and obligations (assets and liabilities) may arise from non-exchange revenue transactions, for example, an entity may receive cash from a multi-lateral agency to perform certain activities. Where the performance of those activities is subject to conditions, an asset and a liability is 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

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

AG8. The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g., a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g., a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard applies to such contracts for an entity's expected purchase, sale or usage requirements if the entity makes a designation in accordance with paragraph 6 (see paragraphs 5–8).

AG9. One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

AG10. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Instead, this Standard provides for special accounting for such regular way contracts (see paragraphs 11 and AG17–20).

AG11. The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Financial Assets and Liabilities Held for Trading

AG12. Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

AG13. Financial liabilities held for trading include:

(a) Derivative liabilities that are not accounted for as hedging instruments;

(b) Obligations to deliver financial assets borrowed by a short seller (i.e., an entity that sells financial assets it has borrowed and does not yet own);

(c) Financial liabilities that are incurred with a management model to repurchase them in the near term (e.g., a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and

(d) Financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

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

Recognition and Derecognition

Initial Recognition

AG15. As a consequence of the principle in paragraph 10, an entity 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). 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).

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

(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, its net fair value is recognised as an asset or a liability on the commitment date (see paragraph AG92(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(b) and 138).

(c) A forward contract that is within the scope of this Standard (see paragraph 2) 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) 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. 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 and AG20. An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with this Standard. For this purpose assets that are mandatorily measured at fair value through surplus or deficit form a separate classification from assets designated as measured at fair value through surplus or deficit. In addition, investments in equity instruments accounted for using the option provided in paragraph 106 form a separate classification.

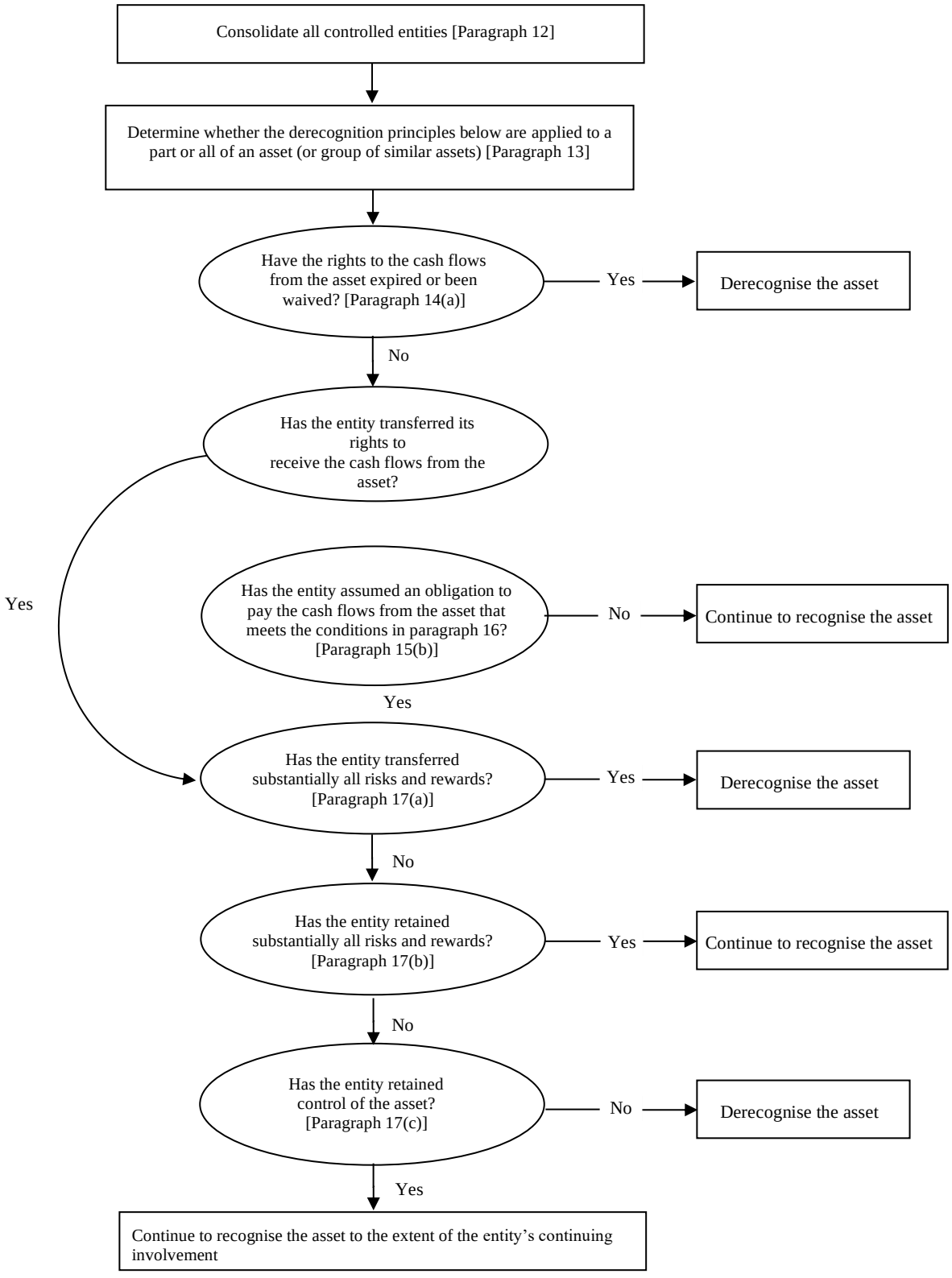
AG18. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

AG19. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

AG20. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets measured at amortised cost; it is recognised in surplus or deficit for assets classified as financial assets measured at fair value through surplus or deficit; and it is recognised in other comprehensive revenue and expense for financial assets measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 and for investments in equity instruments accounted for in accordance with paragraph 106.

Derecognition of Financial Assets

AG21. 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(b))

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

AG23. In applying paragraph 16, the entity could be, for example, the originator of the financial asset, or it could be an economic entity that includes a controlled entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

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

AG24. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

(a) An unconditional sale of a financial asset;

(b) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

(c) A sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).

AG25. Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) A securities lending agreement;

(c) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) A sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

AG26. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not 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. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

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

(a) A contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset, and

(b) An ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:

(i) The transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e., it must be a unilateral ability), and

(ii) The transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (e.g., conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

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

Transfers that Qualify for Derecognition

AG30. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 24, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is 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. 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, an entity applies the fair value measurement requirements in paragraphs 66–68 and AG144–AG155.

Transfers that do not Qualify for Derecognition

AG32. The following is an application of the principle outlined in paragraph 26. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being 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. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 27.

All Assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being 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 surplus or deficit on a time proportion basis (see PBE IPSAS 9) 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 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 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. 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. 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.

Examples

AG37. The following examples illustrate the application of the derecognition principles of this Standard.

(a) *Repurchase agreements and securities lending*. If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not 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). 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 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. 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 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	—
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 surplus or deficit for impairment losses of CU300.

Derecognition of Financial Liabilities

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

(a) Discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) Is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

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

AG41. Payment to a third party, including a trust (sometimes called 'in-substance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

AG42. If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph AG39(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor 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. 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 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. For the purpose of paragraph 36, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 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. 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

Classification of Financial Assets

The Entity's Management Model for Financial Assets

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

AG49. An entity's management model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular objective. The entity's management model does not depend on management's 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 management model for its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to 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. An entity's management model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's management model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the management model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the management model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements (see PBE IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors*) nor does it change the classification of the remaining financial assets held in that management 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 model assessment. However, when an entity assesses the management model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information.

AG51. An entity's management model for financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the management model. An entity will need to use judgement when it assesses its management model for financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

(a) How the performance of the management model and the financial assets held within that management model are evaluated and reported to the entity's key management personnel;

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

(c) How management is compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

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

AG52. Financial assets that are held within a management model whose objective is to hold assets in order to collect contractual cash flows are managed to 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 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. Although the objective of an entity's management model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's management model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur or are expected to occur in the future.

AG54. The management model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets' credit risk. To determine whether there has been an increase in the assets' credit risk, the entity considers reasonable and supportable information, including forward looking information. Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a management model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a management model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk.

AG55. Sales that occur for other reasons, such as sales made to manage credit concentration risk (without an increase in the assets' credit risk), may also be consistent with a management model whose objective is to hold financial assets in order to collect contractual cash flows. In particular, such sales may be consistent with a management model whose objective is to hold financial assets in order to collect contractual cash flows if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to this assessment. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's management model. In addition, sales may be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows.

AG56. The following are examples of when the objective of an entity's management model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive. Furthermore, the examples are not intended to discuss all factors that may be relevant to the assessment of the entity's management model nor specify the relative importance of the factors.

Example	Analysis
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 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 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 model.

Example	Analysis
Example 3 An entity has a management model with the objective of originating student loans 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 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 holds financial assets to meet redemption needs in a 'stress case' scenario (e.g., a run on the government's issued securities). The entity does not anticipate selling these assets except in such scenarios. 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 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 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 needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's management model is not to hold the financial assets to collect contractual cash flows. Similarly, if the entity is required by law or regulation to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's management model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.

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

AG57. An entity may hold financial assets in a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets. In this type of management model, the entity's key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the management model. There are various objectives that may be consistent with this type of management model. For example, the objective of the management model may be to manage everyday liquidity needs, to maintain a particular

interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding. To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.

AG58. Compared to a management model whose objective is to hold financial assets to collect contractual cash flows, this management model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the management model's objective instead of being only incidental to it. However, there is no threshold for the frequency or value of sales that must occur in this management model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

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

Example	**Analysis**
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 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 model is to hold financial assets to collect contractual cash flows.
Example 6 An entity 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 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 model's objective.

Example	Analysis
Example 7 A social security fund holds financial assets in order to fund social security liabilities. The fund uses the proceeds from the contractual cash flows on the financial assets to settle social security liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the fund undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.	The objective of the management model is to fund the social security liabilities. To achieve this objective, the entity collects contractual cash flows as they come due and sells financial assets to maintain the desired profile of the asset portfolio. Thus both collecting contractual cash flows and selling financial assets are integral to achieving the management model's objective.

Other Management Models

AG60. Financial assets are measured at fair value through surplus or deficit if they are not held within a management model whose objective is to hold assets to collect contractual cash flows or within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets (but see also paragraph 106). One management model that results in measurement at fair value through surplus or deficit is one in which an entity manages the financial assets with the objective of 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 model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the management model's objective; instead, it is incidental to it.

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

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

AG62. Paragraph 39(b) requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held within a management model whose objective is to hold assets to collect contractual cash flows or within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets, unless paragraph 44 applies. To do so, the condition in paragraphs 40(b) and 41(b) requires an entity to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

AG63. Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs AG67–AG71) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other

basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices, commodity prices, a specific profitability or income threshold being reached by the borrower or lender, or the achievement (or otherwise) of specific financial or other ratios, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

AG64. In accordance with paragraph 42(a), principal is the fair value of the financial asset at initial recognition. However that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

AG65. An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

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

Consideration for the Time Value of Money

AG67. Time value of money is the element of interest that provides consideration for only the passage of time. That is, the time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the element provides consideration for only the passage of time, an entity applies 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. However, in some cases, the time value of money element may be modified (i.e., imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment.

AG69. When assessing a modified time value of money element, the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit risk except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 40(b) and 41(b). To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. The reason for the interest rate being set in this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.

AG70. When assessing a modified time value of money element, an entity must consider factors that could affect future contractual cash flows. For example, if an entity is assessing a bond with a five-year term and the variable interest rate is reset every six months to a five-year rate, the entity cannot conclude that the contractual cash flows are solely payments of principal and interest on the principal amount

outstanding simply because the interest rate curve at the time of the assessment is such that the difference between a five-year interest rate and a six-month interest rate is not significant. Instead, the entity must also consider whether the relationship between the five-year interest rate and the six-month interest rate could change over the life of the instrument such that the contractual (undiscounted) cash flows over the life of the instrument could be significantly different from the (undiscounted) benchmark cash flows. However, an entity must consider only reasonably possible scenarios instead of every possible scenario. If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 40(b) and 41(b) and therefore cannot be measured at amortised cost or fair value through other comprehensive revenue and expense.

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

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

AG72. If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e., the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk. (See also paragraph AG80.)

AG73. The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

(a) A variable interest rate that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin;

(b) A contractual term that permits the issuer (i.e., the debtor) to prepay a debt instrument or permits the holder (i.e., the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable compensation for the early termination of the contract; and

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

AG74. Despite paragraph AG72, a financial asset that would otherwise meet the condition in paragraphs 40(b) and 41(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer

to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive revenue and expense (subject to meeting the condition in paragraph 40(a) or the condition in paragraph 41(a)) if:

(a) The entity acquires or originates the financial asset at a premium or discount to the contractual par amount;

(b) The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable 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 For the purpose of applying paragraphs AG73(b) and AG74(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. 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) 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).

Instrument	Analysis
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 for a three-month term or the one-month interbank offered rate 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). The fact that the interbank offered 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.
	In such cases, the entity must qualitatively or quantitatively assess the contractual cash flows against those on an instrument that is identical in all respects except the tenor of the interest rate matches the interest period to determine if the cash flows are solely payments of principal and interest on the principal amount outstanding. (But see paragraph AG71 for guidance on regulated interest rates.) 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	Analysis
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) 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 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. 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); 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 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.)

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

AG78. This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the condition in paragraphs 40(b) and 41(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

AG79. However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraphs 40(b) and 41(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraphs 40(b) and 41(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

AG80. A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

AG81. In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are 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. 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. In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:

(a) The contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g., the interest rate on the tranche is not linked to a commodity index);

(b) The underlying pool of financial instruments has the cash flow characteristics set out in paragraphs AG85 and AG86; and

(c) The exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, the credit rating of the tranche being assessed for classification is equal to or higher than the credit rating that would apply to a single tranche that funded the underlying pool of financial instruments).

AG84. An entity must look through until it can identify the underlying pool of instruments that are creating (instead of passing through) the cash flows. This is the underlying pool of financial instruments.

AG85. The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

AG86. The underlying pool of instruments may also include instruments that:

(a) Reduce the cash flow variability of the instruments in paragraph AG85 and, when combined with the instruments in paragraph AG85, result in cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g., an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in paragraph AG85); or

(b) Align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph AG85 to address differences in and only in:

(i) Whether the interest rate is fixed or floating;

(ii) The currency in which the cash flows are denominated, including inflation in that currency; or

(iii) The timing of the cash flows.

AG87. If any instrument in the pool does not meet the conditions in either paragraph AG85 or paragraph AG86, the condition in paragraph 83(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. (See also paragraph AG80 for guidance on contractual cash flow characteristics that have only a de minimis effect.)

AG88. If the holder cannot assess the conditions in paragraph AG83 at initial recognition, the tranche must be measured at fair value through surplus or deficit. If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the conditions in paragraphs A85–AG86, the tranche does not meet the conditions in paragraph AG83 and must be measured at fair value through surplus or deficit. However, if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions in paragraphs AG85–AG86, the ability to take possession of such assets shall be disregarded for the purposes of applying this paragraph unless the entity acquired the tranche with the management model of controlling the collateral.

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

AG89. Subject to the conditions in paragraphs 44 and 46, this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through surplus or deficit provided that doing so results in more relevant information.

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

Designation Eliminates or Significantly Reduces an Accounting Mismatch

AG91. Measurement of a financial asset or financial liability and classification of 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 surplus or deficit, a financial asset would be classified as subsequently measured at fair value through surplus or deficit and a liability the entity considers related would be subsequently measured at 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 surplus or deficit.

AG92. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through surplus or deficit only if it meets the principle in paragraph 44 or 46(a):

(a) An entity has liabilities under insurance contracts, whose measurement incorporates current information (as permitted by paragraph 24 of PBE IFRS 4) and financial assets that it considers to be related and that would otherwise be measured at either fair value through other comprehensive 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 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 are not met.

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

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

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

entirety. It could not designate either a component of a liability (e.g., changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e., percentage) of a liability.

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

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

AG96. For example, an entity may use this condition to designate financial liabilities as at fair value through surplus or deficit if it meets the principle in paragraph 46(b) and the entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments.

AG97. As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial liabilities as at fair value through surplus or deficit on the basis of this condition shall so designate all eligible financial liabilities that are managed and evaluated together.

AG98. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 46(b). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel—clearly demonstrates that its performance is evaluated on this basis, no further documentation is required to demonstrate compliance with paragraph 46(b).

Embedded Derivatives

AG99. When an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard, paragraph 49 requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently at fair value through surplus or deficit.

AG100. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

AG101. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

AG102. Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see PBE IPSAS 28) are accounted for separately from those classified as assets or liabilities. In addition, if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

AG103. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 49(a)) in the following examples. In these examples, assuming the conditions in

paragraph 49(b) and 49(c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.

(b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

(c) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(d) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

(i) The option's exercise price is approximately equal on each exercise date to the 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.

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

AG104. An example of a hybrid contract is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through surplus or deficit, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 49 because the host contract is a debt instrument under paragraph AG100 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG103(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

AG105. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each

component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

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

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its 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 *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in surplus or deficit.

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) The functional currency of any substantial party to that contract;

(ii) The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) A currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

(e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.

(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) variable lease payments based on related sales or (iii) variable lease payments based on variable interest rates.

(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking

feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract).

Instruments Containing Embedded Derivatives

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

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

Reassessment of Embedded Derivatives

AG109. In accordance with paragraph 49, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

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

(a) A PBE combination (as defined in PBE IPSAS 40 *PBE Combinations*); or

(b) [Deleted by NZASB]

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

or their possible reassessment at the date of acquisition.

Reclassification of Financial Assets

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

(a) A government agency extends loans to small business owners and has a management model to sell the loan portfolios to private entities at a discount due 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.

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

AG113. The following are not changes in management model:

(a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).

(b) The temporary disappearance of a particular market for financial assets.

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

Measurement

Non-Exchange Revenue Transactions

AG114. The initial recognition and measurement of assets and liabilities resulting from non-exchange revenue transactions is dealt with in 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

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

AG115. The fair value of a financial instrument at initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received, see also paragraph AG117). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs 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 unless it qualifies for recognition as some other type of asset.

AG116. If an entity originates a loan that bears an off-market interest rate (e.g., 5 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.

AG117. The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price. If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 58, the entity shall account for that instrument at that date as follows:

(a) At the measurement required by paragraph 57 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, 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.

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.

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

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

AG138. 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 revenue and expense in accordance with either paragraph 106 or 41. 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 revenue and expense. If the financial asset is measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41, the transaction costs are amortised to surplus or deficit using the effective interest method.

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

Investments in Equity Instruments and Contracts on Those Investments

AG140. 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. 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. The list in paragraph AG141 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. Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Fair Value Measurement Considerations

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.'

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.

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.

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

Effective Interest Method

AG156. 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 surplus or deficit. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

AG157. Fees that are an integral part of the effective interest rate of a financial instrument include:

(a) Origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.

(b) Commitment fees received by the entity to originate a loan when the loan commitment is not measured in accordance with paragraph 45(a) and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is 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. 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 include:

(a) Fees charged for servicing a loan;

(b) Commitment fees to originate a loan when the loan commitment is not measured in accordance with paragraph 45(a) and it is unlikely that a specific lending arrangement will be entered into; and

(c) Loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

AG159. 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. 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. If an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 71 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. The adjustment is recognised in surplus or deficit as revenue or expense.

AG162. 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. 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. 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

Collective and Individual Assessment Basis

AG165 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. 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. 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 loans for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument until a borrower breaches the contractual terms. If changes in the credit risk for individual financial instruments are not captured before they become past due, a loss allowance based only on credit information at an individual financial instrument level would not faithfully represent the changes in credit risk since initial recognition.

AG168. 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. 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. Paragraph 76 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. 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. 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. 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. 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. 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. 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. 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, 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. 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. 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(c). An entity need not undertake an exhaustive search for information when determining whether credit risk has increased significantly since initial recognition.

AG180. 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 for the recognition of lifetime expected credit losses has been met.

AG181. The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

(a) Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

(b) Other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher revenue coverage) because of changes in the credit risk of the financial instrument since initial recognition.

(c) Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:

(i) The credit spread;

(ii) The credit default swap prices for the borrower;

(iii) The length of time or the extent to which the fair value of a financial asset has been less than its 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 or organisational structure (such as the discontinuance of a segment of the entity) that results in a significant change in the borrower's ability to meet its debt obligations.

(h) Significant increases in credit risk on other financial instruments of the same borrower.

(i) An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology.

(j) Significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.

(k) A significant change in the quality of the guarantee provided by an entity's owners (or an individual's guarantors) if the entity's owners (or guarantors) have an incentive and financial ability to prevent default by capital or cash infusion.

(l) Significant changes, such as reductions in financial support from a controlling entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in 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 (for example, an increase in the expected number or extent of delayed contractual payments).

(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.

AG182. 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. The rebuttable presumption in paragraph 83 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. 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. 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. The credit risk on a financial instrument is considered low for the purposes of paragraph 82, 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. 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. 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.

Modifications

AG189. 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. 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 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. 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 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. 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. 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. 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. 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. 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. 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 surplus or deficit as an impairment gain or loss.

AG198. 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 *Leases*.

AG199. An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 90. An example of a practical expedient is the calculation of the expected credit losses on receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs AG215–AG216) for receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 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).

Definition of Default

AG200. Paragraph 81 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. 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. In accordance with paragraph 92, 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. However, in accordance with paragraph 93, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For example, revolving credit facilities, such as line of credit provided by a government owned bank, can be contractually withdrawn by the lender with as little as one day's notice. However, in practice lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases, which could be too late to prevent some or all of the expected credit losses. These financial instruments generally have the following characteristics as a result of the nature of the financial instrument, the way in which the financial instruments are managed, and the nature of the available information about significant increases in credit risk:

(a) The financial instruments do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day);

(b) The contractual ability to cancel the contract is not enforced in the normal day-to-day management of the financial instrument and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level; and

(c) The financial instruments are managed on a collective basis.

AG204. 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. 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. Paragraph 90(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.

AG207. 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. 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.

AG209. 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. 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.

AG211. 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. 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. 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. 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. 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. 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. 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. 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. 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

AG220. If an entity reclassifies financial assets in accordance with paragraph 54, paragraph 94 requires that the reclassification is applied prospectively from the reclassification date. Both the amortised cost measurement category and the fair value through other comprehensive 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 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 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 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 revenue and expense and would be disclosed from the reclassification date.

AG221. 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 surplus or deficit. Consequently, when an entity reclassifies a financial asset out of the fair value through surplus or deficit measurement category, the effective interest rate is determined on the basis of the fair value of the asset at the reclassification date. In addition, for the purposes of applying paragraphs 73–93 to the financial asset from the reclassification date, the date of the reclassification is treated as the date of initial recognition.

Gains and Losses

AG222. Paragraph 106 permits an entity to make an irrevocable election to present in other comprehensive 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 revenue and expense shall not be subsequently transferred to surplus or deficit. However, the entity may transfer the cumulative gain or loss within net assets/equity. Dividends or similar distributions on such investments are recognised in surplus or deficit in accordance with paragraph 107 unless the dividend clearly represents a recovery of part of the cost of the investment.

AG223. Unless paragraph 44 applies, paragraph 41 requires that a financial asset is measured at fair value through other comprehensive 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 model whose objective is achieved by both collecting contractual cash flows and selling financial assets. This measurement category recognises information in 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 surplus or deficit in accordance with paragraphs 111–112, are recognised in other comprehensive revenue and expense. When these financial assets are derecognised, cumulative gains or losses previously recognised in other comprehensive revenue and expense are reclassified to surplus or deficit.

This reflects the gain or loss that would have been recognised in surplus or deficit upon derecognition if the financial asset had been measured at amortised cost.

AG224. An entity applies PBE IPSAS 4 to financial assets and financial liabilities that are monetary items in accordance with PBE IPSAS 4 and denominated in a foreign currency. PBE IPSAS 4 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in surplus or deficit. An exception is a monetary item that is designated as a hedging instrument in a cash flow hedge (see paragraph 140), a hedge of a net investment (see paragraph 142) or a fair value hedge 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 (see paragraph 137).

AG225. For the purpose of recognising foreign exchange gains and losses under PBE IPSAS 4, a financial asset measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 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 surplus or deficit and other changes in the carrying amount are recognised in accordance with paragraph 111.

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

AG227. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in surplus or deficit.

Liabilities Designated as at Fair Value Through Surplus or Deficit

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

AG229. To make that determination, an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in surplus or deficit by a change in the fair value of another financial instrument measured at fair value through surplus or deficit. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument.

AG230. 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 revenue and expense the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in surplus or deficit. However, an entity may use different methodologies when there are different economic relationships between the characteristics of the liabilities designated as at fair value through surplus or deficit and the characteristics of the other financial instruments. PBE IPSAS 30 *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. If such a mismatch would be created or enlarged, the entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in surplus or deficit. If such a mismatch would not be created or enlarged, the entity is required to present the effects of changes in the liability's credit risk in other comprehensive revenue and expense.

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

AG233. The following example describes a situation in which an accounting mismatch would be created in surplus or deficit if the effects of changes in the credit risk of the liability were presented in other comprehensive revenue and expense. A Mortgage and Housing Corporation 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. 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 liability decreases), the fair value of the Mortgage and Housing Corporation'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. Consequently, the effects of changes in the credit risk of the liability (the bond) will be offset in surplus or deficit by a corresponding change in the fair value of a financial asset (the loan). If the effects of changes in the liability's credit risk were presented in other comprehensive revenue and expense there would be an accounting mismatch in surplus or deficit. Consequently, the Mortgage and Housing Corporation is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in surplus or deficit.

AG234. In the example in paragraph AG233, 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). However, an accounting mismatch may also occur in the absence of a contractual linkage.

AG235. For the purposes of applying the requirements in paragraphs 108 and 109, an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk. An accounting mismatch in surplus or deficit would arise only when the effects of changes in the liability's credit risk (as defined in PBE IPSAS 30) are expected to be offset by changes in the fair value of another financial instrument. A mismatch that arises solely as a result of the measurement method (i.e., because an entity does not isolate changes in a liability's credit risk from some other changes in its fair value) does not affect the determination required by paragraphs 108 and 109. 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 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 surplus or deficit. However, such a mismatch is caused by measurement imprecision, not the offsetting relationship described in paragraph AG229 and, therefore, does not affect the determination required by paragraphs 108 and 109.

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

AG236. PBE IPSAS 30 defines credit risk as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. The requirement in paragraph 108(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. For the purposes of applying the requirement in paragraph 108(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. 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. For the purposes of applying the requirement in paragraph 108(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 and AG241); 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. 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. 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(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 revenue and expense in accordance with paragraph 108(a).

AG242. The example in paragraph AG241 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(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 revenue and expense in accordance with paragraph 108(a).

AG243. As with all fair value measurements, an entity's measurement method for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk must make maximum use of relevant observable inputs and minimum use of unobservable inputs.

Hedge Accounting

Hedging Instruments

Qualifying Instruments

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

AG245. 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. 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.

Written Options

AG247. This Standard does not restrict the circumstances in which a derivative that is measured at fair value through surplus or deficit may be designated as a hedging instrument, except for some written options. A written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability).

Designation of Hedging Instruments

AG248. For hedges other than hedges of foreign currency risk, when an entity designates a non-derivative financial asset or a non-derivative financial liability measured at fair value through surplus or deficit as a hedging instrument, it may only designate the non-derivative financial instrument in its entirety or a proportion of it.

AG249. A single hedging instrument may be designated as a hedging instrument of more than one type of risk, provided that there is a specific designation of the hedging instrument and of the different risk positions as hedged items. Those hedged items can be in different hedging relationships.

Hedged Items

Qualifying Items

AG250. A firm commitment to acquire an operation in a PBE 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. An equity method investment cannot be a hedged item in a fair value hedge. This is because the equity method recognises in surplus or deficit the investor's share of the investee's surplus or deficit, instead of changes in the investment's fair value. For a similar reason, an investment in a consolidated controlled entity cannot be a hedged item in a fair value hedge. This is because consolidation recognises in surplus or deficit the controlled entity's surplus or deficit, instead of changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

AG252. Paragraph 125 permits an entity to designate as hedged items aggregated exposures that are a combination of an exposure and a derivative. When designating such a hedged item, an entity assesses whether the aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks). In that case, the entity may designate the hedged item on the basis of the aggregated exposure. For example:

(a) An entity may hedge a given quantity of highly probable oil purchases in 15 months' time against price risk (based on US dollars) using a 15-month futures contract for oil. The highly probable oil purchases and the futures contract for oil in combination can be viewed as a 15-month fixed-amount US dollar foreign currency risk exposure for risk management purposes (i.e., like any fixed-amount US dollar cash outflow in 15 months' time).

(b) An entity may hedge the foreign currency risk for the entire term of a 10-year fixed-rate debt denominated in a foreign currency. However, the entity requires fixed-rate exposure in its

functional currency only for a short to medium term (say two years) and floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (i.e., on a two-year rolling basis) the entity fixes the next two years' interest rate exposure (if the interest level is such that the entity wants to fix interest rates). In such a situation an entity may enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed-rate foreign currency debt into a variable-rate functional currency exposure. This is overlaid with a two-year interest rate swap that—on the basis of the functional currency—swaps variable-rate debt into fixed-rate debt. In effect, the fixed-rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable-rate debt functional currency exposure for risk management purposes.

AG253. 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. Paragraph 127 states that in consolidated financial statements the foreign currency risk of a highly probable forecast transaction within an economic entity may qualify as a hedged item in a cash flow hedge, provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and that the foreign currency risk will affect consolidated surplus or deficit. For this purpose an entity can be a controlling entity, controlled entity, associate, joint arrangement or branch. If the foreign currency risk of a forecast transaction within the economic entity does not affect consolidated surplus or deficit, the transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same economic entity, unless there is a related external transaction. However, when the foreign currency risk of a forecast transaction within an economic entity will affect consolidated surplus or deficit, the transaction within the economic entity can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same economic entity if there is an onward sale of the inventory to a party external to the economic entity. Similarly, a forecast sale of plant and equipment within the economic entity from the entity that manufactured it to an entity that will use the plant and equipment in its operations may affect consolidated surplus or deficit. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast transaction within the economic entity is denominated in a currency other than the functional currency of the purchasing entity.

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

Designation of Hedged Items

AG256. 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. 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. 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. 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) 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. 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. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a 'one-sided risk'). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, the entity designates only cash flow losses that result from an increase in the price above the specified level. The hedged risk does not include the time value of a purchased option, because the time value is not a component of the forecast transaction that affects surplus or deficit.

AG262. 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. 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. 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. 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. An example of a component that is a proportion is 50 per cent of the contractual cash flows of a loan.

AG267. 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;[4]

(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

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

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

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

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

(b) A negative residual component.

AG272. However, in the case of a fixed-rate financial liability whose effective interest rate is (for example) 100 basis points below the market rate, an entity can designate as the hedged item the change in the value of that entire liability (i.e., principal plus interest at the market rate minus 100 basis points) that is attributable to changes in the market rate. If a fixed-rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a risk component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day when it first designates the hedged item. For example, assume that an entity originates a fixed-rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when the market rate is 4 per cent. It begins to hedge that asset some time later when the market rate 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 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 is less than this effective yield, the entity can designate the market rate 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. If a variable-rate financial liability bears interest of (for example) three-month interbank offered rate minus 20 basis points (with a floor at zero basis points), an entity can designate as the hedged item the change in the cash flows of that entire liability (i.e., three-month interbank offered rate minus 20 basis points—including the floor) that is attributable to changes in the interbank offered rate. Hence, as long as the three-month interbank offered rate forward curve for the remaining life of that liability does not fall below 20 basis points, the hedged item has the same cash flow variability as a liability that bears interest at the three-month interbank offered rate with a zero or positive spread. However, if the three-month interbank offered rate forward curve for the remaining life of that liability (or a part of it) falls

below 20 basis points, the hedged item has a lower cash flow variability than a liability that bears interest at the three-month interbank offered rate with a zero or positive spread.

AG274. A similar example of a non-financial item is a specific type of crude oil from a particular oil field that is priced off the relevant benchmark crude oil. If an entity sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at the benchmark crude oil price minus CU10 with a floor of CU15, the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in the benchmark crude oil price. Hence, as long as the forward price (for each delivery) does not fall below CU25, the hedged item has the same cash flow variability as a crude oil sale at the benchmark crude oil price (or with a positive spread). However, if the forward price for any delivery falls below CU25, the hedged item has a lower cash flow variability than a crude oil sale at the benchmark crude oil price (or with a positive spread).

Qualifying Criteria for Hedge Accounting

Hedge Effectiveness

AG275. 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. 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 arising from rebalancing a hedging relationship) is the basis for the entity's assessment of meeting the hedge effectiveness requirements.

AG277. 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 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. 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. 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. 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. 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. 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. 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. 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. 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 purchases with standard oil futures contracts that have a contract size of 1,000 barrels. The entity could only use either seven or eight contracts (equivalent to 980 tonnes and 1,120 tonnes respectively) to hedge the purchase volume of 1,000 tonnes. In that case, the entity designates the hedging relationship using the hedge ratio that results from the number of oil 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. 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. 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. 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).

AG289. 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. 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). 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). An entity can use the same or different methods for those two different purposes.

AG291. 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. 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. 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).

Accounting for Qualifying Hedging Relationships

AG294. 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. The purpose of a cash flow hedge is to defer the gain or loss on the hedging instrument to a period or periods in which the hedged expected future cash flows affect surplus or deficit. An example of a cash flow hedge is the use of a swap to change floating rate debt (whether measured at 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 surplus or deficit, is an example of an item

that cannot be the hedged item in a cash flow hedge, because any gain or loss on the hedging instrument that would be deferred could not be appropriately reclassified to surplus or deficit during a period in which it would achieve offset. For the same reason, a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value with changes in fair value presented in other comprehensive revenue and expense also cannot be the hedged item in a cash flow hedge.

AG296. 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, 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. 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. 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. 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. 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. Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs AG302–AG314. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised immediately before adjusting the hedging relationship.

AG302. 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. 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. 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. 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. 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.

AG307. 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. 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).

AG309. If a hedging relationship is rebalanced, the adjustment to the hedge ratio can be effected in different ways:

(a) The weighting of the hedged item can be increased (which at the same time reduces the weighting of the hedging instrument) by:

(i) Increasing the volume of the hedged item; or

(ii) Decreasing the volume of the hedging instrument.

(b) The weighting of the hedging instrument can be increased (which at the same time reduces the weighting of the hedged item) by:

(i) Increasing the volume of the hedging instrument; or

(ii) Decreasing the volume of the hedged item.

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

AG310. 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. 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 for the consequences for the derivative volume (i.e., the 10 tonnes) that is no longer a part of the hedging relationship).

AG312. 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. 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 and AG315–AG321).

AG314. 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). The documentation of the hedging relationship shall be updated accordingly.

Discontinuation of Hedge Accounting

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

AG316. 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. 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 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. 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. 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. 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); 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) and hence whether they are eligible as hedged items.

AG321. 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. An option can be considered as being related to a time period because its time value represents a charge for providing protection for the option holder over a period of time. However, the relevant aspect for the purpose of assessing whether an option hedges a transaction or time-period related hedged item are the characteristics of that hedged item, including how and when it affects surplus or deficit. Hence, an entity shall assess the type of hedged item (see paragraph 144(a)) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

(a) The time value of an option relates to a transaction related hedged item if the nature of the hedged item is a transaction for which the time value has the character of costs of that transaction. An example is when the time value of an option relates to a hedged item that results in the recognition of an item whose initial measurement includes transaction costs (for example,

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

(b) The time value of an option relates to a time-period related hedged item if the nature of the hedged item is such that the time value has the character of a cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of a transaction cost in accordance with (a)). For example, if commodity inventory is hedged against a fair value decrease for six months using a commodity option with a corresponding life, the time value of the option would be allocated to surplus or deficit (i.e., 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. The characteristics of the hedged item, including how and when the hedged item affects surplus or deficit, also affect the period over which the time value of an option that hedges a time-period related hedged item is amortised, which is consistent with the period over which the option's intrinsic value can affect surplus or deficit in accordance with hedge accounting. For example, if an interest rate option (a cap) is used to provide protection against increases in the interest expense on a floating rate bond, the time value of that cap is amortised to surplus or deficit over the same period over which any intrinsic value of the cap would affect surplus or deficit:

(a) If the cap hedges increases in interest rates for the first three years out of a total life of the floating rate bond of five years, the time value of that cap is 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. The accounting for the time value of options in accordance with paragraph 144 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 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 surplus or deficit (see paragraph 144(b)) would be nil.

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

AG325. The accounting for the time value of options in accordance with paragraph 144 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). 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. 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 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 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 surplus or deficit.

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

AG327. A forward contract can be considered as being related to a time period because its forward element represents charges for a period of time (which is the tenor for which it is determined). However, the relevant aspect for the purpose of assessing whether a hedging instrument hedges a transaction or time-period related hedged item are the characteristics of that hedged item, including how and when it affects surplus or deficit. Hence, an entity shall assess the type of hedged item (see paragraphs 144(a) and 145) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

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

(b) The forward element of a forward contract relates to a time-period related hedged item if the nature of the hedged item is such that the forward element has the character of a cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of a transaction cost in accordance with (a)). For example, if commodity inventory is hedged against changes in fair value for six months using a commodity forward contract with a corresponding life, the forward element of the forward contract would be allocated to surplus or deficit (i.e., 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. The characteristics of the hedged item, including how and when the hedged item affects surplus or deficit, also affect the period over which the forward element of a forward contract that hedges a time-period related hedged item is 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. The accounting for the forward element of a forward contract in accordance with paragraph 145 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 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 surplus or deficit (see paragraphs 144(b) and 145) would be nil.

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

AG330. The accounting for the forward element of forward contracts in accordance with paragraph 145 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). 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. 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 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 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 surplus or deficit.

AG332. 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(b)), the application guidance in paragraphs AG327–AG331 applies to the foreign currency basis spread in the same manner as it is applied to the forward element of a forward contract.

Hedge of a Group of Items

Hedge of a Net Position

Eligibility for Hedge Accounting and Designation of a Net Position

AG333. 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.

AG334. 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. 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 are met.

AG336. 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. When an entity determines whether the hedge effectiveness requirements of paragraph 129(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(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. Similarly, if in the example in paragraph AG337 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(c) are met.

Cash Flow Hedges that Constitute a Net Position

AG339. When an entity hedges a group of items with offsetting risk positions (i.e., a net position), the eligibility for hedge accounting depends on the type of hedge. If the hedge is a fair value hedge, then the net position may be eligible as a hedged item. If, however, the hedge is a cash flow hedge, then the net position can only be eligible as a hedged item if it is a hedge of foreign currency risk and the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect surplus or deficit and also specifies their nature and volume.

AG340. For example, an entity has a net position that consists of a bottom layer of FC100 of sales and a bottom layer of FC150 of purchases. Both sales and purchases are denominated in the same foreign currency.

In order to sufficiently specify the designation of the hedged net position, the entity specifies in the original documentation of the hedging relationship that sales can be of Product A or Product B and purchases can be of Machinery Type A, Machinery Type B and Raw Material A. The entity also specifies the volumes of the transactions by each nature. The entity documents that the bottom layer of sales (FC100) is made up of a forecast sales volume of the first FC70 of Product A and the first FC30 of Product B. If those sales volumes are expected to affect surplus or deficit in different reporting periods, the entity would include that in the documentation, for example, the first FC70 from sales of Product A that are expected to affect surplus or deficit in the first reporting period and the first FC30 from sales of Product B that are expected to affect surplus or deficit in the second reporting period. The entity also documents that the bottom layer of the purchases (FC150) is made up of purchases of the first FC60 of Machinery Type A, the first FC40 of Machinery Type B and the first FC50 of Raw Material A. If those purchase volumes are expected to affect surplus or deficit in different reporting periods, the entity would include in the documentation a disaggregation of the purchase volumes by the reporting periods in which they are expected to affect surplus or deficit (similarly to how it documents the sales volumes). For example, the forecast transaction would be specified as:

(a) The first FC60 of purchases of Machinery Type A that are expected to affect surplus or deficit from the third reporting period over the next ten reporting periods;

(b) The first FC40 of purchases of Machinery Type B that are expected to affect surplus or deficit from the fourth reporting period over the next 20 reporting periods; and

(c) The first FC50 of purchases of Raw Material A that are expected to be received in the third reporting period and sold, i.e., affect surplus or deficit, in that and the next reporting period.

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

AG341. For a cash flow hedge of a net position, the amounts determined in accordance with paragraph 140 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(a)–140(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. 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. For the same reasons noted in paragraph AG268, 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. 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. If items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of comprehensive revenue and expense. The presentation of hedging gains or losses in that statement depends on the group of items.

AG346. 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 comprehensive 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. 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 comprehensive 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 surplus or deficit (when the net position affects surplus or deficit) shall be presented in a separate line item from the hedged sales and expenses. Moreover, if the sales occur in an earlier period than the expenses, the sales revenue is still measured at the spot exchange rate in accordance with PBE IPSAS 4. The related hedging gain or loss is presented in a separate line item, so that surplus or deficit reflects the effect of hedging the net position, with a corresponding adjustment to the cash flow hedge reserve. When the hedged expenses affect surplus or deficit in a later period, the hedging gain or loss previously recognised in the cash flow hedge reserve on the sales is reclassified to surplus or deficit and presented as a separate line item from those that include the hedged expenses, which are measured at the spot exchange rate in accordance with PBE IPSAS 4.

AG348. For some types of fair value hedges, the objective of the hedge is not primarily to offset the fair value change of the hedged item but instead to transform the cash flows of the hedged item. For example, an entity hedges the fair value interest rate risk of a fixed-rate debt instrument using an interest rate swap. The entity's hedge objective is to transform the fixed-interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationship by accruing the net interest accrual on the interest rate swap in surplus or deficit. In the case of a hedge of a net position (for example, a net position of a fixed-rate asset and a fixed-rate liability), this net interest accrual must be presented in a separate line item in the statement of comprehensive 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

Transition

Financial Assets Held for Trading

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

paragraph 106. 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. 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 applies.

AG351. 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–AG170.

AG352. An entity with little historical information may use information from internal reports and statistics (that may have been generated when deciding whether to launch a new product), information about similar products or peer group experience for comparable financial instruments, if relevant.

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

This Appendix is an integral part of PBE IPSAS 41.

Introduction

B1. Many reporting entities have investments in foreign operations (as defined in PBE IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* paragraph 10). Such foreign operations may be controlled entities, associates, joint ventures or branches. PBE IPSAS 4 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in other comprehensive revenue and expense until it disposes of the foreign operation.

B2. Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements. This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint 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. PBE IPSAS 41 *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 and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.

B4. This Appendix applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with PBE IPSAS 41. It should not be applied by analogy to other types of hedge accounting. This Appendix refers to such an entity as a controlling entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a controlling entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.

B5. This Appendix provides guidance on:

(a) Identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation, given that an entity with many foreign operations may be exposed to a number of foreign currency risks. It specifically addresses:

(i) Whether the controlling entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the controlling entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the controlling entity's consolidated financial statements and the functional currency of the foreign operation; and

(ii) If the controlling entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate controlling entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate controlling entity (i.e., whether the fact that the net investment in the foreign operation is held through an intermediate controlling entity affects the economic risk to the ultimate controlling entity).

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

(i) 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, regardless of its functional currency, can hold the hedging instrument.

(c) What amounts should be reclassified from net assets/equity to surplus or deficit 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 entity's foreign currency translation reserve in respect of the hedging instrument and of that foreign operation should be reclassified from net assets/equity to surplus or deficit in the controlling entity's consolidated financial statements; and

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

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. Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the controlling entity's functional currency.

B7. In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the controlling entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a controlling entity depends on whether any lower level controlling entity of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the controlling entity's consolidated financial statements.

B8. The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any controlling entity (the immediate, intermediate or ultimate controlling entity) of that foreign operation. The fact that the net investment is held through an intermediate controlling entity does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate controlling entity.

B9. An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one controlling entity within the economic entity (e,g., both a direct and an indirect controlling entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate controlling entity. A hedging relationship designated by one controlling entity in its consolidated financial statements need not be maintained by another higher level controlling entity. However, if it is not maintained by the higher level controlling entity, the hedge accounting applied by the lower level controlling entity must be reversed before the higher level controlling entity's hedge accounting is recognised.

Where the Hedging Instrument can be Held

B10. A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the economic entity, as long as the designation, documentation and effectiveness requirements of PBE IPSAS 41 paragraph 129 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the economic entity should be clearly documented because of the possibility of different designations at different levels of the economic entity.

B11. For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the controlling entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting

the total change in value might be recognised in surplus or deficit, in other comprehensive revenue and expense, 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 or in other comprehensive revenue and expense. As part of the application of hedge accounting, the total effective portion of the change is included in other comprehensive revenue and expense. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

Disposal of a Hedged Foreign Operation

B12. When a foreign operation that was hedged is disposed of, the amount reclassified to surplus or deficit as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the controlling entity in respect of the hedging instrument is the amount that PBE IPSAS 41 paragraph 143 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.

B13. The amount reclassified to surplus or deficit from the foreign currency translation reserve in the consolidated financial statements of a controlling entity in respect of the net investment in that foreign operation in accordance with PBE IPSAS 4 paragraph 57 is the amount included in that controlling entity's foreign currency translation reserve in respect of that foreign operation. In the ultimate controlling entity's consolidated financial statements, the aggregate net amount 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 uses the direct or the step-by-step method of consolidation, 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).

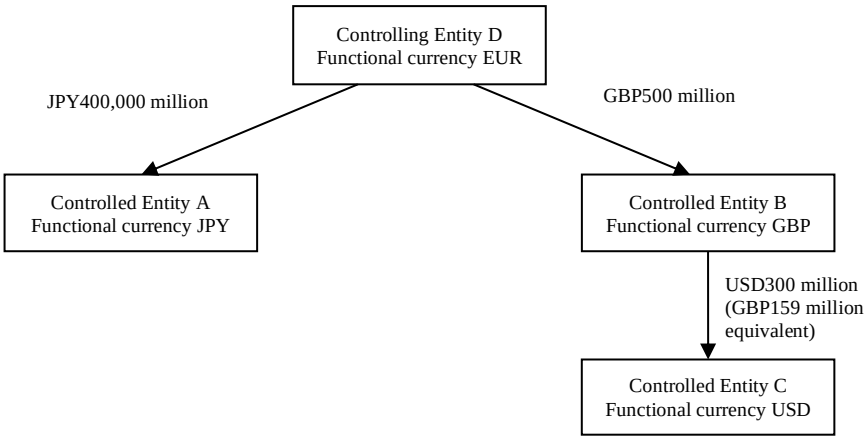
B15. The use of the step-by-step method of consolidation may result in the reclassification to surplus or deficit of an amount different from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by PBE IPSAS 4. However, it is an accounting policy choice that should be followed consistently for all net investments.

Example

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

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

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



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

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

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

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

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

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

B21. Controlling Entity D cannot designate the US$300 million external borrowing in Controlled Entity A as a hedge of both the EUR/USD spot foreign exchange risk and the GBP/USD spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Controlled Entity B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the economic entity comprising Controlled Entity B and Controlled Entity C.

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

B22. As noted in paragraph B20, the total change in value in respect of foreign exchange risk of the US$300 million external borrowing in Controlled Entity A would be recorded in both surplus or deficit (USD/JPY

spot risk) and other comprehensive revenue and expense (EUR/JPY spot risk) in Controlling Entity D's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in paragraph B19 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Controlling Entity D against the US dollar functional currency of Controlled Entity C, in accordance with the hedge documentation. The method of consolidation (i.e., direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

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

B23. When Controlled Entity C is disposed of, the amounts reclassified to surplus or deficit in 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 Controlled Entity A, the amount that PBE IPSAS 41 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 as the effective portion of the hedge; and

(b) In respect of the US$300 million net investment in Controlled Entity C, the amount determined by the entity's consolidation method. If Controlling Entity D uses the direct method, its FCTR in respect of Controlled Entity C will be determined directly by the EUR/USD foreign exchange rate. If Controlling Entity D uses the step-by-step method, its FCTR in respect of Controlled Entity C will be determined by the FCTR recognised by Controlled Entity B reflecting the GBP/USD foreign exchange rate, translated to Controlling Entity D's functional currency using the EUR/GBP foreign exchange rate. Controlling Entity D's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be reclassified when it disposes of 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, B9 and B11)

B24. The following examples illustrate that in the consolidated financial statements of Controlling Entity D, the risk that can be hedged is always the risk between its functional currency (euro) and the functional currencies of Controlled Entities B and C. No matter how the hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements when both foreign operations are hedged are US$300 million for EUR/USD risk and £341 million for EUR/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Controlling Entity D's consolidated surplus or deficit. Of course, it would be possible for Controlling Entity D to designate US$300 million only for changes in the USD/GBP spot foreign exchange rate or £500 million only for changes in the GBP/EUR spot foreign exchange rate.

Entity D Holds Both USD and GBP Hedging Instruments

B25. Controlling Entity D may wish to hedge the foreign exchange risk in relation to its net investment in Controlled Entity B as well as that in relation to Controlled Entity C. Assume that Controlling Entity D holds suitable hedging instruments denominated in US dollars and pounds sterling that it could designate as hedges of its net investments in Controlled Entity B and Controlled Entity C. The designations Controlling Entity D can make in its consolidated financial statements include, but are not limited to, the following:

(a) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in Controlled Entity C with the risk being the spot foreign exchange exposure (EUR/USD) between Controlling Entity D and Controlled Entity C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between Controlling Entity D and Controlled Entity B.

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

B26. The EUR/USD risk from Controlling Entity D's net investment in Controlled Entity C is a different risk from the EUR/GBP risk from Controlling Entity D's net investment in Controlled Entity B. However, in the case described in paragraph B25(a), by its designation of the USD hedging instrument it holds,

Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in Controlled Entity C. If Controlling Entity D also designated a GBP instrument it holds as a hedge of its £500 million net investment in Controlled Entity B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in Controlled Entity C, would be hedged twice for GBP/EUR risk in Controlling Entity D's consolidated financial statements.

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

Entity B Holds the USD Hedging Instrument

B28. Assume that Controlled Entity B holds US$300 million of external debt the proceeds of which were transferred to Controlling Entity D by an inter-entity loan denominated in pounds sterling. Because both its assets and liabilities increased by £159 million, Controlled Entity B's net assets are unchanged. Controlled Entity B could designate the external debt as a hedge of the GBP/USD risk of its net investment in Controlled Entity C in its consolidated financial statements. Controlling Entity D could maintain Controlled Entity B's designation of that hedging instrument as a hedge of its US$300 million net investment in Controlled Entity C for the GBP/USD risk (see paragraph B9) and Controlling Entity D could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in Controlled Entity B. The first hedge, designated by Controlled Entity B, would be assessed by reference to Controlled Entity B's functional currency (pounds sterling) and the second hedge, designated by Controlling Entity D, would be assessed by reference to Controlling Entity D's functional currency (euro). In this case, only the GBP/USD risk from Controlling Entity D's net investment in Controlled Entity C has been hedged in Controlling Entity D's consolidated financial statements by the USD hedging instrument, not the entire EUR/USD risk. Therefore, the entire EUR/GBP risk from Controlling Entity D's £500 million net investment in Controlled Entity B may be hedged in the consolidated financial statements of Controlling Entity D.

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

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

Appendix C: Extinguishing Financial Liabilities with Equity Instruments

This Appendix is an integral part of PBE IPSAS 41.

Introduction

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

Scope

C2. This Appendix addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability. It does not address the accounting by the creditor.

C3. An entity shall not apply this Appendix to transactions in situations where:

(a) The creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder.

(b) The creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity.

(c) Extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability.

C4. This Appendix addresses the following issues:

(a) Are an entity's equity instruments issued to extinguish all or part of a financial liability 'consideration paid' in accordance with paragraph 37 of PBE IPSAS 41 *Financial Instruments*?

(b) How should an entity initially measure the equity instruments issued to extinguish such a financial liability?

(c) How should an entity account for any difference between the carrying amount of the financial liability extinguished and the initial measurement amount of the equity instruments issued?

Consensus

C5. The issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraph 37 of PBE IPSAS 41. An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished in accordance with paragraph 35 of PBE IPSAS 41.

C6. 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. 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 of PBE IPSAS 41 is not applied.

C8. If only part of the financial liability is extinguished, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid does relate to a modification of the terms of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding. The entity shall consider all relevant facts and circumstances relating to the transaction in making this allocation.

C9. The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognised in surplus or deficit, in accordance with paragraph 37 of PBE IPSAS 41. The equity instruments issued shall be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished.

C10. When only part of the financial liability is extinguished, consideration shall be allocated in accordance with paragraph C8. The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability as required by paragraph 36 of PBE IPSAS 41.

C11. 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 or in the notes.

Appendix D

Amendments to Other Standards

The amendments contained in this appendix when this PBE Standard was issued in 2019 have been incorporated into the relevant pronouncements.

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 at that time. However, the IPSASB was aware that the IASB was in the process of updating the requirements for financial instruments and had already issued the first version of IFRS 9 *Financial Instruments*. The IPSASB was also aware that the completion of IFRS 9 could take a number of years. It therefore decided to monitor the IASB's work on 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*, which is substantially converged with IFRS 9, in August 2018. IPSAS 41 superseded 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 and a PBE Standard based on IPSAS 41, for-profit entities applying NZ IFRS 9 *Financial Instruments* and PBEs applying PBE IPSAS 29 *Financial Instruments Recognition and Measurement* 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.[5]

BC6. The development of PBE IFRS 9 was a limited scope project 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 PBE Standard, 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), as the NZASB preferred to wait for the IPSASB to consider these matters.

[5] The NZASB subsequently deferred this effective date to 1 January 2022 so that PBE IFRS 9 did not become mandatorily effective before PBE IPSAS 41.

Decision to develop PBE IPSAS 41

BC7. Following the issue of IPSAS 41 in 2018 the NZASB agreed 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:

(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 PBE IPSAS 41 *Financial Instruments* 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. Respondents supported the NZASB's actions.

Transition from PBE IFRS 9

BC11. Because the majority of the requirements in the proposed PBE IPSAS 41 were identical, or almost identical, to the requirements in PBE IFRS 9, the NZASB developed transitional provisions to minimise the amount of effort required to transition between the two standards. ED 2018-5 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 retrospectively.

BC12. Respondents supported these proposals.

Transition from PBE IPSAS 29

BC13. With respect to entities transitioning from PBE IPSAS 29 the proposed transitional provisions in ED 2018-5 were based on the provisions in IFRS 9, PBE IFRS 9 and IPSAS 41. Respondents were generally in support of the proposals, although a respondent requested that the NZASB add a specific

transition provision in relation to the measurement of financial guarantee contracts issued through a non-exchange transaction whose fair value could not previously be reliably measured at initial recognition. In response to this request the NZASB added a specific transition provision (paragraph 169.1) which mirrored, to the extent possible, the requirements in paragraph 45(c).

Interest Rate Benchmark Reform

BC14. In September 2019 the IASB issued *Interest Rate Benchmark Reform* which amended IFRS 9, IAS 39 and IFRS 7 *Financial Instruments: Disclosures*. In November 2019 the NZASB incorporated these amendments in NZ IFRS. These temporary exceptions addressed the potential impact of uncertainty about the long-term viability of some interest rate benchmarks on specific hedge accounting requirements. The NZASB considered that any PBEs subject to such uncertainty would also benefit from these temporary exceptions. The NZASB therefore issued NZASB ED 2019-5 *PBE Interest Rate Benchmark Reform* in November 2019 and finalised these amendments in February 2020.

Interest Rate Benchmark Reform—Phase 2

BC15. In August 2020 the IASB issued *Interest Rate Benchmark Reform—Phase 2* which amended IFRS 9, IAS 39, IFRS 7 *Financial Instruments: Disclosures*, IFRS 4 *Insurance Contracts* and IFRS 16 *Leases.* In September 2020 the NZASB made equivalent amendments to NZ IFRS. These amendments addressed the financial reporting issues that arise during the reform of an interest rate benchmark, including the replacement of an interest rate benchmark with alternative, nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates). The amendments provided a practical expedient for changes in the contractual cash flows of a financial asset or financial liability when such changes are directly required by interest rate benchmark reform. As a consequence of the amendments, entities meeting certain criteria will not have to derecognise or adjust the carrying amount of financial instruments for changes required by the reform, but will instead update the effective interest rate to reflect the change to the alternative benchmark rate. The amendments also provided relief to continue hedge accounting when changes to financial instruments or hedging relationships occur as a result of the reform.

BC16. The NZASB considered that PBEs affected by the replacement of interest rate benchmarks could also urgently require these amendments and proposed equivalent amendments to PBE Standards. The NZASB issued NZASB ED 2020-5 *PBE Interest Rate Benchmark Reform—Phase 2* in September 2020 and finalised the amendments in November 2020.

ILLUSTRATIVE EXAMPLES

CONTENTS

Illustrative Examples

These examples accompany, but are not part of, PBE IPSAS 41.

Financial Liabilities at Fair Value Through Surplus or Deficit

IE1. The following example illustrates the calculation that an entity might perform in accordance with paragraph AG241 of PBE IPSAS 41 *Financial Instruments.*

IE2. On January 1, 20X1 an entity issues a 10-year bond with a par value of CU150,000[6] 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.[7]

IE4. The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.

IE5. The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

[paragraph AG241(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)] 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(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)]

[6] In this guidance monetary amounts are denominated in 'currency units' (CU).

[7] This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

[paragraph AG241(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(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 revenue and expense in accordance with paragraph 108(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 revenue and expense, 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)

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.[8] Company Y qualifies for assistance from the National Development Bank which provides a tranche of the loan facility to Company Y. At the time of origination of the loan by the National Development Bank, although Company Y's leverage was relatively high compared with other issuers with similar credit risk, it was expected that Company Y would be able to meet the covenants for the life of the instrument. In addition, the generation of revenue and cash flow was expected to be stable in Company Y's industry over the term of the senior facility. However, there was some business risk related to the ability to grow gross margins within its existing businesses.

IE8. At initial recognition, because of the considerations outlined in paragraph IE7, the National Development Bank considers that despite the level of credit risk at initial recognition, the loan is not an originated credit-impaired loan because it does not meet the definition of a credit-impaired financial asset in paragraph 9 of PBE IPSAS 41.

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.

IE10. The National Development Bank makes an overall assessment of the credit risk on the loan to Company Y at the reporting date by taking into consideration all reasonable and supportable information that is available without undue cost or effort and that is relevant for assessing the extent of the increase in credit risk since initial recognition. This may include factors such as:

(a) The National Development Bank's expectation that the deterioration in the macroeconomic environment may continue in the near future, which is expected to have a further negative impact on Company Y's ability to generate cash flows and to deleverage.

[8] 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 of PBE IPSAS 41.

(b) Company Y is closer to breaching its covenants, which may result in a need to restructure the loan or reset the covenants.

(c) The National Development Bank's assessment that the trading prices for Company Y's bonds have decreased and that the credit margin on newly originated loans have increased reflecting the increase in credit risk, and that these changes are not explained by changes in the market environment (for example, benchmark interest rates have remained unchanged). A further comparison with the pricing of Company Y's peers shows that reductions in the price of Company Y's bonds and increases in credit margin on its loans have probably been caused by company-specific factors.

(d) The National Development Bank has reassessed its internal risk grading of the loan on the basis of the information that it has available to reflect the increase in credit risk.

IE11. The National Development Bank determines that there has been a significant increase in credit risk since initial recognition of the loan in accordance with paragraph 75 of PBE IPSAS 41. Consequently, the National Development Bank recognises lifetime expected credit losses on its senior secured loan to Company Y. Even if the National Development Bank has not yet changed the internal risk grading of the loan it could still reach this conclusion—the absence or presence of a change in risk grading in itself is not determinative of whether credit risk has increased significantly since initial recognition.

Example 2—No Significant Increase in Credit Risk

IE12. Company C, is the holding company of a group that operates in a cyclical production industry. State Government B provided a loan to Company C. At that time, the prospects for the industry were positive, because of expectations of further increases in global demand. However, input prices were volatile and given the point in the cycle, a potential decrease in sales was anticipated.

IE13. In addition, in the past Company C has been focused on external growth, acquiring majority stakes in companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to 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 B originates the loan, its creditors are concerned about Company C's ability to refinance its debt because of the short remaining life until the maturity of the current financing. There is also concern about Company C's ability to continue to service interest using the dividends it receives from its operating subsidiaries.

IE14. At the time of the origination of the loan by State Government B, Company C's leverage was in line with that of other borrowers with similar credit risk and based on projections over the expected life of the loan, the available capacity (i.e., headroom) on its coverage ratios before triggering a default event, was high. State Government B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its loans. State Government B's internal rating categories are based on historical, current and forward-looking information and reflect the credit risk for the tenor of the loans. On initial recognition, State Government B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group's uncertain prospects for cash generation, could lead to default. However, State Government B does not consider the loan to be originated credit-impaired because it does not meet the definition of a purchased or originated credit-impaired financial asset in paragraph 9 of PBE IPSAS 41.

IE15. Subsequent to initial recognition, Company C has announced that three of its five key subsidiaries had a significant reduction in sales volume because of deteriorated market conditions but sales volumes are expected to improve in line with the anticipated cycle for the industry in the following months. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure to streamline its operating subsidiaries. This restructuring will increase the flexibility to refinance existing debt and the ability of the operating subsidiaries to pay dividends to Company C.

IE16. Despite the expected continuing deterioration in market conditions, State Government B determines, in accordance with paragraph 75 of PBE IPSAS 41, that there has not been a significant increase in the credit risk on the loan to Company C since initial recognition. This is demonstrated by factors that include:

(a) Although current sale volumes have fallen, this was as anticipated by State Government B at initial recognition. Furthermore, sales volumes are expected to improve, in the following months.

(b) Given the increased flexibility to refinance the existing debt at the operating subsidiary level and the increased availability of dividends to Company C, State Government B views the corporate restructure as being credit enhancing. This is despite some continued concern about the ability to refinance the existing debt at the holding company level.

(c) State Government B's credit risk department, which monitors Company C, has determined that the latest developments are not significant enough to justify a change in its internal credit risk rating.

IE17. As a consequence, State Government B does not 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 which is financed by a five-year loan from the State-owned Agricultural Bank with a loan-to-value (LTV) ratio of 50 per cent. The loan is secured by a first-ranking security over the land. At initial recognition of the loan, the State-owned Agricultural Bank does not consider the loan to be originated credit-impaired as defined in paragraph 9 of PBE IPSAS 41.

IE19. Subsequent to initial recognition, the revenues and operating profits of Company H have decreased because of an economic recession. Furthermore, expected increases in regulations have the potential to further negatively affect revenue and operating profit. These negative effects on Company H's operations could be significant and ongoing.

IE20. As a result of these recent events and expected adverse economic conditions, Company H's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. The State-owned Agricultural Bank estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due.

IE21. Recent third party appraisals have indicated a decrease in the value of the land, resulting in a current LTV ratio of 70 per cent.

IE22. At the reporting date, the loan to Company H is not considered to have low credit risk in accordance with paragraph 82 of PBE IPSAS 41. The State-owned Agricultural Bank therefore needs to assess whether there has been a significant increase in credit risk since initial recognition in accordance with paragraph 75 of PBE IPSAS 41, irrespective of the value of the collateral it holds. It notes that the loan is subject to considerable credit risk at the reporting date because even a slight deterioration in cash flows could result in Company H missing a contractual payment on the loan. As a result, the State-owned Agricultural Bank determines that the credit risk (i.e., the risk of a default occurring) has increased significantly since initial recognition. Consequently, the State-owned Agricultural Bank 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 of PBE IPSAS 41 and may result in the expected credit losses on the loan being very small.

Example 4—Public Investment-Grade Bond

IE24. Company A is a large listed national logistics company. The only debt in the capital structure is a five-year public bond with a restriction on further borrowing as the only bond covenant. Company A reports quarterly to its shareholders. The National Public Investment Fund is one of many investors in the bond. The Investment Fund considers the bond to have low credit risk at initial recognition in accordance with paragraph 82 of PBE IPSAS 41. This is because the bond has a low risk of default and Company A is considered to have a strong capacity to meet its obligations in the near term. The Investment Fund's expectations for the longer term are that adverse changes in economic and business conditions may, but will not necessarily, reduce Company A's ability to fulfil its obligations on the bond. In addition, at initial

recognition the bond had an internal credit rating that is correlated to a global external credit rating of investment grade.

IE25. At the reporting date, the Investment Fund's main credit risk concern is the continuing pressure on the total volume of sales that has caused Company A's operating cash flows to decrease.

IE26. Because the Investment Fund relies only on quarterly public information and does not have access to private credit risk information (because it is a bond investor), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

IE27. The Investment Fund applies the low credit risk simplification in paragraph 82 of PBE IPSAS 41. Accordingly, at the reporting date, the Investment Fund evaluates whether the bond is considered to have low credit risk using all reasonable and supportable information that is available without undue cost or effort. In making that evaluation, the Investment Fund reassesses the internal credit rating of the bond and concludes that the bond is no longer equivalent to an investment grade rating because:

(a) The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent.

(b) Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.

(c) The bond price has also declined significantly, which has resulted in a higher yield to maturity. The Investment Fund assesses that the bond prices have been declining as a result of increases in Company A's credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity etc are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).

IE28. While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described in paragraph IE27, the Investment Fund determines that the bond does not have low credit risk at the reporting date. As a result, the Investment Fund needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, the Investment Fund determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime expected credit losses should be recognised in accordance with paragraph 75 of PBE IPSAS 41.

Example 5—Responsiveness to Changes in Credit Risk

IE29. Housing Corporation ABC provides mortgages to citizens of ABC to finance residential real estate in three different regions. The mortgage loans are originated across a wide range of LTV criteria and a wide range of income groups. As part of the mortgage application process, borrowers are required to provide information such as the industry within which the borrower is employed and the post code of the property that serves as collateral on the mortgage.

IE30. Housing Corporation ABC sets its acceptance criteria based on credit scores. Loans with a credit score above the 'acceptance level' are approved because these borrowers are considered to be able to meet contractual payment obligations. When new mortgage loans are originated, Housing Corporation ABC uses the credit score to determine the risk of a default occurring as at initial recognition.

IE31. At the reporting date Housing Corporation ABC determines that economic conditions are expected to deteriorate significantly in all regions. Unemployment levels are expected to increase while the value of residential property is expected to decrease, causing the LTV ratios to increase. As a result of the expected deterioration in economic conditions, Housing Corporation ABC expects default rates on the mortgage portfolio to increase.

Individual Assessment

IE32. In Region One, Housing Corporation ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process. Its scoring models are based on current and historical past due statuses, levels of borrower indebtedness, LTV measures, the loan size and the time since the

origination of the loan. Housing Corporation ABC updates the LTV measures on a regular basis through an automated process that re-estimates property values using recent sales in each post code area and reasonable and supportable forward-looking information that is available without undue cost or effort.

IE33. Housing Corporation ABC has historical data that indicates a strong correlation between the value of residential property and the default rates for mortgages. That is, when the value of residential property declines, a borrower has less economic incentive to make scheduled mortgage repayments, increasing the risk of a default occurring.

IE34. Through the impact of the LTV measure in the 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 ABC is able to identify significant increases in credit risk since initial recognition on individual borrowers before a mortgage becomes past due if there has been a deterioration in the 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 ABC measures the loss allowance by using the LTV measures to estimate the severity of the loss, i.e., the loss given default (LGD). The higher the LTV measure, the higher the expected credit losses all else being equal.

IE36. If Housing Corporation ABC was unable to update 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 ABC does not have an automated scoring capability. Instead, for credit risk management purposes, Housing Corporation ABC tracks the risk of a default occurring by means of past due statuses. It 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 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 of PBE IPSAS 41 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 ABC becomes aware of a significant decline in coal exports and anticipates the closure of several coal mines. Because of the expected increase in the unemployment rate, the risk of a default occurring on mortgage loans to borrowers who are employed by the coal mines is determined to have increased significantly, even if those borrowers are not past due at the reporting date. Housing Corporation ABC therefore segments its mortgage portfolio by the industry within which borrowers are employed (using the information recorded as part of the mortgage application process) to identify borrowers that rely on coal mining as the dominant source of employment (i.e., a 'bottom up' approach in which loans are identified based on a common risk characteristic). For those mortgages, Housing Corporation ABC 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.[9] Newly originated mortgages to borrowers who are economically dependent on the coal mines in this community would, however, have a loss allowance at an amount equal to 12-month expected credit losses because they would not have experienced significant increases in credit risk since initial recognition. However, some of these mortgages may experience

[9] Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

significant increases in credit risk soon after initial recognition because of the expected closure of the coal mines.

Region Three

IE39. In Region Three, Housing Corporation ABC anticipates the risk of a default occurring and thus an increase in credit risk, as a result of an expected increase in interest rates during the expected life of the mortgages. Historically, an increase in interest rates has been a lead indicator of future defaults on mortgages in Region Three—especially when borrowers do not have a fixed interest rate mortgage. Housing Corporation ABC determines that the variable interest-rate portfolio of mortgages in Region Three is homogenous and that unlike for Region Two, it is not possible to identify particular sub portfolios on the basis of shared risk characteristics that represent borrowers who are expected to have increased significantly in credit risk. However, as a result of the homogenous nature of the mortgages in Region Three, Housing Corporation ABC determines that an assessment can be made of a proportion of the overall portfolio that has significantly increased in credit risk since initial recognition (i.e., a 'top down' approach can be used). Based on historical information, Housing Corporation ABC estimates that an increase in interest rates of 200 basis points will cause a significant increase in credit risk on 20 per cent of the variable interest-rate portfolio. Therefore, as a result of the anticipated increase in interest rates, Housing Corporation ABC determines that the credit risk on 20 per cent of mortgages in Region Three has increased significantly since initial recognition. Accordingly Housing Corporation ABC 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.[10]

Example 6—Comparison to Maximum Initial Credit Risk

IE40. The Economic Development Agency has two portfolios of small business loans with similar terms and conditions in Region W. The Economic Development Agency's policy on financing decisions for each loan is based on an internal credit rating system that considers a borrower's credit history, payment behaviour and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to repeat borrowers with a similar internal credit risk rating and at initial recognition all loans were rated 3 or 4 on the internal rating scale. The Economic Development Agency determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to borrowers that responded to an advertisement for small business loans and the internal credit risk ratings of these borrowers range between 4 and 7 on the internal rating scale. The Economic Development Agency never originates a small business loan with an internal credit risk rating worse than 7 (i.e., with an internal rating of 8–10).

IE41. For the purposes of assessing whether there have been significant increases in credit risk, the Economic Development Agency determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk but that there has been a significant increase in credit risk on any loan in this portfolio that has an internal rating worse than 5. This means that the Department of Finance does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the reporting date to determine whether lifetime expected credit losses should be recognised in accordance with paragraph 75 of PBE IPSAS 41.

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 of PBE IPSAS 41. This is because the Economic Development Agency determines that significant increases in credit risk arise not only when credit risk increases above the level at which an entity would originate new financial assets (i.e., when the internal rating is worse than 7). Although the Economic Development Agency never originates a small business loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition

[10] Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

to apply the approach used for Portfolio 1. This means that the Economic Development Agency cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly because the initial credit quality of loans in the portfolio is too diverse. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

Example 7—Counterparty Assessment of Credit Risk

Scenario 1

IE43. In 20X0 the Infrastructure Bank of Country A granted a loan of CU10,000 with a contractual term of 15 years to Company Q when the company had an internal credit risk rating of 4 on a scale of 1 (lowest credit risk) to 10 (highest credit risk). The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. In 20X5, when Company Q had an internal credit risk rating of 6, the Infrastructure Bank issued another loan to Company Q for CU5,000 with a contractual term of 10 years. In 20X7 Company Q fails to retain its contract with a major customer and correspondingly experiences a large decline in its revenue. The Infrastructure Bank considers that as a result of losing the contract, Company Q will have a significantly reduced ability to meet its loan obligations and changes its internal credit risk rating to 8.

IE44. The Infrastructure Bank assesses credit risk on a counterparty level for credit risk management purposes and determines that the increase in Company Q's credit risk is significant. Although the Infrastructure Bank did not perform an individual assessment of changes in the credit risk on each loan since its initial recognition, assessing the credit risk on a counterparty level and recognising lifetime expected credit losses on all loans granted to Company Q, meets the objective of the impairment requirements as stated in paragraph 76 of PBE IPSAS 41. 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. The Infrastructure Bank re-assesses Company X's internal credit risk rating, and determines it to be 7 at the reporting date. The Infrastructure Bank considered the change in credit risk on the loan, including considering the change in the internal credit risk rating, and determines that there has been a significant increase in credit risk and 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 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 only assessed credit risk on a counterparty level, without considering whether the conclusion about changes in credit risk applies to all individual financial instruments provided to the same borrower, the objective in paragraph 76 of PBE IPSAS 41 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 of PBE IPSAS 41, as well as the interaction with the hedge accounting requirements.

Example 8—12-Month Expected Credit Loss Measurement Using an Explicit 'Probability of Default' Approach

Scenario 1

IE49. Government A originates a single 10 year 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 A estimates that the loan at initial recognition has a probability of default (PD) of 0.5 per cent over the next 12 months. Government A also determines that changes in the 12-month PD are a reasonable approximation of the changes in the lifetime PD for determining whether there has been a significant increase in credit risk since initial recognition.

IE50. At the reporting date (which is before payment on the loan is due[11]), there has been no change in the 12-month PD and Government A determines that there was no significant increase in credit risk since initial recognition. Government A determines that 25 per cent of the gross carrying amount will be lost if the loan defaults (i.e., the LGD is 25 per cent).[12] Government A measures the loss allowance at an amount equal to 12-month expected credit losses using the 12-month PD of 0.5 per cent. Implicit in that calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12 month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

Scenario 2

IE51. Government B acquires a portfolio of 1,000 five year bullet loans for CU1,000 each (i.e., CU1 million in total) with an average 12-month PD of 0.5 per cent for the portfolio. Government B determines that because the loans only have significant payment obligations beyond the next 12 months, it would not be appropriate to consider changes in the 12-month PD when determining whether there have been significant increases in credit risk since initial recognition. At the reporting date Government B therefore uses changes in the lifetime PD to determine whether the credit risk of the portfolio has increased significantly since initial recognition.

IE52. Government B determines that there has not been a significant increase in credit risk since initial recognition and estimates that the portfolio has an average LGD of 25 per cent. Government B determines that it is appropriate to measure the loss allowance on a collective basis in accordance with PBE IPSAS 41. The 12-month PD remains at 0.5 per cent at the reporting date. Government 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 A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. Government A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per borrower of CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per borrower of CU300, for a total gross carrying amount of CU300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

IE54. Government A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Government A considers samples of its own historical default and loss experience for those types of loans. In addition, Government A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

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[11] Thus for simplicity of illustration it is assumed there is no amortisation of the loan.

[12] Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money.

	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(b) expected credit losses should be discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed.

IE55. At the reporting date, Government A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Government A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the historical loss per client.

IE56. On the basis of the expected life of the loans, Government A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Government A measures the loss allowance at an amount equal to 12-month expected credit losses on the 1,000 loans in each group amounting to CU750 and CU675 respectively. This equates to a loss rate in the first year of 0.375 per cent for Group X and 0.225 per cent for Group Y.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	5	CU1,000	CU750	0.375%
Y	1,000	CU300	CU300,000	3	CU900	CU675	0.225%

IE57. Government A uses the loss rates of 0.375 per cent and 0.225 per cent respectively to estimate 12-month expected credit losses on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

Example 10—Revolving Credit Facilities

IE58. The Development Agency of Country A issues revolving loans to small construction companies that deliver public infrastructure. These revolving loans provide small construction companies with liquidity when cash inflows are limited. The revolving loans have a one-day notice period after which the Development Agency has the contractual right to cancel the loan (both the drawn and undrawn components). However, the Development Agency does not enforce its contractual right to cancel the revolving loans in the normal day-to-day management of the instruments and only cancels facilities when it becomes aware of an increase in credit risk and starts to monitor borrowers on an individual basis. The Development Agency therefore does not consider the contractual right to cancel the revolving loans to limit its exposure to credit losses to the contractual notice period.

IE59. For credit risk management purposes the Development Agency considers that there is only one set of contractual cash flows from borrowers to assess and does not distinguish between the drawn and undrawn balances at the reporting date. The portfolio is therefore managed and expected credit losses are measured on a facility level.

IE60. At the reporting date the outstanding balance on the revolving loan portfolio is CU60,000 and the available undrawn facility is CU40,000. The Development Agency determines the expected life of the portfolio by estimating the period over which it expects to be exposed to credit risk on the facilities at the reporting date, taking into account:

(a) The period over which it was exposed to credit risk on a similar portfolio of revolving construction loans;

(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 determines that the expected life of the revolving loan portfolio is 30 months.

IE62. At the reporting date the Development Agency assesses the change in the credit risk on the portfolio since initial recognition and determines in accordance with paragraph 75 of PBE IPSAS 41 that the credit risk on a portion of the loan facilities representing 25 per cent of the portfolio, has increased significantly since initial recognition. The outstanding balance on these credit facilities for which lifetime expected credit losses should be recognised is CU20,000 and the available undrawn facility is CU10,000.

IE63. When measuring the expected credit losses in accordance with paragraph 93 of PBE IPSAS 41, Development Agency considers its expectations about future draw-downs over the expected life of the portfolio (i.e., 30 months) in accordance with paragraph AG195 and estimates what it expects the outstanding balance (i.e., exposure at default) on the portfolio would be if borrowers were to default. By using its credit risk models Development Agency determines that the exposure at default on the revolving loan facilities for which lifetime expected credit losses should be 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 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 are used to measure the lifetime expected credit losses and 12-month expected credit losses on its loan portfolio.

IE65. The Development Agency measures expected credit losses on a facility level and therefore cannot separately identify the expected credit losses on the undrawn commitment component from those on the loan component. It 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 *Financial Instruments: Disclosures*).

Example 11—Modification of Contractual Cash Flows

IE66. Government A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is CU1,000 with an interest rate of 5 per cent payable annually. The effective interest rate is 5 per cent. At the end of the first reporting period (Period 1), Government A 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 A determines that the credit risk on the loan has increased significantly since initial recognition. As a result of this increase, Government 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 A modifies the contractual cash flows on the loan. It extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in the derecognition of the loan by Government A.

IE69. As a result of that modification, Government A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan's original effective interest rate of 5 per cent. In accordance with paragraph 71 of PBE IPSAS 41, 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 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.

IE70. Government A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan shall continue to be measured at an amount equal to lifetime expected credit losses. Government A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Government A determines that the loan is not credit-impaired at the reporting date but that credit risk has still significantly increased compared to the credit risk at initial recognition and continues to measure the loss allowance at an amount equal to lifetime expected credit losses. The loss allowance balance for lifetime expected credit losses is CU100 at the reporting date.

Period	Beginning gross carrying amount	Impairment (loss)/gain	Modification (loss)/gain	Interest revenue	Cash flows	Ending gross carrying amount	Loss allowance	Ending amortised cost amount
	A	B	C	D Gross: A × 5%	E	F = A + C + D – E	G	H = F – G
1	CU1,000	(CU20)		CU50	CU50	CU1,000	CU20	CU980
2	CU1,000	(CU10)		CU50	CU50	CU1,000	CU30	CU970
3	CU1,000	(CU70)	(CU300)	CU50	CU50	CU700	CU100	CU600

IE71. At each subsequent reporting date, Government A evaluates whether there is a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows), in accordance with paragraph 84 of PBE IPSAS 41.

IE72. Two reporting periods after the loan modification (Period 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Government A adjusts the borrower's internal credit rating at the end of the reporting period.

IE73. Given the positive overall development, Government A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Government A once again measures the loss allowance at an amount equal to 12-month expected credit losses.

Example 12—Provision Matrix

IE74. Municipality M provides water delivery services for households within its jurisdiction. Households are invoiced on a monthly basis based on the water consumed during the period. This represents a portfolio of trade receivables of CU30 million in 20X1 for Municipality M. The portfolio consists of a large number of households with small balances outstanding. The trade receivables are categorised by common risk characteristics that are representative of the households' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component. In accordance with paragraph 87 of PBE IPSAS 41 the loss allowance for such trade receivables is always measured at an amount equal to lifetime time expected credit losses.

IE75. To determine the expected credit losses for the portfolio, Municipality M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

IE76. On that basis, Municipality M estimates the following provision matrix:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

IE77. The trade receivables from the large number of households amount to CU30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	CU15,000,000	CU45,000
1–30 days past due	CU7,500,000	CU120,000
31–60 days past due	CU4,000,000	CU144,000
61–90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	**CU580,000**

Example 13—Debt Instrument Measured at Fair Value Through other Comprehensive Revenue and Expense

IE78. Public Investment Fund A purchases a debt instrument with a fair value of CU1,000 on December 15, 20X0 and measures the debt instrument at fair value through other comprehensive revenue and expense. 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	CU1,000	
Cash		CU1,000
(To recognise the debt instrument measured at its fair value)		

IE79. On 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)	CU30	
Other comprehensive revenue or expense[(a)]	CU20	
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense		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 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 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		CU950
Loss (surplus or deficit)	CU20	
Other comprehensive revenue and expense		CU20
(To derecognise the fair value through other comprehensive revenue and expense asset and recycle amounts accumulated in other comprehensive revenue and expense to surplus or deficit)		

Example 14—Interaction Between the Fair Value Through Other Comprehensive Revenue and Expense 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 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 January 1, 20X0 and classifies the bond as measured at fair value through other comprehensive revenue and expense. 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 January 1, 20X0. At initial recognition the entity determines that the bond is not purchased or originated credit-impaired. In addition, as at January 1, 20X0 the 12-month expected credit losses are determined to be FC1,200. Its amortised cost in FC as at 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:[13] a fair value hedge of the bond in FC as the hedged item with changes in benchmark interest rate risk in FC as the hedged risk. The entity enters into an on-market swap that pays fixed and receives variable interest on the same day and designates the swap as the hedging instrument. The tenor of the swap matches that of the hedged item (i.e., five years).

IE87. For simplicity, in this example it is assumed that no hedge ineffectiveness arises in the hedge accounting relationship. This is because of the assumptions made in order to better focus on illustrating the accounting mechanics in a situation that entails measurement at fair value through other comprehensive revenue and expense 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.

[13] The cumulative loss in other comprehensive revenue and expense 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 of PBE IPSAS 41). 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 of PBE IPSAS 41).

IE88. The entity makes the following journal entries to recognise the bond and the swap on January 1, 20X0:

	Debit LC	Credit LC
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense	100,000	
Cash		100,000
(To recognise the bond at its fair value)		
Impairment loss (surplus or deficit)	1,200	
Other comprehensive revenue and expense		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 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 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.[14] As at December 31, 20X0, the exchange rate is FC1 to LC1.4. This is reflected in the following table:

	January 1, 20X0	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 in accordance with paragraphs 27(a) and 32 of PBE IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* and recognises other changes in accordance with PBE IPSAS 41. For the purposes of applying paragraph 32 of PBE IPSAS 4 the asset is treated as an asset measured at amortised cost in the foreign currency.

IE91. As shown in the table, on 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).

IE92. The gain recognised in surplus or deficit that is due to the changes in foreign exchange rates is LC39,520 (LC138,320 – LC98,800), i.e., the change in the 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 during 20X0 as a reduction is LC 4,602 (LC3,402 + LC1,200).

[14] For the purposes of simplicity the example ignores the impact of discounting when computing expected credit losses.

IE93. A gain of LC2,572 (FC1,837 × 1.4) on the swap is recognised in surplus or deficit and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive revenue and expense 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 December 31, 20X0:

	Debit LC	**Credit LC**
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense	34,918	
Other comprehensive revenue and expense	4,602	
Surplus or deficit		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		2,572
(To remeasure the swap at fair value)		
Surplus or deficit	2,572	
Other comprehensive revenue and expense		2,572
(To recognise in surplus or deficit the change in fair value of the bond due to a change in the hedged risk)		

IE95. In accordance with paragraph 20A of PBE IPSAS 30, the loss allowance for financial assets measured at fair value through other comprehensive revenue and expense 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.

IE96. As at 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 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.[15] The estimate of lifetime expected credit losses as at December 31, 20X1 is FC9,700. As at December 31, 20X1, the exchange rate is FC1 to LC1.25. This is reflected in the following table:

	December 31, 20X0	**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 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 December 31, 20X1. Thus the impairment loss recognised in surplus or deficit in LC is LC10,625 (FC(9,700 – 1,200) x 1.25).

[15] For simplicity this example assumes that credit risk does not dominate the fair value hedge relationship.

IE99. The loss recognised in surplus or deficit because of the changes in foreign exchange rates is LC14,820 (LC112,875 – LC138,320 + LC10,625), which is the change in the gross carrying amount of the bond on the basis of 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 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 during 20X1 as a reduction in other comprehensive revenue and expense 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 and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive revenue and expense in the same period.

IE101. The entity makes the following journal entries on December 31, 20X1:

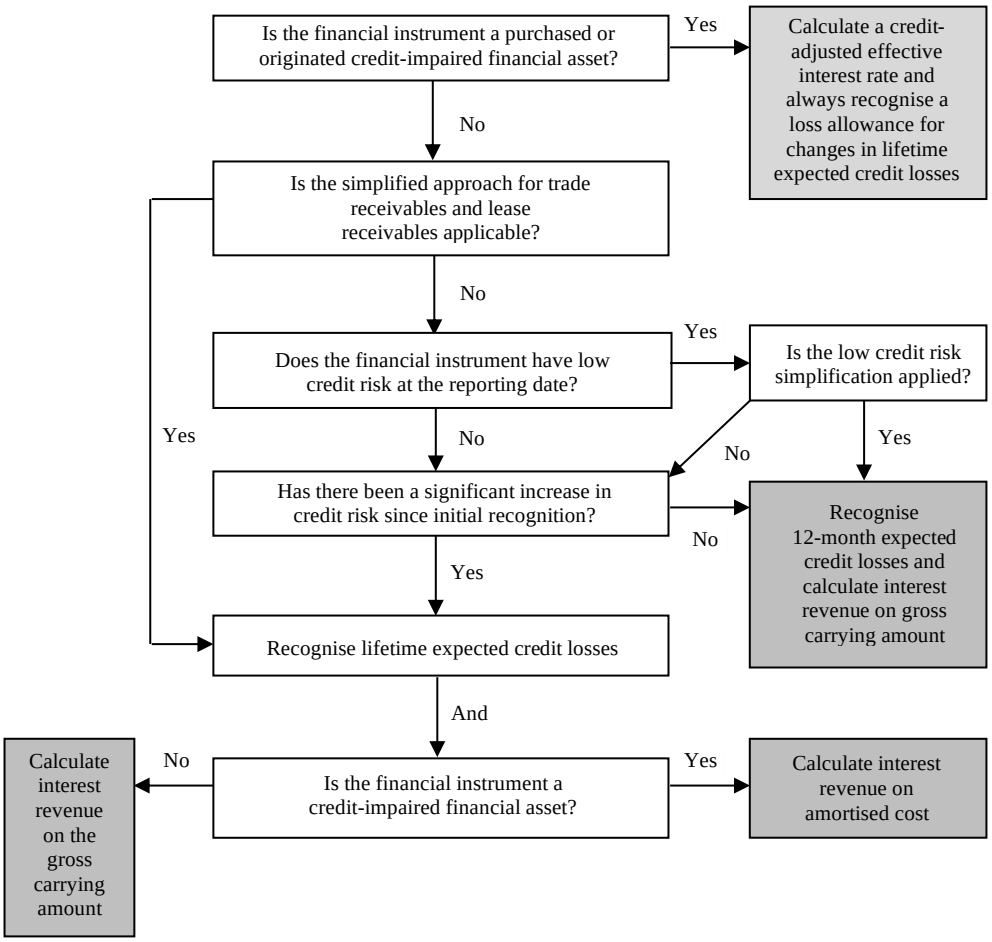
	Debit LC	**Credit LC**
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense		26,025
Other comprehensive revenue and expense	11,205	
Surplus or deficit	14,820	
(To recognise the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)		
Swap	43	
Surplus or deficit		43
(To remeasure the swap at fair value)		
Surplus or deficit	43	
Other comprehensive revenue and expense		43
(To recognise in surplus or deficit the change in fair value of the bond due to a change in the hedged risk)		
Surplus or deficit (impairment loss)	10,625	
Other comprehensive revenue and expense (accumulated impairment amount)		10,625
(To recognise lifetime expected credit losses)		

IE102. On 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 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 would be as follows:

	Debit LC	**Credit LC**
Cash	108,893	
Financial asset—Fair Value Through Other Comprehensive Revenue and Expense		108,893
Loss on sale (surplus or deficit)	1,367[(a)]	
Other comprehensive revenue and expense		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 (LC2,572 + LC1,200 + LC43 + LC10,625 – LC4,602 – LC11,205 = -LC1,367, which is recycled as a loss in surplus or deficit).

Application of the Impairment Requirements on a Reporting Date



Reclassification of Financial Assets (paragraphs 94–100)

IE103. This example illustrates the accounting requirements for the reclassification of financial assets between measurement categories in accordance with 94–100 of PBE IPSAS 41. The example illustrates the interaction with the impairment requirements in paragraphs 73–93 of PBE IPSAS 41.

Example 15—Reclassification of Financial Assets

IE104. An entity purchases a portfolio of bonds for its fair value (gross carrying amount) of CU500,000.

IE105. The entity changes the management model for managing the bonds in accordance with paragraph 54 of PBE IPSAS 41. 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 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 or Deficit Measurement Category

IE109. Department of Treasury A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through surplus or deficit measurement category. At the reclassification date, the portfolio of bonds is measured at fair value. Any gain or loss arising from a difference between

the previous amortised cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognised in surplus or deficit on reclassification.

	Debit	Credit
Bonds (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)	CU4,000	
(To recognise the reclassification of bonds from amortised cost to fair value through surplus or deficit and to derecognise the loss allowance.)		

Scenario 2: Reclassification Out of the Fair Value Through Surplus or Deficit Measurement Category and into the Amortised Cost Measurement Category

IE110. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through surplus or deficit measurement category and into the 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 (Fair Value Through Surplus or Deficit assets)		CU490,000
Impairment loss (surplus or deficit)	CU4,000	
Loss allowance		CU4,000
(To recognise reclassification of bonds from fair value through surplus or deficit 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 Revenue and Expense Measurement Category

IE111. Department of Treasury A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through other comprehensive revenue and expense 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. 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 (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[(a)]	CU4,000	
(To recognise the reclassification from amortised cost to fair value through other comprehensive revenue and expense. 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 CU10,000 (fair value changes) and CR other comprehensive revenue and expense CU6,000 (accumulated impairment amount).

Scenario 4: Reclassification Out of the Fair Value Through Other Comprehensive Revenue and Expense Measurement Category and into the Amortised Cost Measurement Category

IE112. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through other comprehensive revenue and expense 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 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 (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[(a)]		CU4,000
(To recognise the reclassification from fair value through other comprehensive revenue and expense 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 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.

Scenario 5: Reclassification Out of the Fair Value Through Surplus or Deficit Measurement Category and into the Fair Value Through Other Comprehensive Revenue and Expense Measurement Category

IE113. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through surplus or deficit measurement category and into the fair value through other comprehensive revenue and expense 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 assets)	CU490,000	
Bonds (Fair Value Through Surplus or Deficit assets)		CU490,000
Impairment loss (surplus or deficit)	CU4,000	
Other comprehensive revenue and expense [(a)]		CU4,000
(To recognise the reclassification of bonds from fair value through surplus or deficit to fair value through other comprehensive revenue and expense including commencing accounting for impairment. The other comprehensive revenue and expense 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 Measurement Category and into the Fair Value Through Surplus or Deficit Measurement Category

IE114. Department of Treasury A reclassifies the portfolio of bonds out of the fair value through other comprehensive revenue and expense measurement category and into the fair value through surplus or deficit measurement category. The portfolio of bonds continues to be measured at fair value. However, the cumulative gain or loss previously recognised in other comprehensive revenue and expense is reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (see PBE IPSAS 1 *Presentation of Financial Reports*).

	Debit	Credit
Bonds (Fair Value Through Surplus or Deficit assets)	CU490,000	
Bonds (Fair Value Through Other Comprehensive Revenue and Expense assets)		CU490,000
Reclassification loss (surplus or deficit)	CU4,000	
Other comprehensive revenue and expense		CU4,000

(To recognise the reclassification of bonds from fair value through other comprehensive revenue and expense to fair value through surplus or deficit.)

(a) The cumulative loss in other comprehensive revenue and expense 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.

Hedge Accounting for Aggregated Exposures

IE115. The following examples illustrate the mechanics of hedge accounting for aggregated exposures.

Example 16—Combined Commodity Price Risk and Foreign Currency Risk Hedge (Cash Flow Hedge/Cash Flow Hedge Combination)

Fact Pattern

IE116. Municipality A wants to hedge a highly probable forecast electricity purchase (which is expected to occur at the end of Period 5). Municipality A's functional currency is its Local Currency (LC). Electricity is traded in Foreign Currency (FC). Municipality A has the following risk exposures:

(a) Commodity price risk: the variability in cash flows for the purchase price, which results from fluctuations of the spot price of electricity in FC; and

(b) Foreign currency (FX) risk: the variability in cash flows that result from fluctuations of the spot exchange rate between LC and FC.

IE117. Municipality A hedges its risk exposures using the following risk management strategy:

(a) Municipality A uses benchmark commodity forward contracts, which are denominated in FC, to hedge its electricity purchases four periods before delivery. The electricity price that Municipality A actually pays for its purchase is different from the benchmark price because of differences in the type of electricity, the location and delivery arrangement.[16] This gives rise to the risk of changes in the relationship between the two electricity prices (sometimes referred to as 'basis risk'), which affects the effectiveness of the hedging relationship. Municipality A does not hedge this risk because it is not considered economical under cost/benefit considerations.

(b) Municipality A also hedges its FX risk. However, the FX risk is hedged over a different horizon—only three periods before delivery. Municipality A considers the FX exposure from the variable payments for the electricity purchase in FC and the gain or loss on the commodity forward contract in FC as one aggregated FX exposure. Hence, Municipality A uses one single FX forward contract to hedge the FX cash flows from a forecast electricity purchase and the related commodity forward contract.

[16] For the purpose of this example it is assumed that the hedged risk is not designated based on a benchmark electricity price risk component. Consequently, the entire electricity price risk is hedged.

IE118. The following table sets out the parameters used for Example 16 (the 'basis spread' is the differential, expressed as a percentage, between the price of the electricity that Municipality A actually buys and the price for the benchmark electricity):

Example 16—Parameters					
Period	**1**	**2**	**3**	**4**	**5**
Interest rates for remaining maturity [FC]	0.26%	0.21%	0.16%	0.06%	0.00%
Interest rates for remaining maturity [LC]	1.12%	0.82%	0.46%	0.26%	0.00%
Forward price [FC/MWh]	1.25	1.01	1.43	1.22	2.15
Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
FX rate (spot) [FC/LC]	1.3800	1.3300	1.4100	1.4600	1.4300

Accounting Mechanics

IE119. Entity A designates as cash flow hedges the following two hedging relationships:[17]

(a) A commodity price risk hedging relationship between the electricity price related variability in cash flows attributable to the forecast electricity purchase in FC as the hedged item and a commodity forward contract denominated in FC as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the end of Period 1 with a term to the end of Period 5. Because of the basis spread between the price of the electricity that Municipality A actually buys and the price for the benchmark electricity, Municipality A designates a volume of 112,500 MWh of electricity as the hedging instrument and a volume of 118,421 MWh as the hedged item.[18]

(b) An FX risk hedging relationship between the aggregated exposure as the hedged item and an FX forward contract as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 2 with a term to the end of Period 5. The aggregated exposure that is designated as the hedged item represents the FX risk that is the effect of exchange rate changes, compared to the forward FX rate at the end of Period 2 (i.e., the time of designation of the FX risk hedging relationship), on the combined FX cash flows in FC of the two items designated in the commodity price risk hedging relationship, which are the forecast electricity purchase and the commodity forward contract. Municipality A's long-term view of the basis spread between the price of the electricity that it actually buys and the price for the benchmark electricity has not changed from the end of Period 1. Consequently, the actual volume of hedging instrument that Municipality A enters into (the nominal amount of the FX forward contract of FC140,625) reflects the cash flow exposure associated with a basis spread that had remained at -5 per cent. However, Municipality A's actual aggregated exposure is affected by changes in the basis spread. Because the basis spread has moved from -5 per cent to -5.5 per cent during Period 2, Municipality A's actual aggregated exposure at the end of Period 2 is FC140,027.

[17] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 129 of PBE IPSAS 41). 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) of PBE IPSAS 41).

[18] In this example, the current basis spread at the time of designation is coincidentally the same as Municipality A's long-term view of the basis spread (-5 per cent) that determines the volume of electricity purchases that it actually hedges. Also, this example assumes that Municipality A designates the hedging instrument in its entirety and designates as much of its highly probable forecast purchases as it regards as hedged. That results in a hedge ratio of 1/(100%-5%). Other entities might follow different approaches when determining what volume of their exposure they actually hedge, which can result in a different hedge ratio and also designating less than a hedging instrument in its entirety (see paragraph 129 of PBE IPSAS 41).

IE120. The following table sets out the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserves and hedge ineffectiveness:[19]

Example 16—Calculations							
		Period	**1**	**2**	**3**	**4**	**5**
Commodity Price Risk Hedging Relationship (First Level Relationship)							
Forward Purchase Contract for Electricity							
Volume (MWh)	112,500						
Forward price		Price (fwd)					
[FC/MWh]	1.25	[FC/MWh]	1.25	1.01	1.43	1.22	2.15
		Fair value [FC]	0	(26,943)	20,219	(3,373)	101,250
		Fair value [LC]	0	(20,258)	14,339	(2,310)	70,804
		Change in fair value [LC]		(20,258)	34,598	(16,650)	73,114
Hedged Forecast Electricity Purchase							
Hedge ratio	105.26%	Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
		Price (fwd)					
Hedged volume	118,421	[FC/MWh]	1.19	0.95	1.34	1.18	2.00
		Present value					
Implied forward price	1.1875	[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				0	1,199	(2,781)	5,143
Accumulated surplus or deficit			0	0	1,199	(1,582)	3,561
FX Risk Hedging Relationship (Second Level Relationship)							
FX rate [FC/LC]		Spot	1.3800	1.3300	1.4100	1.4600	1.4300
		Forward	1.3683	1.3220	1.4058	1.4571	1.4300
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					(76)	76	(291)
Accumulated surplus or deficit				0	(76)	0	(291)

IE121. The commodity price risk hedging relationship is a cash flow hedge of a highly probable forecast transaction that starts at the end of Period 1 and remains in place when the FX risk hedging relationship starts at the end of Period 2, i.e., the first level relationship continues as a separate hedging relationship.

[19] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities, net assets/equity and surplus or deficit) are in the format of positive (plus) and negative (minus) numbers (e.g., a surplus or deficit amount that is a negative number is a loss).

IE122. The volume of the aggregated FX exposure (in FC), which is the hedged volume of the FX risk hedging relationship, is the total of:[20]

(a) The hedged electricity purchase volume multiplied by the current forward price (this represents the expected spot price of the actual electricity purchase); and

(b) The volume of the hedging instrument (designated nominal amount) multiplied by the difference between the contractual forward rate and the current forward rate (this represents the expected price differential from benchmark electricity price movements in FC that Municipality A will receive or pay under the commodity forward contract).

IE123. The present value (in LC) of the hedged item of the FX risk hedging relationship (i.e., the aggregated exposure) is calculated as the hedged volume (in FC) multiplied by the difference between the forward FX rate at the measurement date and the forward FX rate at the designation date of the hedging relationship (i.e., the end of Period 2).[21]

IE124. Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 140 of PBE IPSAS 41).

IE125. The following table shows the effect on Municipality A's statement of comprehensive revenue and expense and its statement of financial position (for the sake of transparency the line items[22] 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 and Financial Position
[All amounts in LC]

Period	**1**	**2**	**3**	**4**	**5**
Statement of comprehensive revenue and expense					
Hedge ineffectiveness					
Commodity hedge		0	(1,199)	2,781	(5,143)
FX hedge		0	76	(76)	291
Surplus or deficit	0	0	(1,123)	2,705	(4,852)
Other comprehensive revenue and expense					
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	0	20,258	(27,162)	17,472	(70,067)
Comprehensive revenue and expense	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/equity					
Accumulated other comprehensive revenue and expense					
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)

[20] For example, at the end of Period 3 the aggregated FX exposure is determined as: 118,421 MWh × 1.34 FC/MWh = FC159,182 for the expected price of the actual electricity purchase and 112,500 MWh × (1.25 [FC/MWh] – 1.43 [FC/MWh]) = FC(20,250) for the expected price differential under the commodity forward contract, which gives a total of FC138,932—the volume of the aggregated FX exposure at the end of Period 3.

[21] For example, at the end of Period 3 the present value of the hedged item is determined as the volume of the aggregated exposure at the end of Period 3 (FC138,932) multiplied by the difference between the forward FX rate at the end of Period 3 (1/1.4058) and the forward FX rate and the time of designation (i.e., the end of Period 2: 1/1.3220) and then discounted using the interest rate (in LC) at the end of Period 3 with a term of 2 periods (i.e., until the end of Period 5 – 0.46%). The calculation is: FC138,932 × (1/(1.4058[FC/LC]) – 1/(1.3220 [FC/LC]))/(1 + 0.46%) = LC6,237.

[22] The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (PBE IPSAS 30 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

Example 16—Overview of Effect on Statements of Comprehensive Revenue and Expense and Financial Position *[All amounts in LC]*					
Period	**1**	**2**	**3**	**4**	**5**
Accumulated surplus or deficit					
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)

IE126. The total cost of inventory after hedging is as follows:[23]

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 purchase at the spot price and the settlement of the two derivatives) is LC102,813. It differs from the hedge adjusted cost of inventory by LC3,270, which is the net amount of cumulative hedge ineffectiveness from the two hedging relationships. This hedge ineffectiveness has a cash flow effect but is excluded from the measurement of the inventory.

Example 17—Combined Interest Rate Risk and Foreign Currency Risk Hedge (Fair Value Hedge/Cash Flow Hedge Combination)

Fact Pattern

IE128. State Government B wants to hedge a fixed rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of Period 4. State Government B's functional currency is its Local Currency (LC). State Government B has the following risk exposures:

(a) Fair value interest rate risk and FX risk: the changes in fair value of the fixed rate liability attributable to interest rate changes, measured in LC.

(b) Cash flow interest rate risk: the exposure that arises as a result of swapping the combined fair value interest rate risk and FX risk exposure associated with the fixed rate liability (see (a) above) into a variable rate exposure in LC in accordance with State Government B's risk management strategy for FC denominated fixed rate liabilities (see paragraph IE129(a) below).

IE129. State Government B hedges its risk exposures using the following risk management strategy:

(a) State Government B uses cross-currency interest rate swaps to swap its FC denominated fixed rate liabilities into a variable rate exposure in LC. State Government B hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, State Government B enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap State Government B receives fixed interest in FC (used to pay the interest on the liability) and pays variable interest in LC.

(b) State Government B considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated variable rate exposure in LC. From time to time, in accordance with its risk management strategy for variable rate interest rate risk (in LC), State Government B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC. State Government B seeks to obtain as a fixed rate exposure a single blended fixed coupon rate (i.e., the uniform forward coupon rate for the hedged term that exists at the start of the hedging relationship).[24] Consequently, State

[23] 'CFHR' is the cash flow hedge reserve, i.e., the amount accumulated in other comprehensive revenue and expense for a cash flow hedge.

[24] An entity may have a different risk management strategy whereby it seeks to obtain a fixed rate exposure that is not a single blended rate but a series of forward rates that are each fixed for the respective individual interest period. For such a strategy the hedge effectiveness is measured based on the difference between the forward rates that existed at the start of the hedging relationship and the forward rates that

Government B uses interest rate swaps (denominated entirely in LC) under which it receives variable interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays fixed interest.

IE130. The following table sets out the parameters used for Example 17:

Example 17—Parameters					
	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 B designates the following hedging relationships:[25]

(a) As a fair value hedge, a hedging relationship for fair value interest rate risk and FX risk between the FC denominated fixed rate liability (fixed rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the beginning of Period 1 (i.e., t_0) with a term to the end of Period 4.

(b) As a cash flow hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 1, when State Government B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate

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).

[25] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 129 of PBE IPSAS 41). 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) of PBE IPSAS 41.

exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the variability in cash flows that is the effect of changes in the combined cash flows of the two items designated in the fair value hedge of the fair value interest rate risk and FX risk (see (a) above), compared to the interest rates at the end of Period 1 (i.e., the time of designation of the hedging relationship between the aggregated exposure and the interest rate swap).

IE132. The following table[26] sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve and hedge ineffectiveness.[27] In this example, hedge ineffectiveness arises on both hedging relationships.[28]

Example 17—Calculations					
	t_0	**Period 1**	**Period 2**	**Period 3**	**Period 4**
Fixed rate FX liability					
Fair value [FC]	(1,000,000)	(995,522)	(1,031,008)	(1,030,193)	(1,000,000)
Fair value [LC]	(1,200,000)	(1,045,298)	(1,464,031)	(1,555,591)	(1,370,000)
Change in fair value [LC]		154,702	(418,733)	(91,560)	185,591
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:

[26] Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

[27] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and 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).

[28] For a situation such as in this example, hedge ineffectiveness can result from various factors, for example credit risk, differences in the day count method or, depending on whether it is included in the designation of the hedging instrument, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis').

Example 17—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								
	t_1								
Period 1	t_2								
	t_3								
	t_4								
	t_5	0	0	0	0	(14,771)	(14,591)	17,089	16,881
Period 2	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
	t_9	0	0	0	0	(17,060)	(15,974)	17,089	16,002
Period 3	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
	t_{13}	0	0	0	0	(18,188)	(16,066)	17,089	15,095
Period 4	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								
	t_0								
	t_1								
Period 1	t_2								
	t_3								
	t_4								
	t_5	0	0	0	0	0	0	0	0
Period 2	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
	t_9	0	0	0	0	(18,120)	(17,850)	17,089	16,835
Period 3	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
	t_{13}	0	0	0	0	(19,718)	(18,243)	17,089	15,810
Period 4	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.[29]

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 of PBE IPSAS 41).

IE136. The following table shows the effect on State Government B's statement of comprehensive revenue and expense and its statement of financial position (for the sake of transparency some line items[30] are disaggregated on the face of the statements by the two hedging relationships, i.e., for the fair value hedge of the fixed rate FX liability and the cash flow hedge of the aggregated exposure):[31]

[29] This is the amount that is included in the table with the overview of the calculations (see paragraph IE132) as the present value of the cash flow variability of the aggregated exposure at the end of Period 2.

[30] The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (PBE IPSAS 30 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

[31] For Period 4 the values in the table with the overview of the calculations (see paragraph IE132) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (i.e., including interest accruals) equal the 'clean' values (i.e., excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, i.e., the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and accumulated comprehensive revenue and expense would be nil).

Example 17—Overview of Effect on Statements of Comprehensive Revenue and Expense and Financial Position
[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Statement of comprehensive revenue and expense					
Interest expense					
FX liability		45,958	50,452	59,848	58,827
FVH adjustment		(12,731)	11,941	14,385	(49,439)
		33,227	62,393	74,233	9,388
Reclassifications (CFH)			5,990	(5,863)	58,982
Total interest expense		33,227	68,383	68,370	68,370
Other gains/losses					
Change in fair value of the CCIRS		154,673	(418,788)	(91,437)	185,553
FVH adjustment (FX liability)		(154,702)	418,733	91,560	(185,591)
Hedge ineffectiveness		0	(72)	(54)	(19)
Total other gains/losses		(29)	(127)	68	(57)
Surplus or deficit		33,198	68,255	68,438	68,313
Other comprehensive revenue and expense					
Effective CFH gain/loss			(12,834)	71,713	229
Reclassifications			(5,990)	5,863	(58,982)
Total other comprehensive revenue and expense			(18,842)	77,577	(58,753)
Comprehensive revenue and expense		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		0	(18,824)	58,753	0
Accumulated surplus or deficit	0	33,198	101,454	169,892	238,205
Total net assets/equity	0	33,198	82,630	228,645	238,205

IE137. The total interest expense in surplus or deficit reflects State Government B's interest expense that results from its risk management strategy:

(a) In Period 1 the risk management strategy results in interest expense reflecting variable interest rates in LC after taking into account the effect of the cross-currency interest rate swap, including a difference between the cash flows on the fixed rate FX liability and the fixed leg of the cross-currency interest rate swap that were settled during Period 1 (this means the interest expense does not exactly equal the variable interest expense that would arise in LC on a borrowing of LC1,200,000). There is also some hedge ineffectiveness that results from a difference in the changes in value for the fixed rate FX liability (as represented by the fair value hedge adjustment) and the cross-currency interest rate swap.

(b) For Periods 2 to 4 the risk management strategy results in interest expense that reflects, after taking into account the effect of the interest rate swap entered into at the end of Period 1, fixed interest rates in LC (i.e., locking in a single blended fixed coupon rate for a three-period term based on the interest rate environment at the end of Period 1). However, State Government B's interest expense is affected by the hedge ineffectiveness that arises on its hedging relationships. In Period 2 the interest expense is slightly higher than the fixed rate payments locked in with the interest rate swap because the variable payments received under the interest rate swap are less

than the total of the cash flows resulting from the aggregated exposure.[32] In Periods 3 and 4 the interest expense is equal to the locked in rate because the variable payments received under the swap are more than the total of the cash flows resulting from the aggregated exposure.[33]

Example 18—Combined Interest Rate Risk and Foreign Currency Risk Hedge (Cash Flow Hedge/Fair Value Hedge Combination)

Fact Pattern

IE138. State Government C wants to hedge a variable rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of Period 4. State Government C's functional currency is its Local Currency (LC). State Government C has the following risk exposures:

(a) Cash flow interest rate risk and FX risk: the changes in cash flows of the variable rate liability attributable to interest rate changes, measured in LC.

(b) Fair value interest rate risk: the exposure that arises as a result of swapping the combined cash flow interest rate risk and FX risk exposure associated with the variable rate liability (see (a) above) into a fixed rate exposure in LC in accordance with State Government C's risk management strategy for FC denominated variable rate liabilities (see paragraph IE139(a) below).

IE139. State Government C hedges its risk exposures using the following risk management strategy:

(a) State Government C uses cross-currency interest rate swaps to swap its FC denominated variable rate liabilities into a fixed rate exposure in LC. State Government C hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, State Government C enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap State Government C receives variable interest in FC (used to pay the interest on the liability) and pays fixed interest in LC.

(b) State Government C considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated fixed rate exposure in LC. From time to time, in accordance with its risk management strategy for fixed rate interest rate risk (in LC), State Government C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC. Consequently, State Government C uses interest rate swaps (denominated entirely in LC) under which it receives fixed interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays variable interest.

[32] In other words, the cash flow variability of the interest rate swap was lower than, and therefore did not fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'underhedge' situation). In those situations the cash flow hedge does not contribute to the hedge ineffectiveness that is recognised in surplus or deficit because the hedge ineffectiveness is not recognised (see paragraph 140 of PBE IPSAS 41). The hedge ineffectiveness arising on the fair value hedge affects surplus or deficit in all periods.

[33] In other words, the cash flow variability of the interest rate swap was higher than, and therefore more than fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'overhedge' situation). In those situations the cash flow hedge contributes to the hedge ineffectiveness that is recognised in surplus or deficit (see paragraph 140 of PBE IPSAS 41). The hedge ineffectiveness arising on the fair value hedge affects surplus or deficit in all periods.

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%	
	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 C designates the following hedging relationships:[34]

(a) As a cash flow hedge, a hedging relationship for cash flow interest rate risk and FX risk between the FC denominated variable rate liability (variable rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the ‘first level relationship’). This hedging relationship is designated at the beginning of Period 1 (i.e., t_0) with a term to the end of Period 4.

(b) As a fair value hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the ‘second level relationship’). This hedging relationship is designated at the end of Period 1, when State Government C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the change in value that is the effect of changes in the value of the combined cash flows of the two items designated in the cash flow hedge of the cash flow interest rate risk and FX risk (see (a) above), compared to

[34] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 129 of PBE IPSAS 41). 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) of PBE IPSAS 41).

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[35] sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve.[36] In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made.[37]

Example 18—Calculations					
	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
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 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 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

[35] Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

[36] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and 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).

[37] Those assumptions have been made for didactical reasons, in order to better focus on illustrating the accounting mechanics in a cash flow hedge/fair value hedge combination. The measurement and recognition of hedge ineffectiveness has already been demonstrated in Example 16 and Example 17. However, in reality such hedges are typically not perfectly effective because hedge ineffectiveness can result from various factors, for example credit risk, differences in the day count method or, depending on whether it is included in the designation of the hedging instrument, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis').

swap that is determined to be an effective hedge).[38] This means that from the end of Period 1 the part of the effective cash flow hedging gain or loss that represents the fair value interest rate risk (in LC), and is recognised in other comprehensive revenue and expense in a first step, is in a second step immediately (i.e., in the same period) transferred from the cash flow hedge reserve to surplus or deficit. That reclassification adjustment offsets the gain or loss on the interest rate swap that is recognised in surplus or deficit.[39] In the context of accounting for the aggregated exposure as the hedged item, that reclassification adjustment is the equivalent of a fair value hedge adjustment because in contrast to a hedged item that is a fixed rate debt instrument (in LC) at 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 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).

(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).[40]

IE144. The change in value of the aggregated exposure is calculated as follows:

(a) At the point in time from which the change in value of the aggregated exposure is hedged (i.e., the start of the second level relationship at the end of Period 1), all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term (i.e., until the end of Period 4) are mapped out and their combined present value, in LC, is calculated. This calculation establishes the present value that is used at subsequent dates as the reference point to measure the change in present value of the aggregated exposure since the start of the hedging relationship. This calculation is illustrated in the following table:

[38] As a consequence of hedging its exposure to cash flow interest rate risk by entering into the cross-currency interest rate swap that changed the cash flow interest rate risk of the variable rate FX liability into a fixed rate exposure (in LC), State Government C in effect assumed an exposure to fair value interest rate risk (see paragraph IE139).

[39] In the table with the overview of the calculations (see paragraph IE142) this reclassification adjustment is the line item "Reclassification for interest rate risk" in the reconciliation of the cash flow hedge reserve (e.g., at the end of Period 2 a reclassification of a gain of LC82,656 from the cash flow hedge reserve to surplus or deficit—see paragraph IE144 for how that amount is calculated).

[40] 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.

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						
Period 1	t_0						
	t_1						
	t_2						
	t_3						
	t_4						
Period 2	t_5	(11,039)	(10,918)	11,039	10,918	(9,117)	(9,094)
	t_6	(11,331)	(11,082)	11,331	11,082	(9,117)	(9,067)
	t_7	(11,375)	(11,000)	11,375	11,000	(9,117)	(9,035)
	t_8	(10,689)	(10,227)	10,689	10,227	(9,117)	(9,000)
Period 3	t_9	(10,375)	(9,824)	10,375	9,824	(9,117)	(8,961)
	t_{10}	(10,164)	(9,528)	10,164	9,528	(9,117)	(8,918)
	t_{11}	(10,028)	(9,307)	10,028	9,307	(9,117)	(8,872)
	t_{12}	(10,072)	(9,255)	10,072	9,255	(9,117)	(8,825)
Period 4	t_{13}	(10,256)	(9,328)	10,256	9,328	(9,117)	(8,776)
	t_{14}	(10,159)	(9,147)	10,159	9,147	(9,117)	(8,727)
	t_{15}	(10,426)	(9,290)	10,426	9,290	(9,117)	(8,678)
	t_{16}	(1,010,670)	(891,093)	1,010,670	891,093	(1,209,117)	(1,144,358)
	Totals		(1,000,000)		1,000,000		(1,242,310)
	Totals in LC		(1,050,000)		1,050,000		(1,242,310)
PV of aggregated exposure [LC]			(1,242,310) ◄		Σ		

The present value of all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term at the end of Period 1 is LC-1,242,310.[41]

(b) At subsequent dates, the present value of the aggregated exposure is determined in the same way as at the end of Period 1 but for the remainder of the hedged term. For that purpose, all remaining cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the remainder of the hedged term (i.e., from the effectiveness measurement date until the end of Period 4) are updated (as applicable) and then discounted. The total of those present values represents the present value of the aggregated exposure. This calculation is illustrated in the following table for the end of Period 2:

[41] In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made (see paragraph IE142). Consequently, the absolute values of the variable rate FX liability and the FC denominated leg of the cross-currency interest rate are equal (but with opposite signs). In situations in which hedge ineffectiveness arises, those absolute values would not be equal so that the remaining net amount would affect the present value of the aggregated exposure.

Example 18—Present Value of the Aggregated Exposure (at the End of Period 2)							
		Present Value of the Aggregated Exposure					
		FX liability		**CCIRS FC leg**		**CCIRS LC leg**	
		CF(s) [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.[42]

IE145. Using the change in present value of the hedged item (i.e., the aggregated exposure) and the fair value of the hedging instrument (i.e., the interest rate swap), the related reclassifications from the cash flow hedge reserve to surplus or deficit (reclassification adjustments) are then determined.

IE146. The following table shows the effect on State Government C's statement of comprehensive revenue and expense and its statement of financial position (for the sake of transparency some line items[43] are disaggregated on the face of the statements by the two hedging relationships, i.e., for the cash flow hedge of the variable rate FX liability and the fair value hedge of the aggregated exposure):[44]

[42] This is the amount that is included in the table with the overview of the calculations (see paragraph IE142) as the change in present value of the aggregated exposure at the end of Period 2.

[43] The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (PBE IPSAS 30 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

[44] For Period 4 the values in the table with the overview of the calculations (see paragraph IE142) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (i.e., including interest accruals) equal the 'clean' values (i.e., excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, i.e., the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and accumulated surplus or deficit would be nil).

Example 18—Overview of Effect on Statements of Comprehensive Revenue and Expense and Financial Position
[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Statement of comprehensive revenue and expense					
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		36,466	30,092	67,087	23,788
Other comprehensive revenue and expense					
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		42,310	(14,103)	(14,103)	(14,103)
Comprehensive revenue and expense		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	0	42,310	28,207	14,103	0
Accumulated surplus or deficit	0	36,466	66,558	133,645	157,433
Total net assets/equity	0	78,776	94,765	147,748	157,433

IE147. The total interest expense in surplus or deficit reflects State Government C's interest expense that results from its risk management strategy:

(a) In Period 1 the risk management strategy results in interest expense reflecting fixed interest rates in LC after taking into account the effect of the cross-currency interest rate swap.

(b) For Periods 2 to 4, after taking into account the effect of the interest rate swap entered into at the end of Period 1, the risk management strategy results in interest expense that changes with variable interest rates in LC (i.e., the variable interest rate prevailing in each period). However, the amount of the total interest expense is not equal to the amount of the variable rate interest because of the amortisation of the amount that was in the cash flow hedge reserve for the first level relationship at the end of Period 1.[45]

Foreign Operations (Appendix B)

IE148. This example illustrates the application of paragraphs B12, B13, B14 and B15 of Appendix B in connection with the reclassification adjustment on the disposal of a foreign operation.

[45] See paragraph IE143(b). That amortisation becomes an expense that has an effect like a spread on the variable interest rate.

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–AG127)

Example 20—Receipt of a Concessionary Loan (Interest Concession)

IE153. A local authority receives loan funding to the value of CU5 million from an international development agency to build primary healthcare clinics over a period of 5 years. The agreement stipulates that the loan is to be repaid over the 5 year period as follows:

Year 1: no 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 *Revenue from Non-Exchange Transactions*.

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	–

Example 21—Payment of a Concessionary Loan (Principal Concession)[46]

IE156. The department of education makes low interest loans available to qualifying students with delayed repayment terms as a means of promoting post-secondary education.

IE157. The department advanced CU250 million to various students at the beginning of the financial year, with the following terms and conditions:

Principal to be repaid as follows:

Year 1 to 3: no principal repayments

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.

[46] For simplicity, this example excludes any considerations in relation to calculating expected credit losses.

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[47] – (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))

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))

[47] See table 4 in this example for reference to fair values.

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	–

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

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 in respect of the financial guarantee contract. In its statement of comprehensive revenue and expense 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 paragraphs AG149–AG154.

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 10 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 5 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
FCF[48]	-	100	100	100	100	100
Terminal value[49]						1,121.8
DCF Method using enterprise value less fair value of debt						
Discount factors[50]		0.9182	0.8430	0.7740	0.7107	0.6525
Present value of FCF and terminal value[51]		91.8	84.3	77.4	71.1	797.2
Enterprise value	1,121.8					
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;[52] and
- a discount for the lack of liquidity, because Government A's interest in Entity R is unquoted. For the purposes of this example, it has been assumed that the discount for the lack of liquidity amounts to CU4.09 million.[51]

IE185. As a result, Government A concludes that CU32 million is the price that is most representative of the fair value of its 5 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 10 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.

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.

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48 FCF represent cash flows before interest expense and debt movements. The tax charge has been computed considering no deduction for interest expense.

49 The terminal value has been computed assuming the yearly cash flows amounting to CU100 million would grow in perpetuity at a rate of zero (i.e., assuming that the impact of inflation on future cash flows is expected to be offset by market shrinkage).

50 The discount factors have been computed using the formula: 1/(1 + WACC) ^ year. This formula, however, implies that the cash flows are expected to be received at the end of each period. Sometimes it might be more appropriate to assume that cash flows are received more or less evenly throughout the year (mid-year discounting convention). Using the mid-year discounting convention, the discount factor for year 'n' would have been computed as follows: 1/(1 + WACC) ^ (n – 0.5).

51 The present value amounts have been computed by multiplying the FCF and terminal value by the corresponding discount factors.

52 The process shown above is not the only possible method that a public benefit 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.

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 5 per cent per annum until 20X8 with the same EBIT margin (as a percentage of sales) as in 20X3. Consequently, Public Investment Fund T projects the EBIT of Entity S as follows:[53]

	Year 1 CU'000	**Year 2 CU'000**	**Year 3 CU'000**	**Year 4 CU'000**	**Year 5 CU'000**	**Year 6 CU'000**	**Year 7 CU'000**
Sales	150	200	210	221	232	243	255
EBIT margin	23%	25%	25%	25%	25%	25%	25%
EBIT	**35**	**50**	**53**	**55**	**58**	**61**	**64**

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 2 per cent on the basis of the long-term outlook of Entity S, its industry and the economy in the country where Entity S operates. If Entity S has not reached the stable growth stage by the end of the projection period, Public Investment Fund T would need to extend the projection period until the stable growth stage is reached and calculate the terminal value at that point.[54]

IE190. Finally, Public Investment Fund T cross-checks this valuation by comparing Entity S's implied multiples to those of its comparable company peers.[55]

Example 27—Valuation of Unquoted Equity Instruments (Adjusted Net Assets)

IE191. State Government A has a 10 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 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

[53] To derive Entity S's FCF for use in the discounted cash flow method, Public Investment Fund T used Entity S's two-year budget and its understanding of the investee's asset and capital structures, reinvestment requirements and working capital needs.

[54] This example illustrates a two-stage model in which the first stage is delineated by a finite number of periods (20X2–20X8) and after this first stage the example assumes a period of constant growth for which Public Investment Fund T calculates a terminal value for Entity S. In other cases an investor might conclude that a multiple-stage model rather than a two-stage model would be more appropriate. A multiple-stage model would generally have a period after the discrete projection period in which growth might be phased down over a number of years before the constant growth period for which a terminal value can be estimated.

[55] This example assumes that the fair value conclusion would have included any necessary adjustments (for example, non-controlling interest discount, discount for the lack of liquidity etc.) that market participants would incorporate when pricing the equity instruments at the measurement date.

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 10 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 10 per cent non-controlling equity interest in Entity V is CU285 at the measurement date (CU405 – (CU40 – CU85 = CU285).[56]

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).

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 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

[56] The process shown above is not the only possible method that a public benefit 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.

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.

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 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*.[57] 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 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. Government B concludes puttable subscription rights are required to be classified at fair value through surplus or deficit.

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.

[57] 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.

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.

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 of oil in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the oil at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of oil. Is the contract accounted for as a derivative?

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of oil, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the oil and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under PBE IPSAS 41 *Financial Instruments*. Instead, it is accounted for as an executory contract (unless the entity irrevocably designates it as measured at fair value through surplus or deficit in accordance with paragraph 6 of PBE IPSAS 41).

A.2 Option to Put a Non-Financial Asset

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for CU150 million. The current value of the building is CU175 million.[58] **The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?**

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (paragraph 5 of PBE IPSAS 41; but see also paragraph 6 of PBE IPSAS 41).

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, paragraph 8). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from PBE IPSAS 41 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract instead of an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative. (But see also paragraph 6 of PBE IPSAS 41).

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.

[58] In this guidance, monetary amounts are denominated in 'currency units' (CU).

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 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. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions may apply, for example, if it is a weather derivative (see paragraph AG1 of PBE IPSAS 41), a contract to buy or sell a non-financial item such as commodity (see paragraphs 6–8 and AG8 of PBE IPSAS 41) or a contract settled in an entity's own shares (see paragraphs 25–29 of PBE IPSAS 28 *Financial Instruments: Presentation*). 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, 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 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. 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.

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. Therefore, the contract is not accounted for as a derivative under PBE IPSAS 41. 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?

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 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 requires that the instrument 'is settled at a future date'. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a Derivative: Foreign Currency Contract Based on Sales Volume

A South African entity, Entity XYZ, whose functional currency is the South African rand, sells electricity to Mozambique denominated in US dollars. XYZ enters into a contract with an investment bank to convert US dollars to rand at a fixed exchange rate. The contract requires XYZ to remit US dollars based on its sales volume in Mozambique in exchange for rand at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. PBE IPSAS 41 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, 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). If there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.12 Definition of Gross Carrying Amount: Perpetual Debt Instruments with Fixed or Market-Based Variable Rate

Sometimes entities purchase or issue debt instruments that are required to be measured at 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 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 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?

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 of PBE IPSAS 41, 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 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 Example of Calculating the Gross Carrying Amount: Debt Instruments with Stepped Interest Payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively ('stepped interest') over the term of the debt instrument. If a debt instrument with stepped interest is issued at CU1,250 and has a maturity amount of CU1,250, would the gross carrying amount equal CU1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount.

The following example illustrates how the gross carrying amount is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument ('stepped interest').

On January 1, 20X0, Entity A issues a debt instrument for a price of CU1,250. The contractual par amount is CU1,250 and the debt instrument is repayable on December 31, 20X4. The rate of interest is specified in the debt agreement as a percentage of the contractual par amount as follows: 6.0 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 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 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 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 not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.18 Regular Way Contracts: Which Customary Settlement Provisions Apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases 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 Regular Way Contracts: Share Purchase by Call Option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.20 Recognition and Derecognition of Financial Liabilities Using Trade Date or Settlement Date Accounting

PBE IPSAS 41 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 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in paragraphs 10 and 35 of PBE IPSAS 41 apply. Paragraph 10 of PBE IPSAS 41 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. Paragraph 35 of PBE IPSAS 41 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 Embedded Derivatives: Equity Kicker

In some instances, investment entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an 'equity kicker') in addition to the contractual payments. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognised in surplus or deficit (paragraph 49(c) of PBE IPSAS 41), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (paragraph 49(a) of PBE IPSAS 41). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (paragraph 49(b) and paragraph 9 of PBE IPSAS 41). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. Paragraph AG7 of PBE IPSAS 41 states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.4 Embedded Derivatives: Synthetic Instruments

Entity A issues a five-year floating rate debt instrument. At the same time, it enters into a five-year pay-fixed, receive-variable interest rate swap with Entity B. Entity A regards the combination of the debt

instrument and swap as a synthetic fixed rate instrument. Entity A contends that separate accounting for the swap is inappropriate since paragraph AG106(a) of PBE IPSAS 41 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. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.5 Embedded Derivatives: Purchases and Sales Contracts in Foreign Currency Instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under PBE IPSAS 41?

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 unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.6 Embedded Foreign Currency Derivatives: Unrelated Foreign Currency Provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of PBE IPSAS 41 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (paragraphs 5 and AG8 of PBE IPSAS 41) and the entity has not irrevocably designated it as measured at fair value through surplus or deficit in accordance with paragraph 6 of PBE IPSAS 41. The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under paragraph 49 of PBE IPSAS 41, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (paragraph AG106(d) of PBE IPSAS 41).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from paragraph AG106(d) of PBE IPSAS 41 that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under paragraph 49 of PBE IPSAS 41.

C.7 Embedded Foreign Currency Derivatives: Currency of International Commerce

Paragraph AG106(d) of PBE IPSAS 41 refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that

is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.8 Embedded Derivatives: Holder Permitted, but not Required, to Settle Without Recovering Substantially all of its 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(a) of PBE IPSAS 41 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 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 for a purchase of a financial asset. On December 29, 20X1, an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On December 31, 20X1 (financial year-end) and on 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**	**Financial assets measured at fair value through surplus or deficit**
December 29, 20X1			
Financial asset	–	–	–

Financial liability	–	–	–
December 31, 20X1			
Receivable	–	2	2
Financial asset	–	–	–
Financial liability	–	–	–
Other comprehensive revenue and expense (fair value adjustment)	–	(2)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(2)
January 4, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive revenue and expense (fair value adjustment)	–	(3)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(3)

Trade date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive revenue and expense**	**Financial assets measured at fair value through surplus or deficit**
December 29, 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
December 31, 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Other comprehensive revenue and expense (fair value adjustment)	–	(2)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(2)
January 4, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive revenue and expense (fair value adjustment)	–	(3)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(3)

D.2.2 Trade Date vs Settlement Date: Amounts to be Recorded for a Sale

How are the trade date and settlement date accounting principles in PBE IPSAS 41 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 for a sale of a financial asset. On December 29, 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its gross carrying amount is CU1,000. On December 31, 20X2 (financial year-end), the fair value of the asset is CU1,012. On January 4, 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any loss allowance or interest revenue on the financial asset is disregarded for the purpose of this example).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive revenue and expense**	**Financial assets measured at fair value through surplus or deficit**
December 29, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Other comprehensive revenue and expense (fair value adjustment)	–	10	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	10
December 31, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Other comprehensive revenue and expense (fair value adjustment)	–	10	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	10
January 4, 20X3			
Other comprehensive revenue and expense (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	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**	**Financial assets measured at fair value through surplus or deficit**
December 29, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Other comprehensive revenue and expense (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	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**	**Financial assets measured at fair value through surplus or deficit**
December 31, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Other comprehensive revenue and expense (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
January 4, 20X3			
Other comprehensive revenue and expense (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	10	10	10

D.2.3 Settlement Date Accounting: Exchange of Non-cash Financial Assets

If an entity 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 of PBE IPSAS 41?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under paragraph 105 of PBE IPSAS 41 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 of PBE IPSAS 41. 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 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 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 December 31, 20X2 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On January 4, 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

December 29, 20X2				
Dr	Bond B		CU1,010	
	Cr	Payable		CU1,010
December 31, 20X2				
Dr	Trading loss		CU1	
	Cr	Bond B		CU1
January 4, 20X3				
Dr	Payable		CU1,010	
Dr	Trading loss		CU2	
	Cr	Note Receivable A		CU1,000
	Cr	Bond B		CU2
	Cr	Realisation gain		CU10

Section E Measurement

E.1 Initial Measurement of Financial Assets and Financial Liabilities

E.1.1 Initial Measurement: Transaction Costs

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value through surplus or deficit. How should this requirement be applied in practice?

For financial assets not measured at fair value through surplus or deficit, transaction costs are added to the fair value at initial recognition. For financial liabilities, transaction costs are deducted from the fair value at initial recognition.

For financial instruments that are measured at 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 over the life of the instrument.

For financial instruments that are measured at fair value through other comprehensive revenue and expense in accordance with either paragraphs 41 and 111 or paragraphs 43 and 106 of PBE IPSAS 41, transaction costs are recognised in other comprehensive revenue and expense as part of a change in fair value at the next remeasurement. If the financial asset is measured in accordance with paragraphs 441 and 111 of PBE IPSAS 41, those transaction costs are amortised to surplus or deficit using the effective interest method and, in effect, amortised through surplus or deficit over the life of the instrument.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.2 Gains and Losses

E.2.1 PBE IPSAS 41 and PBE IPSAS 4—Financial Assets Measured at Fair Value Through Other Comprehensive Revenue and Expense: Separation of Currency Component

A financial asset measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41 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 in accordance with paragraphs 27(a) and 32 of PBE IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* and other changes in the carrying amount in other comprehensive revenue and expense in accordance with PBE IPSAS 41. How is the cumulative gain or loss that is recognised in other comprehensive revenue and expense determined?

It is the difference between the amortised cost of the financial asset[59] and the fair value of the financial asset in the functional currency of the reporting entity. For the purpose of applying paragraph 32 of PBE IPSAS 4 the asset is treated as an asset measured at amortised cost in the foreign currency.

To illustrate: on December 31, 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a contractual par amount of FC1,250, carries fixed interest of 4.7 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 in accordance with paragraph 41 of PBE IPSAS 41, and thus recognises gains and losses in other comprehensive revenue and expense. 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 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 and accumulated in net assets/equity is the difference between the fair value and the amortised cost on December 31, 20X2, i.e., LC38 (= LC2,120 – LC2,082).

Interest received on the bond on December 31, 20X2 is FC59 (= LC118). Interest revenue determined in accordance with the effective interest method is FC100 (= FC1,000 × 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 of PBE IPSAS 4). 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 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		LC38

On December 31, 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 (= 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 is the difference between the fair value and the amortised cost on December 31, 20X3, i.e., negative LC40

[59] The objective of this example is to illustrate the separation of the currency component for a financial asset that is measured at fair value through other comprehensive revenue and expense in accordance with paragraph 41 of PBE IPSAS 41. Consequently, for simplicity, this example does not reflect the effect of the impairment requirements in paragraphs 73–93 of PBE IPSAS 41.

(= LC2,675 – LC2,715). Thus, the amount recognised in other comprehensive revenue and expense equals the change in the difference during 20X3 of LC78 (= LC40 + LC38).

Interest received on the bond on 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 of PBE IPSAS 4). 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 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		LC78	
	Cr	Interest revenue		LC234
	Cr	Exchange gain		LC547

E.2.2 PBE IPSAS 41 and PBE IPSAS 4—Exchange Differences Arising on Translation of Foreign Entities: Other Comprehensive Revenue and Expense or Surplus or Deficit?

Paragraphs 37 and 57 of PBE IPSAS 4 state that all exchange differences resulting from translating the financial statements of a foreign operation should be recognised in other comprehensive revenue and expense until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets measured at fair value through surplus or deficit and financial assets that are measured at fair value through other comprehensive revenue and expense in accordance with PBE IPSAS 41.

PBE IPSAS 41 requires that changes in fair value of financial assets measured at fair value through surplus or deficit should be recognised in surplus or deficit and changes in fair value of financial assets measured at fair value through other comprehensive revenue and expense should be recognised in other comprehensive revenue and expense.

If the foreign operation is a controlled entity whose financial statements are consolidated with those of its controlling entity, in the consolidated financial statements how are PBE IPSAS 41 and paragraph 44 of PBE IPSAS 4 applied?

PBE IPSAS 41 applies in the accounting for financial instruments in the financial statements of a foreign operation and PBE IPSAS 4 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). Entity A has a foreign controlled entity (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). Entity B is the owner of a debt instrument, which meets the definition of held for trading and is therefore measured at fair value through surplus or deficit in accordance with PBE IPSAS 41.

In Entity 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 Entity 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. Entity 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. 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 of Entity B 'at the exchange rates at the dates of the transactions' (paragraph 44(b) of PBE IPSAS 4). Since the fair value gain has accrued through the

year, Entity A uses the average rate as a practical approximation ([3.00 + 2.00] / 2 = 2.50, in accordance with paragraph 25 of PBE IPSAS 4). 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 to comply with paragraph 44(b) of PBE IPSAS 41. 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 until the disposal of the net investment in the foreign operation in accordance with paragraph 57 of PBE IPSAS 4.

E.2.3 PBE IPSAS 41 and PBE IPSAS 4—Interaction Between PBE IPSAS 41 and PBE IPSAS 4

PBE IPSAS 41 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in surplus or deficit. PBE IPSAS 4 includes rules about the reporting of foreign currency items and the recognition of exchange differences in surplus or deficit. In what order are PBE IPSAS 4 and PBE IPSAS 41 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. 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 (paragraph AG224 of PBE IPSAS 41). For example, if a monetary financial asset (such as a debt instrument) is measured at amortised cost in accordance with PBE IPSAS 41, 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 of PBE IPSAS 4). That applies regardless of whether a monetary item is measured at amortised cost or fair value in the foreign currency (paragraph 28 of PBE IPSAS 4). A non-monetary financial asset (such as an investment in an equity instrument) that is measured at fair value in the foreign currency is translated using the closing rate (paragraph 27(c) of PBE IPSAS 4).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under PBE IPSAS 41 (or PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* if an entity chooses as its accounting policy to continue to apply the hedge accounting requirements in PBE IPSAS 29), 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 (paragraph 137 of PBE IPSAS 41 or paragraph 99 of PBE IPSAS 29), 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(b) of PBE IPSAS 4).

Surplus or Deficit

The recognition of a change in the carrying amount of a financial asset or financial liability in surplus or deficit depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of 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).

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 in accordance with PBE IPSAS 4 (paragraph AG224 of PBE IPSAS 41, paragraphs 32 and 37 of PBE IPSAS 41), 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 of PBE IPSAS 41 or paragraph 106 of PBE IPSAS 29). 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 in accordance with PBE IPSAS 41. For example, although an entity recognises gains and losses on financial assets measured at fair value through other comprehensive revenue and expense in other comprehensive revenue and expense (paragraphs 111 and AG225 of PBE IPSAS 41), the entity nevertheless recognises the changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit (paragraph 27(a) of PBE IPSAS 4).

Any changes in the carrying amount of a *non-monetary item* are recognised in surplus or deficit or in other comprehensive revenue and expense in accordance with PBE IPSAS 41. For example, for an investment in an equity instrument that is presented in accordance with paragraph 106 of PBE IPSAS 41, the entire change in the carrying amount, including the effect of changes in foreign currency rates, is presented in other comprehensive revenue and expense (paragraph AG226 of PBE IPSAS 41). 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 of PBE IPSAS 41 or paragraph 106 of PBE IPSAS 29).

When some portion of the change in carrying amount is recognised in other comprehensive revenue and expense and some portion is recognised in surplus or deficit, for example, if the amortised cost of a foreign currency bond measured at fair value through other comprehensive revenue and expense has increased in foreign currency (resulting in a gain in surplus or deficit) but its fair value has decreased in foreign currency (resulting in a loss recognised in other comprehensive revenue and expense), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in surplus or deficit or in other comprehensive revenue and expense.

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.

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 F Other

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 *Cash Flow Statements* 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.

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 *Revenue from Non-Exchange Transactions.* 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.

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.

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.

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.

Comparison with IPSAS 41

PBE IPSAS 41 *Financial Instruments* is drawn from IPSAS 41 *Financial Instruments.*

The significant differences between PBE IPSAS 41 and IPSAS 41 are:

(a) PBE IPSAS 41 includes an additional transition provision for entities transitioning from PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* in respect financial guarantee contracts through non exchange transaction where fair value could not be reliably determined at initial recognition.

(b) PBE IPSAS 41 includes additional transition provisions for entities transitioning from PBE IFRS 9 *Financial Instruments* (paragraphs 157.1 to 157.10 of PBE IPSAS 41; paragraphs 49H.1 and 49H.2, and paragraph 53.7 of PBE IPSAS 30 *Financial Instruments: Disclosures;* and paragraph 51.6 of PBE IPSAS 36 *Investments in Associates and Joint Ventures*).

(c) PBE IPSAS 41, Appendix D *Amendments to Other Standards*, includes more extensive amendments to PBE IPSAS 9 *Revenue from Exchange Transactions* and a number of other PBE Standards. These amendments were required to align with the more recent requirements on interest and dividend revenue in PBE IPSAS 41.

(d) PBE Standards require the presentation of a statement of comprehensive revenue and expense. IPSASs require the presentation of a statement of financial performance.

(e) PBE IPSAS 41 includes amendments equivalent to those issued by the International Accounting Standards Board to support the provision of useful financial information by entities during the period of uncertainty arising from the phasing out of interest-rate benchmarks, such as interbank offered rates.

History of Amendments

Table of Pronouncements – PBE IPSAS 41 *Financial Instruments*

This table lists the pronouncements establishing and substantially amending PBE IPSAS 41. The table is based on amendments issued as at 31 January 2022 other than consequential amendments resulting from early adoption of PBE IFRS 17 *Insurance Contracts* and *Amendments to PBE IFRS 17.*

Pronouncements	**Date approved**	**Early operative date**	**Effective date (annual reporting periods… on or after …)**
PBE IPSAS 41 *Financial Instruments*	Mar 2019	Early application is permitted	1 Jan 2022
PBE IPSAS 40 *PBE Combinations*	July 2019	Early application is permitted	1 Jan 2021
PBE IFRS 17 *Insurance Contracts*	July 2019	Early application is permitted	1 Jan 2023[1]
PBE Interest Rate Benchmark Reform	Feb 2020	Early application is permitted	1 Jan 2020
Amendments to PBE IFRS 17	Aug 2020	Early application is permitted	1 Jan 2023[2]
PBE Interest Rate Benchmark Reform—Phase 2	Nov 2020	Early application is permitted	1 Jan 2021
Editorial Corrections to PBE Standards	Dec 2021	–	–

Table of Amended Paragraphs in PBE IPSAS 41		
Paragraph affected	**How affected**	**By … [date]**
Paragraph 2	Amended	PBE IPSAS 40 [July 2019]
Paragraph 45	Amended	PBE IPSAS 40 [July 2019]
Paragraphs 72.1–72.5 and preceding heading	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraph 106	Amended	PBE IPSAS 40 [July 2019]
Paragraphs 155.1–155.3 and preceding heading	Added	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 155.4 and preceding heading	Added	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 155.5 and preceding heading	Added	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 155.6 and preceding heading	Added	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraphs 155.7–155.8 and preceding heading	Added	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraphs 155.9–155.12 and preceding heading	Added	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 155.13	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]

[1] PBE IFRS 17 has not been compiled. *Amendments to PBE IFRS 17*, issued in August 2020, deferred the effective date of PBE IFRS 17 from 1 January 2022 to 1 January 2023.

[2] *Amendments to PBE IFRS 17* has not been compiled.

Table of Amended Paragraphs in PBE IPSAS 41		
Paragraph affected	**How affected**	**By … [date]**
Paragraphs 155.14–155.19 and preceding heading	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraphs 155.20–155.21 and preceding heading	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraphs 155.22–155.23 and preceding heading	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraphs 155.24–155.26 and preceding heading	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraph 156.1	Added	PBE IPSAS 40 [July 2019]
Paragraph 156.3	Added	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 156.4	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraph 157.7	Amended	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 157.7	Amended	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraph 157.8	Amended	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 157.8	Amended	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraphs 157.12–157.15 and preceding heading	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraph 179	Amended	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 179	Amended	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraph 184	Amended	*PBE Interest Rate Benchmark Reform* [Feb 2020]
Paragraph 184A	Added	*PBE Interest Rate Benchmark Reform—Phase 2* [Nov 2020]
Paragraph AG110	Amended	PBE IPSAS 40 [July 2019]
Paragraph AG250	Amended	PBE IPSAS 40 [July 2019]