



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item
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DATE: November 24, 2009
MEMO TO: Members, Technical Advisors and Observers of the IPSASB
FROM: Jeanine Poggiolini (SAASB) and John Stanford
SUBJECT: Proposed IPSASs 28-30 on Financial Instruments

OBJECTIVE OF THIS SESSION

To **approve** IPSAS 28, “Financial Instruments: Presentation,” IPSAS 29, “Financial Instruments: Recognition and Measurement” and IPSAS 30, “Financial Instruments: Disclosure.”

AGENDA MATERIAL

- 2.1 Draft IPSAS 28, “Financial Instruments: Presentation”
- 2.2 Draft IPSAS 29, Financial Instruments: Recognition and Measurement”
- 2.3 Draft IPSAS 30, “Financial Instruments: Disclosure”

BACKGROUND

At the September 2009 IPSASB meeting, Members directed Staff to revise certain parts of ED 37, “Financial Instruments: Presentation”, ED 38, “Financial Instruments: Recognition and Measurement” and ED 39, “Financial Instruments: Disclosures”. It was agreed that the most significant revisions would be circulated to Members out of session for their review and input.

Members were requested to provide their responses on the revisions circulated out-of-session by October 30, 2009. As at November 9, 2009 a total of 4 responses had been received from Members on ED 37 and 5 responses on ED 38. Responses provided by Members out of session are included at Annexe A and B of this memorandum. In order to confirm Members’ views on the actions taken by Staff to address the decisions taken at the September meeting, this memo outlines:

- The directions provided at the September meeting for ED 37, ED 38 and ED 39;
- Staff’s response to those directions and proposed revisions;
- Comments received from Members on those proposed revisions out-of-session; and
- Additional areas that require the Board’s consideration.

Staff has now allocated the exposure drafts numbers in the sequence IPSAS 28-IPSAS 30. These references have been updated in the proposed IPSASs and used in this memorandum.

This memorandum is separated into four parts:

- Part A – Proposed IPSAS 28 (ED 37), “Financial Instruments: Presentation”
- Part B – Proposed IPSAS 29 (ED 38), “Financial Instruments: Recognition and Measurement”
- Part C – Proposed IPSAS 30 (ED 39), “Financial Instruments: Disclosures”
- Part D – General

**PART A – PROPOSED IPSAS 28 (ED 37), “FINANCIAL INSTRUMENTS:
PRESENTATION”**

1. The Treatment of Financial Guarantee Contracts as Insurance Contracts

1.1 Summary of changes required to the treatment of financial guarantee contracts as insurance contracts

At the September meeting, it was agreed that the following changes should be made to the requirements for financial guarantee contracts:

- The election to treat financial guarantee contracts as insurance contracts should be available for financial guarantees issued through exchange transactions and those issued at no or nominal consideration;
- Where entities elected to treat financial guarantee contracts as insurance contracts, they would be allowed to use IFRS 4, “Insurance Contracts” or a national accounting standard dealing with insurance contracts, but only where such a standard requires insurance obligations to be measured at the current estimate of the contractual cash flows from those contracts (similar to the “liability-adequacy” test in IFRS 4); and
- The current wording relating to the election to treat financial guarantee contracts as financial instruments should be aligned with IFRS 4. It was, however, agreed that the revised wording should consider the needs of both first time adopters of IPSASs and those who had previously applied accounting applicable to insurance contracts. The wording should allow entities that previously applied accounting applicable to insurance contracts to continue with the elections they may have made previously, and allow first time adopters to elect, on a contract-by-contract basis, to treat a financial guarantee as a financial instrument or an insurance contract.

Respondents to the consultation on ED 37 also highlighted various editorial corrections required to the text in relation to financial guarantees. Staff had noted in the analysis of comments presented at the September 2009 meeting that these would be amended when drafting the final IPSASs for approval. In particular, respondents noted that:

- The term “non-exchange” should be used consistently throughout ED 37, ED 38 and ED 39 in relation to financial guarantees. In certain instances, references “no or nominal consideration” had been used instead of “non-exchange”. The wording has therefore been standardized in proposed IPSASs 28-30.
- The wording in paragraph 3(c) should be amended as follows: “With the exception in (a) and (c) above, an entity may apply this Standard to other contracts ~~financial instruments~~ that take the form of insurance contracts which involve the transfer of financial risk”. Staff agreed with this change as it is in line with wording used in IPSAS 15 (paragraph 6).

1.2 Marked-up text of affected paragraphs

The paragraphs in proposed IPSAS 28 relating to financial guarantees have been marked-up and new paragraphs added to reflect the changes that were agreed at the September meeting along with editorial and other amendments that were proposed by

respondents. Sections 1.2.1 to 1.2.4 outline the significant changes to proposed IPSAS 28 agreed at the September meeting as well as any issues identified by Staff that require further consideration by Members.

1.2.1 Consistent treatment of financial guarantee contracts issued through exchange and non-exchange contracts

It was agreed at the September meeting that the election to treat financial guarantee contracts as financial instruments should be available for financial guarantee contracts issued by way of exchange and non-exchange transactions.

In accordance with above decision, the Introduction and Scope section have been amended. As noted above, editorial suggestions by respondents have also been incorporated into these sections.

Members that provided comments out-of-session agreed with the proposed amendments.

The amendments to proposed IPSAS 28 are shown below.

Introduction paragraph IN8

IN8 The scope has been amended as follows:

- Only those interests in controlled entities, joint ventures and associates that are measured in an entity's separate financial statements using cost or the equity method are excluded from the scope of IPSAS 28 ~~XX (ED-37)~~. Derivatives linked to interests in controlled entities, joint ventures and associates are, however, included in the scope of IPSAS 28 ~~(ED-37)~~.
- Insurance contracts are excluded from the scope of IPSAS 28 ~~XX (ED-37)~~, except:
 - Derivatives embedded in insurance contracts, if IPSAS 28 ~~XX (ED-37)~~ requires that they be accounted for separately.
 - ~~Financial guarantee contracts issued by an entity by way of a non-exchange transaction.~~
 - Financial guarantee contracts issued by an entity, ~~by way of an exchange transaction~~ where an entity has not elected to recognize and measure those contracts in accordance with the international or national Standard dealing with insurance contracts.
 - Certain elements of insurance contracts that contain a discretionary participation feature, including any derivatives embedded in such contracts.

Entities are permitted to apply this Standard to contracts ~~financial instruments~~ that take the form of insurance contracts that involve the transfer of financial risk.

Scope paragraph 3

3 An entity that prepares and presents financial statements....

(a)

(c) **Obligations arising from insurance contracts. However, this Standard applies to:**

~~(i) Financial guarantee contracts issued by way of a non-exchange transaction;~~

~~(ii)~~(i) **Derivatives that are embedded in insurance contracts if IPSAS 29-XX (ED-38) requires the entity to account for them separately; and**

~~(iii)~~(ii) **Financial guarantee contracts by way of an exchange transaction, if the issuer applies IPSAS 29-XX (ED-38) in recognizing and measuring the contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them.**

With the exception in (a) and (c) above, an entity may apply this Standard to other contracts ~~financial instruments~~ that take the form of insurance contracts which involve the transfer of financial risk.

The equivalent scope paragraphs in proposed IPSAS 29 and proposed IPSAS 30 were also amended (see IPSAS 29.2 and IPSAS 30.3)

Key Issue 1

Members are requested to **confirm** the amendments made to the Introduction and Scope section of IPSAS 28 or **provide** alternative directions and wording.

1.2.2 Election to treat financial guarantee contracts as financial instruments or insurance contracts

At the September meeting, Staff was asked to align the current election available in paragraph 3(c) of proposed IPSAS 28 with that of IFRS 4. Staff was also asked to consider the impact of those elections on entities that had previously applied insurance accounting and those that had not.

Members that responded out of session agreed with the proposed amendments, subject to editorial improvements. These editorial improvements have been included in the revised wording, which is shown below:

New paragraph: AG8

Financial guarantee contracts are treated as financial instruments unless an entity elects to treat them as insurance contracts in accordance with this paragraph and also complies with the requirements of paragraph AG9. An entity may make this election in the following instances:

- (a) If an entity previously applied accounting applicable to insurance contracts and treated financial guarantee contracts as insurance contracts, it may continue to treat such contracts either as insurance contracts or as financial instruments in accordance with this IPSAS.
- (b) If an entity previously did not apply accounting applicable to insurance contracts, it may elect to treat financial guarantee contracts either as insurance contracts or financial instruments on the initial adoption of this IPSAS.

In both (a) and (b) above, the election is made on a contract by contract basis, and the choice is irrevocable.

At the September meeting it was agreed that the wording of the election should be aligned with IFRS 4. However, in drafting the proposed wording, Staff formed a view that the wording from IFRS 4 requiring an entity to have made an explicit assertion “that contracts are regarded as insurance contracts”, and that accounting applicable to insurance contracts has been used, may be too limiting for entities that previously applied national accounting practices, particularly if those practices are not based on IFRS 4. As a result, the requirements related to entities that previously applied insurance accounting are wider in proposed IPSAS 28 than in IFRS 4, so that they include entities that applied national accounting practices that may not have required an “explicit assertion” in the past.

Key Issue 2

Members are requested to **confirm** the proposed new paragraph AG8 or **provide** alternative directions and wording.

1.2.3 Limitation on the use of national accounting practices

At the September meeting, it was agreed that the election in IFRS 4 should be available for financial guarantees, and that, under specific circumstances, entities would be able to use either the international or national accounting standard dealing with insurance contracts. It was, however, agreed that the use of national accounting practices should only be allowed where such a practice includes a liability-adequacy test similar to that of IFRS 4.

IFRS 4 makes specific reference to an approach that requires testing the adequacy of insurance liabilities at year end. The adequacy of these liabilities is tested using the current estimates of all contractual and related cash flows. As some national practices may not require an explicit test, Staff has considered that it may be appropriate to draft more general wording outlining what the Board sees as the minimum liability that should be recognised for insurance liabilities.

In the out-of-session consultation, Staff drafted two proposals: Option 1, which was the Staff preference, prescribed the minimum measurement basis, and Option 2 which required the performance of an annual test based on certain criteria (similar to IFRS 4). Respondents in the out-of-session consultation agreed with Option 1. The revision to proposed IPSAS 28 is shown below:

New paragraph AG9

In accordance with paragraph 3(c), an entity treats financial guarantee contracts as financial instruments unless it elects to treat such contracts as insurance contracts in accordance with the international or national standard dealing with insurance contracts. An entity is permitted to treat a financial guarantee contract as an insurance contract using a national accounting standard only if that standard requires the recognition of insurance liabilities at an amount that is not less than the current estimates of all contractual cash flows, and of related cash flows e.g. those cash flows related to claim handling costs and from embedded options and guarantees.

Key Issue 3

Members are requested to **confirm** that a specific minimum measurement basis is prescribed when using a national accounting standard to account for financial guarantee contracts, or **provide** alternative directions or wording.

1.2.4 Basis for Conclusions

Staff revised and added paragraphs to the Basis for Conclusions outlining the IPSASB's deliberations on the treatment of financial guarantee contracts. Revised paragraphs were circulated out-of-session for comment. Members agreed in principle with the revised Basis for Conclusions, subject to editorial improvements. The revised Basis for Conclusions paragraphs are included at BC5-BC12 in the mark-up of proposed IPSAS 28.

Key Issue 4

Members are requested to **confirm** whether the revised Basis for Conclusions accurately reflects the IPSASB's deliberations and conclusions on the treatment of financial guarantee contracts, or **provide** alternative directions and wording.

2. Other issues

2.1 Interaction between proposed IPSASs on financial instruments and IPSAS 23

At the September Board meeting, it was directed that the interaction between IPSAS 28 (ED 37), IPSAS 29 (ED 38) and IPSAS 23 should be explained.

The amendments made to paragraphs AG21, BC17 to BC23 of proposed IPSAS 28 to explain this interaction are discussed in Part B of this memorandum.

2.2 Equity instruments

Some public respondents to ED 37 indicated that the section in the Application Guidance dealing with "equity instruments" could be improved by clarifying that it is not essential that equity instruments be issued for a transfer of resources to meet the definition of a contribution from owners.

Staff agrees that this could assist in clarifying the existing Application Guidance and have proposed an amendment to AG24.

PART B – PROPOSED IPSAS 29 (ED 38), “FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT”

1. Concessionary loans

At the September meeting, it was agreed that the principles for the initial measurement of concessionary loans in proposed IPSAS 29 should be retained. Members directed Staff to consider a scenario where a controlling entity grants a concessionary loan to controlled entity and whether this may result in a capital contribution rather than an expense. Consequently, Staff updated the Basis for Conclusion to reflect the Board’s deliberations at the September meeting, and amended the relevant Application Guidance paragraphs as directed.

Staff also made amendments to the Application Guidance paragraphs based on comment received as part of the public consultation on the exposure draft.

The amended paragraphs were issued out of session for comment. Members agreed with the proposed amendments to the Application Guidance and Basis for Conclusions, with additional editorial improvements being provided.

Key Issue 5

Members are requested to **confirm** the amendments proposed to the Application Guidance and Basis for Conclusions paragraphs dealing with concessionary loans, or **provide** alternative wording.

A summary of the amendments is included below:

1. AG84 – Amended reference to “tertiary education” to “university or college education” based on comment received out-of-session.
2. AG88 – Amended paragraph to explain that a concessionary loan may comprise a number of elements or a combination of elements, based on comment received as part of the public consultation.
3. AG89 – Amended part (b) to explain that the off-market portion of the concessionary loan may in fact be a capital contribution (i.e. an investment in an entity) or an expense, based on comment received as part of the public consultation and as directed at the September Board meeting.
4. AG90 – Added wording to clarify which “definitions” are being referred to in paragraph AG90 based on comment received as part of the public consultation.
5. Revised Basis for Conclusions – Paragraphs BC11-BC14.

2. Financial guarantee contracts

At the September Board meeting, it was agreed that the treatment for financial guarantee contracts in proposed IPSAS 29 should be retained, but that references to “Level 1”, “Level 2” and “Level 3” should be deleted. Based on these decisions, Staff updated the Application Guidance and Basis for Conclusions and made these amendments, along with other amendments received during the public consultation, available to members for comment out-of-session.

Members generally agreed with the proposed amendments but proposed editorial improvements to various paragraphs.

Key Issue 6

Members are requested to **confirm** the amendments proposed to the Application Guidance and Basis for Conclusions paragraphs dealing with financial guarantee contracts, or **provide** alternative wording.

A summary of the amendments is included below:

1. AG92 – The sentence in AG92 stating that financial guarantee contracts where the entity is the holder of a financial guarantee contract are outside the scope has been deleted. At consultation a view was expressed that, if financial guarantees are only dealt with from the issuer's perspective in ED 38, the Application Guidance should refer entities to the appropriate IPSAS that deals with the accounting from the holder's perspective. As proposed IPSAS 29 does deal with certain considerations in relation to financial guarantees held (e.g. an entity assesses collateral held when calculating an impairment loss on a financial asset), AG92 has been modified to indicate that proposed IPSAS 29 prescribes specific recognition and measurement requirements for the issuer of a financial guarantee contract.
2. AG93 – Amended title of IPSAS 19 in line with comment received as part of the public consultation.
3. AG94 – Amended reference to financial guarantee contracts issued “at no or nominal consideration” to “non-exchange transaction” based on comment received as part of the public consultation. The term “non-exchange transaction” replaced “no or nominal consideration” in other IPSASs.
4. AG95 – Amended paragraph based on editorial improvements suggested during the out-of-session consultation with members.
5. AG96 – Sentence added to paragraph explaining that an entity needs to satisfy itself that the output of a valuation model that is not based on active market inputs should be reliable and understandable.
6. AG95-97 – Deleted references to “Level One/Level Two/Level Three”
7. Revised Basis for Conclusions – paragraphs BC15-BC18.

3. Interaction between proposed IPSASs on financial instruments and IPSAS 23

At the September meeting, the IPSASB discussed concerns raised by respondents regarding the interaction between IPSAS 23 and ED 38. Many of these concerns, as well as the discussion at the September meeting, focused on the initial and subsequent measurement of assets and liabilities acquired in a non-exchange transaction.

While a principle was agreed for the initial measurement of assets, there was no equivalent debate on the measurement of liabilities. Consequently, the nature of liabilities arising from non-exchange revenue transactions needs to be explored.

In the memorandum circulated out-of-session, Staff outlined its understanding of if, and when, a financial instrument arises from a non-exchange revenue transaction.

As a limited number of comments were received on this issue, Staff has included the previously circulated explanation in this memorandum to inform discussions at the December meeting.

3.1 Circumstances in which an asset or liability recognized in accordance with IPSAS 23 will be a financial asset or a financial liability

3.1.1 Extract from out-of-session memo

A financial asset is any asset that is:

- (a) *Cash;*
- (b) *An equity instrument of another entity;*
- (c) *A contractual right:*
 - (i) *To receive cash or another financial asset from another entity; or*
 - (ii) *To exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or*
- (d)

A financial liability is any liability that is:

- (a) *A contractual obligation:*
 - (i) *To deliver cash or another financial asset to another entity; or*
 - (ii) *To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity;*
- (b)

Note: The definitions have been abridged and certain aspects emphasized for purposes of this discussion.

Analysis: Financial assets

In accordance with the above definitions, for an asset acquired through a non-exchange revenue transaction to be classified as a financial asset, it must:

Be contractual in nature; and

Result in:

The acquisition of equity instruments of another entity; or

The receipt of cash, or the right to receive cash or another financial asset.

Common examples include contractual arrangements concluded with donors for the receipt of cash or other financial assets, such as shares or stock.

Based on this analysis, it is proposed that an asset acquired in a non-exchange revenue transaction is accounted for as follows:

- 1. Initially recognized using IPSAS 23;*

2. *Initially measured using IPSAS 23 and proposed IPSAS 29, i.e. assets are initially measured at fair value, plus transaction costs if the asset is not subsequently measured at fair value through surplus or deficit.*
3. *Subsequently measured using proposed IPSAS 29;*
4. *Derecognized in accordance with proposed IPSAS 29;*
5. *Presented in accordance with proposed IPSAS 28; and*
6. *Disclosed in accordance with proposed IPSAS 29 and IPSAS 23.*

Application Guidance and the Basis for Conclusions in both proposed IPSASs 28 and 29 have been amended to reflect the main points of this analysis.

Analysis: Financial liabilities

In accordance with the above definitions for a liability acquired through a non-exchange revenue transaction to be classified as a financial liability, it must:

Be contractual in nature; and

- (b) Result in an obligation to pay cash or another financial asset.*

In accordance with IPSAS 23.17, liabilities arise when an asset is transferred to an entity subject to conditions.

In analyzing the requirements of IPSAS 23, it is important to note that IPSAS 23 only makes reference to “present obligations” and, that “present obligations” in IPSAS 23 can only arise from law, regulation or binding arrangements, which impose “conditions” on the use of an asset provided to an entity.

The measurement requirements for such “present obligations” set out in IPSAS 23 are based on those for “provisions” in IPSAS 19, “Provisions, Contingent Liabilities and Contingent Assets”. “Conditions” require that an entity consume the economic benefits or service potential of the asset as specified in the agreement or return the resources to the transferor.

The rationale for using an approach based on IPSAS 19 as a recognition and measurement basis, when an entity initially receives an asset subject to conditions, is appropriate because the primary intention is for the entity to use those resources to provide goods and/or services to third parties

For a liability arising from conditions imposed on a transferred asset to qualify as a financial liability, the transaction can only be settled in cash or another financial asset.

Staff is of the view that, based on the intention of the transaction at the outset, it is more appropriate to recognise a present obligation using the existing principles in IPSAS 23, and that a financial liability may only arise once subsequent events have occurred, i.e., the conditions of the transfer are not fulfilled and resources are returned to the transferor, either by delivering cash or another financial asset.

Financial liabilities may, however, arise from other circumstances which are related to the receipt of resources in a non-exchange revenue transaction, but do not necessarily give rise to a “present obligation” as described in IPSAS 23. For

example, paragraph 24 of IPSAS 23 states that: “In some cases, an asset may be transferred subject to the stipulation that it be returned to the transferor if a specified future event does not occur. This may occur where, for example, a national government provides funds to a provincial government entity subject to the stipulation that the entity raises a matching contribution. In these cases, a return obligation does not arise until such time as it is expected that the stipulation will be breached and a liability is not recognized until the recognition criteria have been satisfied.”

IPSAS 23 is not specific about the treatment of such liabilities. Consequently, such liabilities could be measured using IPSAS 23, IPSAS 19 or proposed IPSAS 29.

In summary

As different liabilities arise from non-exchange revenue transactions, the measurement of these liabilities may differ. Staff has concluded that there are two broad types of liabilities that can arise from IPSAS 23:

Type 1: Liabilities arise from conditions imposed on an entity, as a result of a transfer of resources to that entity, when the asset is initially recognized.

Type 2: Liabilities arising from stipulations (in the form of restrictions) imposed on an entity, or other events, that give rise to a liability after the asset is recognised.

Type 1

Staff is of the view that liabilities recognised as a result of conditions imposed on a transfer of resources should be initially recognized and initially measured using the principles in IPSAS 23.

After initial recognition, an entity assesses whether the nature of the obligation has changed. Where the nature of obligation has remained unchanged, for example, where the entity fulfils and intends to fulfil the obligation through the provision of goods and services to third parties, the obligation is in the nature of a provision. Where the nature of the obligation has changed, for example, where the entity cannot fulfil the terms of the agreement and has an obligation to return the resources to the transferor by delivering cash or another financial asset, the liability is in the nature of a financial liability.

For subsequent measurement, Staff is of the view that these liabilities should be treated as follows:

Where the nature of the obligation has not changed, the liability should be subsequently measured using the principles in IPSAS 19.

Where the nature of the obligation has changed, because it is settled in cash or another financial asset, and a financial liability should be recognized for the transfer of resources back to the transferor.

Based on this analysis, Staff is of the view that proposed IPSAS 29 should explain that liabilities that arise from conditions imposed on the receipt of an asset in a non-exchange transaction are non-financial liabilities at initial recognition, but may become financial liabilities subsequently. At this point, the non-financial

liability recognised in accordance with IPSAS 23 is derecognized and a financial liability recognised.

Type 2

As IPSAS 23 is not specific about the treatment of such liabilities, they could be recognized and measured using IPSAS 23, IPSAS 19 or proposed IPSAS 29, depending on circumstances such as whether the arrangement is contractual in nature and how the transaction will be settled.

Staff is of the view that no changes are required to IPSAS 23 for these liabilities, and that proposed IPSAS 29 can explain under what circumstances these liabilities arise.

3.1.2 Comments received out-of-session and approach adopted by Staff

Two Members provided detailed comments on the proposal outlined by Staff. Both Members acknowledged that they could see instances where a liability recognized as part of a non-exchange transaction based on conditions may not always be a non-financial liability. For example, an entity may receive cash to be paid to students as a bursary. On initial recognition, this would result in a financial liability, as cash would either need to be paid to students or the transferor in the event that the conditions are not fulfilled. Staff agrees that, in this instance, a financial liability would arise on initial recognition.

IPSAS 23 only contemplates the initial recognition of a non-financial liability. This means that, in the medium term, consideration should be given to amending IPSAS 23 by:

- Explaining when an entity recognizes a financial liability and a non-financial liability; or
- Excluding financial liabilities that arise from conditions in IPSAS 23.

Both alternatives would require amendments to IPSAS 23 that were not exposed. Staff considers that there are a number of issues relating to the interaction of IPSAS 23 and other IPSASs that merit detailed examination and that these should be considered in a separate project on improving IPSAS 23, rather than in a piecemeal manner.

In drafting the Basis for Conclusions paragraphs on the interaction between IPSAS 23 and proposed IPSAS 28 and 29, Staff has stated that the liability that arises at initial recognition from conditions imposed on a transfer of resources as part of a non-exchange revenue transaction is not “usually” a financial liability. While not ideal, this acknowledges that there may be instances when a financial liability may arise.

While not included in the current Basis for Conclusions, it may be useful to explain that, in rare circumstances, a financial liability may arise from conditions imposed on the transfer of resources as part of a non-exchange revenue transaction, where the transfer is subject to certain conditions, but that the IPSASB will consider this as part of a future project.

3.1.3 Summary of proposed amendments

Amendments to proposed IPSAS 28 – Providing guidance on when an asset and a liability arising from a non-exchange revenue transaction is a financial instrument

The amendments outlined below include those circulated out-of-session for comment and include editorial improvements suggested by Members.

Application Guidance

Definitions

Financial Assets and Financial Liabilities

AG21. In the public sector, it is possible that contractual and non-contractual arrangements are non-exchange in nature. Assets and liabilities arising from non-exchange revenue transactions are accounted for in accordance with IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”. ~~Non-contractual, non-exchange revenue transactions are initially recognized and measured in accordance with IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers).”~~ If non-exchange revenue transactions are contractual, an entity assesses if the assets or liabilities arising from such transactions are financial instruments by using paragraphs 10 and AG8-AG16 of this IPSAS and otherwise meet the definition of a financial asset the principles in this Standard are also applied. An entity uses the guidance in this IPSAS and IPSAS 23 in assessing whether a non-exchange transaction gives rise to a liability or an equity instrument (contribution from owners).

Basis for Conclusions

Contractual Non-Exchange Revenue Transactions

BC17 IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” prescribes the initial recognition, initial measurement and disclosure of assets and liabilities arising out of non-exchange revenue transactions. ~~In acknowledging that certain non-exchange revenue transactions may be contractual in nature, there is an overlap between the requirements of IPSAS XX (ED 37) and IPSAS 23.~~ The IPSASB considered the interaction of this IPSAS and IPSAS 23.

BC18 In considering whether assets and liabilities that arise from non-exchange revenue transactions are financial instruments, the IPSASB identified that the following basic requirements should be fulfilled:

- The arrangement is contractual in nature; and

- The arrangement gives rise to a contractual right or obligation to receive or deliver cash or another financial asset, or exchange financial assets under favourable or unfavourable conditions.

BC19 The IPSASB concluded that assets arising from non-exchange revenue transactions could meet these requirements. In particular, it noted that the nature of arrangements with donors may be contractual in nature, and may be settled by transferring cash or another financial asset from the donor to the recipient. In these instances, assets arising from non-exchange revenue transactions are financial assets.

BC20 The IPSASB ~~agreed~~ ~~concluded~~ that, for financial assets arising from non-exchange transactions, an entity should apply the requirements of IPSAS 23 in conjunction with IPSAS ~~28~~ ~~XX~~ (ED 37). In particular, an entity considers the principles in IPSAS ~~28~~ ~~XX~~ (ED 37) in considering whether an inflow of resources from a non-exchange revenue transaction results in a liability or a transaction that evidences a contribution from owners ~~residual interest in the net assets of the entity.~~

BC21 The IPSASB considered whether the liabilities arising from non-exchange revenue transactions are financial liabilities. Liabilities are recognised in IPSAS 23 when an entity receives an inflow of resources that are subject to specific conditions. Conditions on a transfer of resources are imposed on an entity by a transferor and require that the resources are used in a certain way, often to provide goods and services to third parties, or are returned to the transferor. This gives rise to an obligation to perform in terms of the agreement. At initial recognition, an entity recognises the resources as an asset and, where they are subject to conditions, recognizes a corresponding liability.

BC22 The IPSASB considered whether the liability recognized at initial recognition is in the nature of a financial liability or another liability, e.g. a provision. The IPSASB agreed that, at the time the asset is recognized, the liability is not usually a financial liability as the entity's obligation is to fulfil the terms and conditions of the arrangement by utilizing the resources as intended, usually by providing goods and services to third parties over a period of time. If, after initial recognition, the entity cannot fulfil the terms of the arrangement and is required to return the resources to the transferor, an entity would assess at this stage whether the liability is a financial liability considering the requirements set out in paragraph BC18 and the definitions of a financial instrument and a financial liability.

BC23 The IPSASB also noted that other liabilities may arise from non-exchange revenue transactions after initial recognition. For

example, an entity may receive resources under an arrangement that requires the resources to be returned only after the occurrence or non-occurrence of a future event. An entity assesses whether other liabilities arising from non-exchange revenue transactions are financial instruments by considering whether the requirements in paragraph BC18 have been fulfilled and the definitions of a financial instrument and a financial liability.

Amendments to proposed IPSAS 29 – Providing guidance on the scope of IPSAS 29 for assets and liabilities arising from non-exchange revenue transactions

Scope

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

(a)-(i)....

(j) The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions, to which IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” applies.

Application Guidance

Scope

Rights and Obligations Arising from Non-Exchange Revenue Transactions

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 are may be recognized simultaneously also arise. Where the asset is a financial asset, it is recognized in accordance with IPSAS 23, and initially measured in accordance with IPSAS 23 and this IPSAS. A liability that is initially recognized as a result of conditions imposed on the use of an asset is outside the scope of this IPSAS and is dealt with in IPSAS 23. After initial recognition, if circumstances indicate that recognition of a liability in accordance with IPSAS 23 is no longer appropriate, an entity considers whether a financial liability should be recognized in accordance with this IPSAS. Other liabilities that may arise from non-exchange revenue transactions are recognized and measured in accordance with this IPSAS if they meet the definition of a financial liability in IPSAS 28. ~~Both the asset and, any resulting liability, are initially recognized and measured in accordance with IPSAS 23. Where no conditions are imposed on the resources acquired, non-exchange revenue is recognized in accordance with IPSAS 23.~~

Basis for Conclusions

Scope

~~BC56~~ Assets and liabilities may arise out of contractual non-exchange revenue transactions. The initial recognition and measurement of assets and liabilities arising from non-exchange revenue transactions is addressed in IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”. IPSAS 23 ~~requires assets and liabilities to be measured initially at fair value. It does not provide guidance for the subsequent measurement or derecognition of these assets and liabilities. The IPSASB considered the interaction between this IPSAS and IPSAS 23 for assets and liabilities that arise out of non-exchange revenue transactions that meet the definition of financial assets and financial liabilities.~~

BC6 The IPSASB agreed that where an asset acquired in a non-exchange transaction is a financial asset, an entity:

- Initially recognizes the asset using IPSAS 23; and
- Initially measures the asset using IPSAS 23 and, considers the requirements in this IPSAS to determine the appropriate treatment for any transaction costs incurred to acquire the asset.

As IPSAS 23 does not prescribe subsequent measurement or derecognition requirements for assets acquired in a non-exchange transactions, this IPSAS is applied to those assets if they are financial assets.

~~BC7~~ ~~The IPSASB therefore considered the subsequent measurement and derecognition of such assets and liabilities and concluded that, where the assets and liabilities arise out of contractual arrangements and otherwise meet the definition of a financial instrument, IPSAS XX (ED 38) should be applied for subsequent measurement and derecognition.~~

BC7 For liabilities, the IPSASB agreed that liabilities arising from conditions imposed on a transfer of resources in accordance with IPSAS 23 are initially recognized and initially measured using that IPSAS, as these liabilities usually do not meet the definition of a financial liability at initial recognition (see IPSAS 28). After initial recognition, if circumstances indicate that the liability is a financial liability, an entity assesses if the liability recognized in accordance with IPSAS 23 should be derecognized and a financial liability recognized in accordance with this IPSAS.

BC8 The IPSASB agreed that other liabilities that arise from non exchange revenue transactions, for example, the return of resources based on a restriction on the use of an asset, are recognized and

measured in accordance with this IPSAS if they meet the definition of a financial liability.

Key Issue 7

Members are requested to **confirm**:

- 1 The rationale and approach adopted by Staff in 3.1.1 and 3.1.2; and
 - 2 The amendments proposed to IPSAS 28 and IPSAS 29 outlined in 3.1.3 above; or
- provide** alternative directions and/or wording.

3.2 Measurement of financial assets arising from non-exchange revenue transactions

At the September meeting, an approach was agreed for the measurement of assets that are acquired in non-exchange transactions. It was agreed that:

- Assets should be recognized at their fair value in accordance with IPSAS 23 and that this fair value represents the purchase consideration that an entity would have to pay to acquire the asset; and
- Where assets incurred any transaction costs to acquire these assets, these should be added to the fair value of the asset where other IPSASs allowed the capitalization of these costs.

It was further agreed that the interaction between IPSAS 23 and proposed IPSAS 29 should be explained by amending the Application Guidance and Basis for Conclusions in proposed IPSAS 29.

Proposed amendments were circulated to Members out-of-session. Staff suggested adding an additional illustrative example to demonstrate the interaction between IPSAS 23 and proposed IPSAS 29.

Most members agreed with the proposed amendments, subject to editorial improvements. It was, however, noted by some Members that it would be preferable to amend IPSAS 23 rather than proposed IPSAS 29. Staff has already given a view that a separate project on improving IPSAS 23 should be initiated.

Proposed amendments to IPSAS 29

The amendments outlined below include those circulated out-of-session for comment and include additional editorial improvements suggested by Members.

Application Guidance

Measurement

Non-Exchange Revenue Transactions

AG90. The initial recognition and measurement of assets and liabilities resulting from non-exchange revenue transactions is dealt with in IPSAS 23. Assets resulting from non-exchange revenue transactions can arise out of both contractual and non-contractual arrangements (see IPSAS ~~28-XX (ED-37)~~ paragraphs AG2048 and AG2149). Where these assets and liabilities arise out of contractual arrangements and otherwise

meet the definition of a financial instrument, they are: ~~subsequently measured and derecognized in accordance with this Standard.~~

- (a) Initially recognised in accordance with IPSAS 23;
- (b) Initially measured:
 - (i) at fair value using the principles in IPSAS 23; and
 - (ii) taking account of transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability in accordance with paragraph 45 of this IPSAS, where the asset is subsequently measured other than at fair value through surplus or deficit

(See Illustrative Example ~~65~~ in ~~Appendix C~~.)

Basis for Conclusions

BC9 The IPSASB acknowledged that there is an interaction between IPSAS 23 and this IPSAS for assets acquired through a non-exchange transaction that also meet the definition of a financial asset. IPSAS 23 requires that assets acquired in a non-exchange revenue transaction are measured initially at fair value. This IPSAS requires financial assets to be measured initially at fair value, plus transaction costs, if the asset is not subsequently measured at fair value through surplus or deficit. The two measurement approaches are broadly consistent, except for the treatment of transaction costs.

BC10 The IPSASB concluded that it would be inappropriate for financial assets arising from non-exchange transactions to be measured differently from those arising from exchange transactions. Consequently, the IPSASB agreed that assets acquired in a non-exchange transaction should be measured initially at fair value using the requirements in IPSAS 23, but that this IPSAS should also be considered where transaction costs are incurred to acquire the asset.

Key Issue 8

Members are requested to **confirm** the amendments proposed to IPSAS 29 outlined above, or **provide** alternative wording.

4. Other issues

4.1 Location of section on measuring non-exchange revenue transactions

During the public consultation on the exposure draft, it was suggested that the text in the Application Guidance explaining the measurement of non-exchange revenue transactions should be located before the section on the measurement of “Concessionary Loans”.

Staff agrees that it may be more appropriate to relocate the paragraphs on the measurement of non-exchange revenue transactions as the remainder of this section focuses on fair value measurement, while the discussion on non-exchange revenue

explains the application of the measurement requirements of the proposed IPSAS and IPSAS 23. Staff has therefore relocated this paragraph to the start of the section dealing with “Measurement” in the Application Guidance.

Key Issue 9

Members are requested to **confirm** the proposed amendment.

4.2 Improvements to IFRSs for 2009

When the IPSASB debated the cut-off date for amendments made by the IASB to IAS 39 and their inclusion in ED 38, it agreed that certain near-final amendments proposed in the IASB’s improvements project should be included in ED 38 for exposure. These amendments affected the scope of ED 38, as well as the requirements for hedge accounting.

The final amendments were issued by the IASB in April 2009. Staff has compared the final amendments to those included and made the relevant amendments. In particular, paragraphs 2, 89, 108, 111 and example F.6.2 were affected.

Other amendments made to IAS 39, IFRIC 9 and IFRIC 16 as part of the Improvements to IFRSs issued in April 2009 will be considered as part of the next IPSAS annual improvements project.

Key Issue 10

Members are requested to **confirm** the amendments proposed to paragraphs 2, 89, 108, 111 and example F.6.2, or **provide** alternative wording.

PART C – PROPOSED IPSAS 30, “FINANCIAL INSTRUMENTS: DISCLOSURES”

At the September Board meeting, it was agreed that no substantive changes should be made to the text of ED 39 (proposed IPSAS 30).

However, as a result of changes made to proposed IPSASs 28 and 29, consequential amendments have been made to IPSAS 30. In addition, various editorial improvements suggested as part of the public consultation have been processed by Staff.

When the IPSASB debated the cut-off date for amendments made by the IASB to IFRS 7 and their inclusion in ED 39, it agreed that certain amendments proposed in the exposure draft on “Improving Disclosures about Financial Instruments” should be included in ED 39 for exposure. These amendments affected the fair value and liquidity risk disclosures, along with the related Application Guidance.

The final amendments were issued by the IASB in April 2009. Staff has compared the final amendments to those included and made the relevant amendments. In particular, paragraphs 30-35, 45, definition of liquidity risk, AG11-AG18 and IG14-15 were affected.

Key Issue 11

Members are requested to **confirm**:

1. The amendments made to paragraphs 30-35, 45, definition of liquidity risk, AG11-AG18 and IG14-15; and
 2. The editorial amendments made to proposed IPSAS 30; or
- provide** alternative wording or direction.

PART D - GENERAL

1. Effective date of IPSASs 28-30

At the September meeting, the IPSASB indicated that it would need to consider an effective date for the adoption of IPSASs 28-30.

IFRS 9, “Financial Instruments”, which replaces IAS 39, “Financial Instruments: Recognition and Measurement” was published by the IASB in November 2009 with an effective date of January, 1 2013 (with early adoption encouraged).

In considering an effective date, Board members should consider:

- Those entities that currently apply IFRSs and intend to apply IPSASs in future;
- Those entities that apply IPSASs but have either adopted or are in the process of adopting IFRSs on financial instruments through the hierarchy outlined in IPSAS 3, “Accounting Policies, Changes in Accounting Estimates and Errors”; and
- Those entities that will adopt IPSASs in future.

The proposed effective date for IPSAS 31, “Intangible Assets” and IPSAS 32, “Entity Combinations from Exchange Transactions” is April 1, 2011. Staff considers that a later date is necessary for IPSAS 28-30 and that April 1, 2013 would be appropriate. The draft IPSASs reflect this Staff view.

Key Issue 12

Members are requested to **consider** the effective date for IPSASs 28-30 and determine that date for incorporation in IPSAS 28-30.

2. Withdrawal of IPSAS 15, “Financial Instruments: Disclosure and Presentation”

The intention is that proposed IPSAS 28 replaces IPSAS 15, “Financial Instruments: Disclosure and Presentation”. Consequently, a paragraph has been included in proposed IPSAS 28 stating the following:

Withdrawal and Replacement of IPSAS 15 (2001)

62 This Standard replaces IPSAS 15, “Financial Instruments: Disclosure and Presentation”.

Key Issue 13

Members are requested to **confirm** the approach for withdrawing IPSAS 15, or provide alternative wording or directions.

ANNEXE A - COMMENTS ON ED 37, “FINANCIAL INSTRUMENTS: PRESENTATION”

Respondent	A Bergmann
Key issue 1 – Introduction and scope	I confirm the amendments proposed
Key issue 2 – Election to treat financial guarantees as insurance contracts (AG 8)	Agreed.
Key issue 3 – Minimum requirements for insurance accounting (option 1)	I agree Option 1 is clearer and therefore preferred. However, if a majority of the board members would prefer Option 2, I could also live with it.
Key issue 4 – Basis for conclusions	Agreed, I think that captures well the Toronto discussion.
Other	None

Respondent	K Warren
Key issue 1 – Introduction and scope	I confirm the amendments and have no issues, but one editorial comment (see below).
Key issue 2 – Election to treat financial guarantees as insurance contracts (AG 8)	<p>I consider that the new para AG8 does what the Board wanted. I note that the election seems to be available to all first time adopters of the proposed IPSAS, regardless of whether they previously applied all other accrual IPSAS, some other suite of accrual standards, or the cash basis. I think this is what the Board wanted.</p> <p>I would like to suggest alternative wording for para AG 8 to try and highlight the AG 9 requirement. I don't think that the sentence about AG 9 belongs at the end of AG8. It doesn't flow, and it is a precondition, so there should be some mention of it near the beginning of para AG 8.</p> <p><i>New paragraph: AG8</i></p> <p><i>Financial guarantee contracts are treated as financial instruments unless an entity elects to treat them as insurance contracts in accordance with the requirements of this paragraph and paragraph AG9. An entity may make this election in the following instances:</i></p> <p>(a) <i>If an entity previously applied accounting applicable to insurance contracts and treated financial guarantee contracts as insurance contracts, it may continue to treat such contracts either as insurance contracts or as financial instruments in accordance with this IPSAS.</i></p> <p>(b) <i>If an entity previously did not apply accounting applicable to insurance contracts, it may elect to treat financial guarantee contracts either as insurance contracts or financial</i></p>

Respondent	K Warren
	<i>instruments on the initial adoption of this IPSAS.</i> <i>In both (a) and (b) above, the election is made on a contract by contract basis, and the choice is irrevocable.</i>
Key issue 3 – Minimum requirements for insurance accounting (option 1)	I don't have a strong view about whether it should be option 1 or option 2. If you go with option 2 (which is closer to IFRS 4 approach) then you also need to pull in the requirement from IFRS 4 paragraph 15. Paragraph 15 states that if the assessment shows the liability is inadequate that the deficiency shall be recognised in profit or loss. Presumably the other side of that entry will be to increase the liability.
Key issue 4 – Basis for conclusions	I have a couple of editorial type comments on BC8 and BC9. In BC10 can you clarify that this applies to entities that have not have previously applied insurance accounting because they previously did not recognise insurance assets and liabilities with their accrual financial statements or because they were not applying accrual accounting? I think the paragraph for the body of the standard is reasonably clear that the Board intends the election to be available to all entities adopting this IPSAS for the first time, but the middle sentence of BC10 isn't so clear and could leave people with the impression that it is only available if you have previously been applying accrual accounting.
Other	Editorial

Respondent	F van Schaik
Key issue 1 – Introduction and scope	No comment.
Key issue 2 – Election to treat financial guarantees as insurance contracts (AG 8)	No comment.
Key issue 3 – Minimum requirements for insurance accounting (option 1)	No comment.
Key issue 4 – Basis for conclusions	No comment.
Other	None.

Respondent	S Barr
Key issue 1 – Introduction and scope	I confirm the amendments made to the Introduction to ED 37 and the Scope section of ED 37.
Key issue 2 – Election to	I confirm the proposed new paragraph AG8.

Respondent	S Barr
treat financial guarantees as insurance contracts (AG 8)	
Key issue 3 – Minimum requirements for insurance accounting (option 1)	I confirm the Staff view that Option 1 should be adopted.
Key issue 4 – Basis for conclusions	I confirm the revisions to the Basis for Conclusions. If Option 1 is adopted, the reference to “liability adequacy test” in BC12 will need to be revised.
Other	None.

ANNEXE B – OUT OF SESSION COMMENTS ON ED 38, “FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT”

Respondent	A Bergmann
Key issue 1 – Concessionary loans	I think the wording reflects well the Toronto discussion (although I’m still of a different view, but I accept being defeated)
Key issue 2 – Financial guarantees	I agree, especially with the sentence added to AG95. In the basis of conclusion I would add to the added sentence “This is particularly the case for non-standard guarantees where there is limited OR NO data available on defaults and credit risk.” I’m aware of one case in which the auditors claimed that the absence of data makes it possible to use data from completely unrelated incidence. I think this is what the board wanted to clarify.
Key issue 3 – Recognition of financial assets and financial liabilities & IPSAS 23	I agree in general. I think for the usual non-exchange asset/condition case staff view is correct (e.g. a building which needs to be used for a specific, resource consuming purpose otherwise the value of the building needs to be reimbursed). However, I could imagine cases in which the initial liability is financial, e.g. the Higher Education Funding Council receiving a government grant, which it has to pay out as subsidies to universities or – the condition – return to government. In this case, arguably, the initial liability is financial; the service component of the liability (i.e. administrating the distribution) is very small compared to the financial component (i.e. paying out money). Therefore I would soften (b) a bit by saying “generally” or “normally” and state that a rare but possible initial financial liability shall be measured according to FI from the beginning.
Key issue 4 – When are assets and liabilities arising out of IPSAS financial instruments	The “softening” in KI 3 above should also be reflected in BC16 (although the word usually is already there, but perhaps the unusual case).
Key issue 5 - Interaction IPSAS 23 and ED 37 & 38	I’m quite happy with AG und BC, but I think para 2j is too strongly worded in light of above discussion in KI 3 and 4. I’d rather use the following wording for 2j: (j) The initial recognition and initial measurement of conditions arising from non-exchange revenue transactions, to which IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” applies if they are non-financial in substance.
Key issue 6 - Measurement	ED 38 KI 6: o.k.
Other	

Respondent	K Warren
<p>Key issue 1 – Concessionary loans</p>	<p>I support the changes made. Some minor rewording of the BC paragraphs is suggested below.</p> <p>BCX. Some respondents to the exposure draft disagreed with the proposed treatment of concessionary loans because they do not believe that fair value is an appropriate measurement basis for such loans, while others disagreed with the proposed treatment of the off-market portion of concessionary loans as an expense.</p> <p>BCX. Respondents who disagreed with fair value as a measurement basis cited practical difficulties in determining a fair value for concessionary loans and noted that, because of these difficulties, fair values are often determined using estimates. In their view the use of such estimates would make the information potentially unreliable. Respondents suggested that, as alternatives to fair value, nominal cost or the lender’s borrowing rate should be used as a measurement basis. The IPSASB however, takes the view that the use of fair value enables the most faithfully representative determination of the concession element of a concessionary loan. Also, because loans granted at no or low interest are not unique to the public sector, the IPSASB was not persuaded that there is a public sector specific reason to depart from the fair value principles in IAS 39. They also noted that IPSAS XX [ED 39] required specific disclosures on the measurement of financial instruments, including those instances where unobservable market inputs have been used. Consequently, the IPSASB decided to retain fair value as a measurement basis for concessionary loans.</p> <p>BCX. Respondents who disagreed with expensing the off-market portion of the concessionary loan, noted that because the offmarket portion represents a subsidy, it may be more appropriate to recognize an asset initially and recognize an expense subsequently by reducing this asset as and when the conditions of the subsidy are met or on a time proportionate basis. The IPSASB, however, considered that the initial granting of the loan results in a commitment of resources , in the form of a loan and a subsidy, on day 1. The IPSASB was of the view that initial recognition of this subsidy as an expense on recognition of the transaction provides the most useful information for accountability purposes.</p>
<p>Key issue 2 – Financial guarantees</p>	<p>I support the changes made, subject to the following editorial comments:</p> <p>AG91 Last sentence: Move the word “only” to later in the sentence. Suggest “only for the issuer...”</p> <p>AG93 The third sentence in this paragraph implies that consideration arising from an exchange transaction will always give a fair value. However, there are a number of other factors to consider as per the definition of fair value. I suggest that the third sentence in AG 93 be reworded as follows.</p> <p>“Where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an</p>

Respondent	K Warren
	<p>exchange transaction and <u>whether the consideration</u> therefore represents a fair value.”</p> <p>AG94 The word “imperilled” is not common and may be unfamiliar to many constituents. Would it be possible to reword and avoid the use of this word? The sentence is also very long. Is it possible to split into two sentences? One suggestion for rewording shown below.</p> <p>“Guarantees may be available from commercial issuers, but the public sector entity may agree to enter into a financial guarantee contract for a number of non-commercial reasons. For example the debtor may be unable to afford a commercial fee, and a financial guarantee may ensure that a project which is important in relation to one of the public entity’s social or policy objectives is undertaken .”</p> <p>BC11 First bullet: delete the second “of”.</p> <p>BC11: Only the first bullet point flows from the stub. The second two bullet points are complete sentences.</p> <p>BC12 Final sentence includes a double negative. Suggest rewording to say “..in the absence of an active market, entities should be permitted to use a valuation technique ...”</p>
<p>Key issue 3 – Recognition of financial assets and financial liabilities & IPSAS 23</p>	<p>I like the proposed approach because it allows me to get to the point of initially recognising and measuring the liability under ED 38 (which I think is appropriate). However it seems to use an artificial construct of saying there is never a day 1 liability to achieve this, when I suspect there could sometimes be a day 1 liability. Maybe we need to say somewhere that if there is sufficient uncertainty that you have a day 1 liability you do not have a non-exchange revenue transaction (at that point) and are not within the scope of IPSAS 23.</p> <p>BC16 relates to (b) above and confuses me. BC16 says that “at the time the asset is recognised, the liability is not necessarily a financial liability...”. I thought that staff were saying there could never be a financial liability at time of initial recognition.</p> <p>BC8 (under key issue 4) say that these liabilities “may not” meet the definition of a financial liability. Should BC8 say “will not”?</p>

Respondent	K Warren
Key issue 4 – When are assets and liabilities arising out of IPSAS financial instruments	<p>I haven't identified any concerns regarding AG17 and AG18.</p> <p>AG19- I think the new second sentence is much better than the previous sentence. However, the last sentence is confusing. I think you are trying to say what you've said in the memo under 4.1.1 but it is too abbreviated to be useful. I would amend it to something like:</p> <p>“Where a financial asset or financial liability arises as a result of a non exchange transaction, an entity applies both this IPSAS and IPSAS 23 to those arrangements as follows:</p> <p style="padding-left: 40px;">initial point of recognition using IPSAS 23;</p> <p style="padding-left: 40px;">initial measurement using IPSAS 23 and this IPSAS, (for example assets are initially measured at fair value, plus transaction costs if the asset is not subsequently measured at fair value through surplus or deficit</p> <p style="padding-left: 40px;">subsequent measurement using ED 38;</p> <p style="padding-left: 40px;">derecognition in accordance with ED 38.”</p> <p>BC16 – see comments above about the phrase “not necessarily”.</p> <p>BC17 – see comment above under key issue 3(d).</p>
Key issue 5 - Interaction IPSAS 23 and ED 37 & 38	<p>I am comfortable with the change to scope paragraph 2(j).</p> <p>As with AG19 I found the third sentence in AG6 confusing in referring to “IPSAS 23 and this IPSAS”. On the other hand I found BC7 much clearer and I would observe that BC7 is more in the nature of application guidance than a basis for conclusions. Therefore I would cut and paste BC7 into a replacement for that third sentence in AG6.</p> <p>AG6 Fifth sentence needs changing. As currently drafted it implies that when an IPSAS 23 liability is derecognised a financial liability is recognized. This may occur sometimes but not always. I think it should say “After initial recognition of non-exchange revenue circumstances may indicate that recognition of a liability in accordance with IPSAS 23 is no longer appropriate. In such cases an entity considers whether a financial liability should be recognized in accordance with this IPSAS”. Or it could just say that a financial liability may arise subsequent to initial recognition of non-exchange revenue.</p> <p>BC8 – see comment above under key issue 3</p>
Key issue 6 - Measurement	<p>I need to say that this approach isn't my preference, as I would prefer to see consequential amendments to IPSAS 23. However in the spirit of not re-litigating the broader issue my only suggestion below is based on the presumption that this is the approach that will be used.</p> <p>Suggested change to AG90(b)(ii)</p> <p>(a) Initially recognised in accordance with IPSAS 23;</p> <p>(b) Initially measured:</p> <p style="padding-left: 40px;">(i) at fair value using the principles in IPSAS 23; and</p>

Respondent	K Warren
	(ii) taking account of transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability in accordance with paragraph 45 of this IPSAS, where the asset or liability is subsequently measured other than at fair value through surplus or deficit.
Other	And, finally a couple of editorials page 23 Analysis, 2nd para “are initially” page 23 Analysis 3rd para “a fair”

Respondent	B Prasad
Key issue 1 – Concessionary loans	AG38: Use of word tertiary not clear: Needs reformulation AG85: The intention of a concessional loan at the outset is to....Suggested reformulation: The intention of a concessional load is to....
Key issue 2 – Financial guarantees	AG91: This IPSAS only prescribes specific recognition and measurement....The use of the word “only” in the sentence may be deleted as the scoping out of other aspects is already elaborated in the previous sentence. Heading above BC9: Financial guarantees issued at through...The word “at” may be deleted. BC9:non-exchange transactions ie. they are issued for no consideration or nominal consideration.
Key issue 3 – Recognition of financial assets and financial liabilities & IPSAS 23	No comment.
Key issue 4 – When are assets and liabilities arising out of IPSAS financial instruments	No comment.
Key issue 5 - Interaction IPSAS 23 and ED 37 & 38	No comment.
Key issue 6 - Measurement	No comment.
Other	None.

Respondent	F van Schaik
Key issue 1 – Concessionary loans	No comment.
Key issue 2 – Financial guarantees	No comment.
Key issue 3 – Recognition of financial assets and financial liabilities & IPSAS 23	No comment.
Key issue 4 – When are assets and liabilities arising out of IPSAS financial instruments	No comment.
Key issue 5 - Interaction IPSAS 23 and ED 37 & 38	No comment.
Key issue 6 - Measurement	No comment.
Other	No comment.

Respondent	S Barr
Key issue 1 – Concessionary loans	I confirm the amendments proposed to the Application Guidance and Basis for Conclusions paragraphs dealing with concessionary loans.
Key issue 2 – Financial guarantees	I confirm the amendments proposed to the Application Guidance and Basis for Conclusions paragraphs dealing with financial guarantee contracts.
Key issue 3 – Recognition of financial assets and financial liabilities & IPSAS 23	<p>Based on the discussions outlined above, Staff is of the view that:</p> <ul style="list-style-type: none"> (a) Assets acquired in a non-exchange transaction can be financial assets when certain requirements are met. Amendments to strengthen the current wording in the Application Guidance and Basis for Conclusions of ED 37 and ED 38 are proposed. (b) Liabilities arising from the initial recognition of an asset which is received by an entity subject to conditions, should be initially recognized and measured using IPSAS 23 as the nature of the liability (at initial recognition) is a non-financial liability rather than a financial liability.. (c) After initial recognition, the nature of a liability recognised in accordance with IPSAS 23 may change. Where the

	<p>liability is subsequently a financial liability rather than a provision, the liability recognized in accordance with IPSAS 23 is derecognised and a financial liability recognized in accordance with ED 38. Changes to the Application Guidance and Basis for Conclusions of both ED 37 and ED 38 are proposed.</p> <p>(d) Other liabilities that arise from non-exchange revenue transactions, e.g. as a result of stipulations, are recognised and measured in accordance with ED 38 where they meet the definition of a financial liability.</p> <p>I confirm the views in (a) to (d) above.</p>
Key issue 4 – When are assets and liabilities arising out of IPSAS financial instruments	<p>I confirm that:</p> <ul style="list-style-type: none"> - AG17 and AG18 are appropriate; - The amendments to AG19 and AG20 are appropriate; and - The amendments to the Basis for Conclusions, outlined in BC11 to BC17 are appropriate.
Key issue 5 - Interaction IPSAS 23 and ED 37 & 38	<p>I confirm that the amendments to:</p> <ul style="list-style-type: none"> - The scope paragraph, 2(j) are appropriate; - AG6 are appropriate; and - The Basis for Conclusions, outlined in BC6 to BC 9 are appropriate.
Key issue 6 - Measurement	<p>Members are requested to confirm that:</p> <ul style="list-style-type: none"> - The amendments to AG 90 subject to the comment below; - The amendments to AG 19 and AG20; - The amendments to paragraphs BC11 to BC17 of the Basis for Conclusions; and - The Illustrative Example are appropriate. <p>While I concur with the amendments to AG 90, it is not clear to me how deleting the reference to liabilities in the third sentence relates to the agreed-upon revisions outlined in 4.3 on page 21 of 27. If liabilities are addressed elsewhere or if liabilities are no longer addressed, please consider clarifying as appropriate.</p>
Other	

*International Public Sector Accounting Standard
(IPSAS) 28*

Financial Instruments: Presentation



International Federation
of Accountants

IPSAS 28—FINANCIAL INSTRUMENTS: PRESENTATION

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 32, “Financial Instruments: Presentation” and IFRIC 2, “Members’ Interests in Co-operative Entities” (IFRIC 2) published by the International Accounting Standards Board (IASB). Extracts from IAS 32 and IFRIC 2 are reproduced in this publication of the International Public Sector Accounting Standards Board of the International Federation of Accountants with the permission of the International Accounting Standards Committee Foundation (IASCF).

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IPSAS 28—FINANCIAL INSTRUMENTS: PRESENTATION

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Comparison with IAS 32

International Public Sector Accounting Standard (IPSAS) 28, “Financial Instruments: Presentation” is set out in paragraphs 1–62 and Appendices A–C. All the paragraphs have equal authority. IPSAS 28 should be read in the context of its objective, the Basis for Conclusions, and the “Preface to International Public Sector Accounting Standards.” 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.

Introduction

- IN1. International Public Sector Accounting Standard (IPSAS) ~~28XX (ED-37)~~, “Financial Instruments: Presentation,” replaces IPSAS 15, “Financial Instruments: ~~Disclosure and Presentation and Disclosure~~” (issued December 2001), and should be applied for annual reporting periods beginning on or after ~~Month-Day, Year~~ April 1, 2013. Earlier application of this Standard, simultaneously with IPSAS ~~29XX (ED-38)~~, “Financial Instruments: Recognition and Measurement” and IPSAS ~~30XX (ED-39)~~, “Financial Instruments: Disclosures”, is encouraged.

Reasons for Replacing IPSAS 15

- IN2. The International Public Sector Accounting Standards Board replaced IPSAS 15 in conformity with its strategic theme of converging public sector accounting standards with International Financial Reporting Standards (IFRSs) to the extent appropriate. In developing an IPSAS on the presentation of financial instruments, the IPSASB primarily drew upon IAS 32, “Financial Instruments: Presentation” (issued in 2003) as amended as at December 31, 2008 and IFRIC 2, “Members Shares in Co-operative Entities and Similar Instruments.” Revisions made to IAS 32 up to December 31, 2008 have been taken into account, except those relating to amendments made to IAS 1, “Presentation of Financial Statements” in September 2007.
- IN3. In developing this Standard, the IPSASB has departed from IAS 32 only where a public sector specific reason exists; such variances are noted in the Comparison with IAS 32.

Changes from Previous Requirements

- IN4. The main changes from IPSAS 15 are described below.

General

- IN5. IPSAS ~~28XX (ED-37)~~ does not prescribe disclosure requirements for financial instruments. The disclosure requirements relating to financial instruments are included in IPSAS ~~30XX (ED-39)~~.
- IN6. Application Guidance has been included as an appendix to IPSAS ~~28XX (ED-37)~~, which is an integral part of the Standard. Application Guidance explains selected issues pertaining to the principles included in the main text of IPSAS ~~28XX (ED-37)~~. Guidance on the application of the principles in this Standard to members’ shares in co-operative entities and similar instruments has been provided in an appendix to the Standard. This Guidance is drawn from IFRIC 2 and is an integral part of the Standard.
- IN7. Additional illustrative examples have also been included as an appendix to IPSAS ~~28XX (ED-37)~~. However, these illustrative examples are not authoritative and accompany, rather than form part of, IPSAS ~~28XX (ED-37)~~.

Scope

- IN8. The scope has been amended as follows:

- Only those interests in controlled entities, joint ventures and associates that are measured in an entity's separate financial statements using cost or the equity method are excluded from the scope of IPSAS ~~28 XX (ED 37)~~. Derivatives linked to interests in controlled entities, joint ventures and associates are, however, included in the scope of IPSAS ~~28XX (ED 37)~~.
 - Insurance contracts are excluded from the scope of IPSAS ~~28XX (ED 37)~~, except:
 - Derivatives embedded in insurance contracts, if IPSAS ~~29XX (ED 38)~~ requires that they be accounted for separately.
 - ~~Financial guarantee contracts issued by an entity by way of a non-exchange transaction.~~
 - Financial guarantee contracts issued by an entity ~~by way of an exchange transaction~~ where ~~an entity it~~ has not elected to recognize and measure those contracts in accordance with the international or national ~~s~~Standard dealing with insurance contracts.
 - Certain elements of insurance contracts that contain a discretionary participation feature, including any derivatives embedded in such contracts.
- Entities are permitted to apply this Standard to ~~contracts financial instruments~~ that take the form of insurance contracts that involve the transfer of financial risk.
- Share based payment transactions are excluded from the scope of IPSAS ~~29 XX (ED 38)~~ except:
 - 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; and-
 - Treasury shares purchased, sold, issued or cancelled.

Principle

IN9. In summary, when an issuer determines whether a financial instrument is a financial liability or an equity instrument, the instrument is an equity instrument if, and only if, both conditions (a) and (b) are met.

- (a) The instrument includes no contractual obligation:
 - (i) To deliver cash or another financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the issuer.
- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:

- (i) A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) A derivative that will be settled by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose, the entity's own equity instruments do not include puttable financial instruments classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a pro-rata share of the net assets of the entity only on liquidation and are classified as equity instruments, or the issuer's own equity instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.
- IN10. In addition, when an issuer has an obligation to purchase its own shares for cash or another financial asset, there is a liability for the amount that the issuer is obliged to pay.
- IN11. The definitions of a financial asset and a financial liability, and the description of an equity instrument, are amended consistently with this principle.

Classification of Contracts Settled in an Entity's Own Equity Instruments

- IN12. The classification of derivative and non-derivative contracts indexed to, or settled in, an entity's own equity instruments has been clarified consistently with the principle in paragraph IN9 above. In particular, when an entity uses its own equity instruments "as currency" in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (for example, a commodity price), the contract is not an equity instrument, but is a financial asset or a financial liability.

Puttable Instruments

- IN13. A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset (a "puttable instrument") is a financial liability of the issuer, except if the instrument has certain features. Where certain features are evident in a puttable financial instrument, it is treated as an equity instrument and not a financial asset or a financial liability.

Obligations Arising on Liquidation

- IN14. Some instruments impose an obligation on an entity to deliver a pro rata share of the net assets of that entity to another party only on liquidation. In certain instances, these instruments are classified as equity instruments rather than financial liabilities.

Contingent Settlement Provisions

- IN15. A financial instrument is a financial liability when the manner of settlement depends on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder. Contingent settlement provisions are ignored when they apply only in the event of liquidation of the issuer or are not genuine.

Settlement Options

- IN16. A derivative financial instrument is a financial asset or a financial liability when it gives one of the parties to it a choice of how it is settled unless all of the settlement alternatives would result in it being an equity instrument.

Measurement of the Components of a Compound Financial Instrument on Initial Recognition

- IN17. Previously, IPSAS 15 allowed entities to measure the liability component of a compound financial instrument on initial recognition either as a residual amount after separating the equity component, or by using a relative-fair-value method. IPSAS ~~28XX (ED-37)~~ prescribes that any asset and liability components are separated first and the residual is the amount allocated to the net assets/equity component. These requirements for separating the components of a compound financial instrument are conformed to both the definition of an equity instrument as a residual and the measurement requirements in IPSAS ~~29XX (ED-38)~~.

Treasury Shares

- IN18. Treasury shares arise when an entity re-acquires its own equity instruments. IPSAS ~~28XX (ED-37)~~ clarifies that the acquisition or subsequent resale by an entity of its own equity instruments does not result in a gain or loss for the entity. Rather it represents a transfer between those holders of equity instruments who have given up their equity interest and those who continue to hold an equity instrument.

Interest, Dividends or Similar Distributions, Losses and Gains

- IN19. Transaction costs incurred as a necessary part of completing transactions in an entity's net assets/equity are accounted for as part of that transaction and are deducted from net assets/equity.

Objective

1. The objective of this Standard is to establish principles for presenting financial instruments as liabilities or net assets/equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends or similar distributions, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.
2. The principles in this Standard complement the principles for recognizing and measuring financial assets and financial liabilities in IPSAS ~~29XX (ED 38)~~, “Financial Instruments: Recognition and Measurement,” and for disclosing information about them in IPSAS ~~30XX (ED 39)~~, “Financial Instruments: Disclosures.”

Scope (see also paragraphs AG3-AG~~97~~)

3. An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard to all types of financial instruments except:
 - (a) Those interests in controlled entities, associates or joint ventures that are accounted for in accordance with IPSAS 6, “Consolidated and Separate Financial Statements,” IPSAS 7, “Investments in Associates” or IPSAS 8, “Interests in Joint Ventures.” However, in some cases, IPSAS 6, IPSAS 7 or IPSAS 8 permits an entity to account for an interest in a controlled entity, associate or joint venture using IPSAS ~~29-XX (ED 38)~~; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in controlled entities, associates or joint ventures.
 - (b) Employers’ rights and obligations under employee benefit plans, to which IPSAS 25, “Employee Benefits” applies.
 - (c) Obligations arising from insurance contracts. However, this Standard applies to:
 - (i) ~~Financial guarantee contracts issued by way of a non-exchange transaction;~~
 - (ii) Derivatives that are embedded in insurance contracts if IPSAS ~~29XX (ED 38)~~ requires the entity to account for them separately; and
 - (iii) ~~Financial guarantee contracts by way of an exchange transaction,~~ if the issuer applies IPSAS ~~29XX (ED 38)~~ in recognizing and measuring the contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them.

With the exception in (a) and (c) above, an entity may apply this Standard to other ~~contracts~~financial instruments that take the form of insurance contracts which involve the transfer of financial risk.

- (d) **Financial instruments that are within the scope of the international or national accounting standard dealing with insurance contracts because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 13–37 and AG497–AG6058 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see IPSAS ~~29XX~~ (ED-38)).**
- (e) **Financial instruments, contracts and obligations under share-based payment transactions to which the international or national accounting standard dealing with share-based payments applies, except for:**
 - (i) **Contracts within the scope of paragraphs 4–6 of this Standard, to which this Standard applies;**
 - (ii) **Paragraphs 38 and 39 of this Standard, which shall be applied to treasury shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements.**
- 4. **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.**
- 5. **There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:**
 - (a) **When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;**
 - (b) **When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);**
 - (c) **When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and**
 - (d) **When the non-financial item that is the subject of the contract is readily convertible to cash.**

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirement, and accordingly, whether they are within the scope of this Standard.

6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.
7. **This Standard applies to all public sector entities other than Government Business Enterprises.**
8. The [“Preface to International Public Sector Accounting Standards”](#) issued by the [International Public Sector Accounting Standards Board \(IPSASB\)](#) explains that [Government Business Enterprises \(GBEs\)](#) apply [International Financial Reporting Standards, which are IFRSs](#) issued by the [International Accounting Standards Board \(IASB\)](#). [GBEs are defined in IPSAS 1, “Presentation of Financial Statements.”](#)

Definitions (see also paragraphs AG108–AG486)

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

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is any asset that is:

- (a) **Cash;**
- (b) **An equity instrument of another entity;**
- (c) **A contractual right:**
 - (i) **To receive cash or another financial asset from another entity; or**
 - (ii) **To exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or**
- (d) **A contract that will or may be settled in the entity's own equity instruments and is:**

- (i) A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
- (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

A financial liability is any liability that is:

- (a) A contractual obligation:
 - (i) To deliver cash or another financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
- (b) A contract that will or may be settled in the entity's own equity instruments and is:
 - (i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraph 15 and 16 or paragraphs 17 and 18.

A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Terms defined in other International Public Sector Accounting Standards are used

in this Standard with the same meanings as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

10. The following terms are defined in paragraph 10 of IPSAS ~~29XX (ED-38)~~ and are used in this Standard with the meaning specified in that Standard.
- Amortized cost of a financial asset or financial liability
 - Available-for-sale financial assets
 - Derecognizing
 - Derivative
 - Effective interest method
 - Financial asset or financial liability at fair value through surplus or deficit
 - Financial guarantee contract
 - Firm commitment
 - Forecast transaction
 - Hedge effectiveness
 - Hedged item
 - Hedging instrument
 - Held-to-maturity investments
 - Loans and receivables
 - Regular way purchase or sale
 - Transaction costs.
11. In this Standard, ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.
12. In this Standard, ‘entity’ includes public sector entities, individuals, partnerships, incorporated bodies, and trusts.

Presentation

Liabilities and Net Assets/Equity (see also paragraphs AG4~~97~~–AG5~~42~~)

13. **The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.**
14. When an issuer applies the definitions in paragraph 9 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an

equity instrument if, and only if, both conditions (a) and (b) below are met.

- (a) The instrument includes no contractual obligation:
 - (i) To deliver cash or another financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the issuer.
- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
 - (i) A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 15 and 16 or paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraph 15 and 16 or paragraphs 17 and 18.

Puttable Instruments

15. A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all of the following features:
- (a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
 - (i) Dividing the entity's net assets on liquidation into units of equal amount; and
 - (ii) Multiplying that amount by the number of the units held by the financial instrument holder.
 - (b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:
 - (i) Has no priority over other claims to the assets of the entity on liquidation; and
 - (ii) Does not need to be converted into another instrument before it is in the class

of instruments that is subordinate to all other classes of instruments.

- (c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.
 - (d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.
 - (e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the surplus or deficit, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity over the life of the instrument (excluding any effects of the instrument).
16. For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:
- (a) Total cash flows based substantially on the surplus or deficit, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of such instrument or contract); and
 - (b) The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 15 that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

Instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation

17. Some financial instruments include a contractual obligation for the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation. The obligation arises because liquidation either is certain to occur and outside the control of the entity (for example, a limited life entity) or is uncertain to occur but is at the option of the instrument holder. As an exception to the definition of a financial liability, an

instrument that includes such an obligation is classified as an equity instrument if it has all of the following features:

- (a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
 - (i) Dividing the net assets of the entity on liquidation into units of equal amount; and
 - (ii) Multiplying that amount by the number of the units held by the financial instrument holder.
 - (b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:
 - (i) Has no priority over other claims to the assets of the entity on liquidation, and
 - (ii) Does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.
 - (c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.
18. For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:
- (a) Total cash flows based substantially on the surplus or deficit, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of such instrument or contract); and
 - (b) The effect of substantially restricting or fixing the residual return to the instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 17 that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the instrument as an equity instrument.

Reclassification of puttable instruments and instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation

19. An entity shall classify a financial instrument as an equity instrument in accordance with paragraphs 15 and 16 or paragraphs 17 and 18 from the date when the instrument has all the features and meets the conditions set out in those paragraphs. An entity shall reclassify a financial instrument from the date when the instrument ceases to have all the

features or meet all the conditions set out in those paragraphs. For example, if an entity redeems all its issued non-puttable instruments and any puttable instruments that remain outstanding have all of the features and meet all the conditions in paragraphs 15 and 16, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

20. An entity shall account as follows for the reclassification of an instrument in accordance with paragraph 19:
- (a) It shall reclassify an equity instrument as a financial liability from the date when the instrument ceases to have all of the features or meet the conditions in paragraphs 15 and 16 or paragraphs 17 and 18. The financial liability shall be measured at the instrument's fair value at the date of reclassification. The entity shall recognize in net assets/equity any difference between the carrying value of the equity instrument and the fair value of the financial liability at the date of reclassification.
 - (b) It shall reclassify a financial liability as an equity instrument from the date when the instrument has all of the features and meets the conditions set out in paragraphs 15 and 16 or paragraphs 17 and 18. An equity instrument shall be measured at the carrying value of the financial liability at the date of reclassification.

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraph 14(a))

21. With the exception of the circumstances described in paragraphs 15 and 16 or paragraphs 17 and 18, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavorable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or similar distributions declared, or distributions of the net assets/equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party.
22. The substance of a financial instrument, rather than its legal form, governs its classification on the entity's statement of financial position. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity instruments but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:
- (a) A preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.
 - (b) A financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability,

except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. For example, open-ended mutual funds, unit trusts, partnerships and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash, which results in the unitholders' or members' interests being classified as financial liabilities, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. However, classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an entity that has no contributed net assets/equity (such as some mutual funds and unit trusts, see Illustrative Example 7) or the use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of net assets/equity and puttable instruments that do not (see Illustrative Example 8).

23. If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. For example:
- (a) A restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.
 - (b) A contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.
24. A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:
- (a) A financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.
 - (b) A financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

- (i) Cash or another financial asset; or
- (ii) Its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 25).

Settlement in the Entity's Own Equity Instruments (paragraph 14(b))

- 25. A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (for example, an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to CU100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 barrels of oil. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.
- 26. Except as stated in paragraph 27, a contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to net asset/equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from net assets/equity. Changes in the fair value of an equity instrument are not recognized in the financial statements.
- 27. If the entity's own equity instruments to be received, or delivered, by the entity upon settlement of a contract are puttable financial instruments with all of the features and meeting the conditions described in paragraphs 15 and 16, or instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the

entity only on liquidation with all of the features and meeting the conditions described in paragraphs 17 and 18, the contract is a financial asset or a financial liability. This includes a contract that will be settled by the entity receiving or delivering a fixed number of such instruments in exchange for a fixed amount of cash or another financial asset.

28. With the exception of the circumstances described in paragraphs 15 and 16 or paragraphs 17 and 18, a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognized initially under IPSAS ~~29XX (ED 38)~~, its fair value (the present value of the redemption amount) is reclassified from net assets/equity. Subsequently, the financial liability is measured in accordance with IPSAS ~~29XX (ED 38)~~. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to net assets/equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (for example, a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).
29. A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 barrels of oil.

Contingent Settlement Provisions

30. A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, surplus or deficit or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:
- (a) The part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;
 - (b) The issuer can be required to settle the obligation in cash or another financial asset

(or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or

- (c) The instrument has all of the features and meets the conditions in paragraphs 15 and 16.

Settlement Options

31. **When a derivative financial instrument gives one party a choice over how it is settled (e.g., the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.**
32. An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contracts to buy or sell a non-financial item in exchange for the entity's own equity instruments are within the scope of this Standard because they can be settled either by delivery of the non-financial item or net in cash or another financial instrument (see paragraphs 4–6). Such contracts are financial assets or financial liabilities and not equity instruments.

Compound Financial Instruments (see also paragraphs AG553–AG6058 and Illustrative Examples 9–12)

33. **The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability component and a net assets/equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 13.**
34. An entity recognizes separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and net assets/equity components separately in its statement of financial position.
35. Classification of a convertible instrument into its components is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the

likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.

36. IPSAS [29](#) ~~XX (ED 38)~~ deals with the measurement of financial assets and financial liabilities. Equity instruments evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated into its components, the net assets/equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument is included in the liability component unless it forms part of the component of net assets/equity (such as an equity conversion option). The sum of the carrying amounts assigned to the liability and the net assets/equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognizing the components of the instrument separately.
37. Under the approach described in paragraph 36, the issuer of a bond convertible into ordinary shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated net assets/equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

Treasury Shares (see also paragraph AG[6159](#))

38. **If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from net assets/equity. No gain or loss shall be recognized in surplus or deficit on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the economic entity. Consideration paid or received shall be recognized directly in net assets/equity.**
39. The amount of treasury shares held is disclosed separately either in the statement of financial position or in the notes, in accordance with IPSAS 1, "Presentation of Financial Statements." An entity provides disclosure in accordance with IPSAS 20, "Related Party Disclosures" if the entity reacquires its own equity instruments from related parties.

Interest, Dividends or Similar Distributions, Losses and Gains (see also paragraph AG[620](#))

40. **Interest, dividends or similar distributions, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognized as revenue or expense in surplus or deficit. Distributions to holders of an equity instrument shall be debited by the entity directly to net assets/equity, net of any related income tax benefit. Transaction costs incurred on transactions in net assets/equity shall be**

accounted for as a deduction from net assets/equity, net of any related income tax benefit.

41. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends or similar distributions, losses and gains relating to that instrument are recognized as revenue or expense in surplus or deficit. Thus, dividends or similar distributions on shares wholly recognized as liabilities are recognized as expenses in the same way as interest on a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognized in surplus or deficit, whereas redemptions or refinancings of equity instruments are recognized as changes in net assets/equity. Changes in the fair value of an equity instrument are not recognized in the financial statements.
42. An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. Any related transaction costs are accounted for as a deduction from net assets/equity (net of any related income tax benefit) to the extent they are incremental costs directly attributable to the transaction that otherwise would have been avoided. The costs of such a transaction that is abandoned are recognized as an expense.
43. Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and the net assets/equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.
44. The amount of transaction costs accounted for as a deduction from net assets/equity in the period is disclosed separately under IPSAS 1.
45. Dividends or similar distributions classified as an expense are presented in the statement of financial performance either with interest on other liabilities or as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends or similar distributions is subject to the requirements of IPSAS 1 and IPSAS ~~30XX (ED 39)~~. In some circumstances, because of the differences between interest and dividends or similar distributions with respect to matters such as tax deductibility, it is desirable to disclose them separately in the statement financial performance.
46. Gains and losses related to changes in the carrying amount of a financial liability are recognized as revenue or expense in surplus or deficit even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 22(b)). Under IPSAS 1 the entity presents any gain or loss arising from remeasurement of such an instrument separately in the statement of financial performance when it is relevant in explaining the entity's performance.

Offsetting a Financial Asset and a Financial Liability (see also paragraphs AG631 and AG642)

47. A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:
- (a) Currently has a legally enforceable right to set off the recognized amounts; and
 - (b) Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see IPSAS ~~29-XX (ED-38)~~, paragraph 38).

48. This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity.
49. Offsetting a recognized financial asset and a recognized financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognized item from the statement of financial position but also may result in recognition of a gain or loss.
50. A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered.
51. The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. When an entity intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle

on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

52. An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal operating practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off, but does not intend to settle net or to realize the asset and settle the liability simultaneously, the effect of the right on the entity's credit risk exposure is disclosed in accordance with paragraph [4238](#) of IPSAS [30XX \(ED-39\)](#).
53. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organized financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realization of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.
54. The conditions set out in paragraph 47 are generally not satisfied and offsetting is usually inappropriate when:
- (a) Several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument');
 - (b) Financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;
 - (c) Financial or other assets are pledged as collateral for non-recourse financial liabilities;
 - (d) Financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or
 - (e) Obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.
55. An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements may be commonly used to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects

the realization or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of operations. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 47 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with paragraph ~~4238~~ of IPSAS ~~30-XX (ED-39)~~.

Transitional Provisions

56. An entity shall apply this Standard retrospectively on first time application.
57. When an entity that previously applied IPSAS 15 applies the requirements in paragraphs 15 to 18, an entity is required to split a compound financial instrument with an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation into a liability and net assets/equity component. If the liability component is no longer outstanding, a retrospective application of these requirements would involve separating two components of net assets/equity. The first component would be in accumulated surpluses and deficits and represent the cumulative interest accreted on the liability component. The other component would represent the original net assets/equity component. Therefore, an entity need not separate these two components if the liability component is no longer outstanding when the Standard is adopted.
58. An entity that either previously did not apply IPSAS 15 or adopts accrual accounting for the first time, applies the transitional provision in paragraph 57 to all compound financial instruments.

Effective Date

59. An entity shall apply this ~~International Public Sector Accounting~~ Standard for annual financial statements covering periods beginning on or after April 1, 2013. Earlier application is encouraged. If an entity ~~applies~~~~adopts~~ this Standard for a period beginning before April 1, 2013, it shall disclose that fact.
60. An entity shall not apply this ~~International Public Sector Accounting~~ Standard before April 1, 2013, unless it also applies IPSAS ~~29XX (ED-38)~~ and IPSAS ~~30XX (ED-39)~~.
61. When an entity adopts the accrual basis of accounting, as defined by ~~International Public Sector Accounting Standards~~~~IPSASs~~, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Withdrawal and Replacement of IPSAS 15 (2001)

62. This Standard replaces IPSAS 15, "Financial Instruments: ~~Disclosure and~~ Presentation ~~and Disclosure~~" issued in 2001.

Appendix A

Application Guidance

This appendix is an integral part of IPSAS ~~28XX (ED-37)~~.

- AG1. This Application Guidance explains the application of particular aspects of the Standard.
- AG2. The Standard does not deal with the recognition or measurement of financial instruments. Requirements about the recognition and measurement of financial assets and financial liabilities are set out in IPSAS ~~29 XX (ED-38)~~.

Scope (paragraphs 3–6)

Financial Guarantee Contracts

- AG3. Financial guarantee contracts are those contracts that require 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 terms of a debt instrument. Governments may issue financial guarantees for a variety of reasons. They are often issued to further a government's policy objectives, for example, to support infrastructure projects and stabilize the financial market in times of distress. Governments and public sector entities may be granted the power to issue financial guarantees by legislation or other authority. In assessing whether a guarantee is contractual or non-contractual, an entity distinguishes the right to issue the guarantee and the actual issue of the guarantee. The right to issue the guarantee in terms of legislation or other authority is non-contractual, while the actual issue of the guarantee should be assessed using the principles in paragraph AG~~2018~~ to determine whether the guarantee is contractual ~~or non-contractual~~.
- AG4. The issuing of financial guarantees in favor of a third party, whether explicitly or implicitly, may result in a contractual arrangement. Financial guarantees may be issued to a specific party or they may be issued to the holder of an instrument. Consider the following two examples:
- In a service concession arrangement, a government may issue a financial guarantee directly to the financiers of the transaction stating that, in the event of default, it would assume payment for any outstanding principal and interest payments of a loan. In this instance, the financial guarantee is explicitly issued in favor of an identified counterparty.
 - Road authority A is responsible for constructing and maintaining a country's road infrastructure. It finances the construction of new roads by issuing long term bonds. National government A exercises its powers in legislation and guarantees the bond issue of road authority A. At the time the guarantee is issued, there are no specific counterparties that have been identified, rather the guarantee is implicitly issued in favor of the holders of a specific instrument.

In both these scenarios, assuming that all the other features of a contract are met, the financial guarantee is contractual in nature.

Insurance Contracts

- AG5. Some economic entities in the public sector may include entities that issue insurance contracts. Those entities are within the scope of this Standard, but the insurance contracts themselves are outside the scope of this Standard.
- AG6. For the purposes of this Standard, an insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (i.e. in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and interruption of operations. Additional guidance on insurance contracts is available in the international [or national](#) standard dealing with insurance contracts.
- AG7. Some financial instruments take the form of insurance contracts but principally involve the transfer of financial risks, such as market, credit, or liquidity risk. Examples of such instruments include financial guarantee contracts, reinsurance and guaranteed investment contracts issued by public sector insurers and other entities. An entity is required to apply this Standard to certain financial guarantee contracts, and is permitted to apply this Standard to other insurance contracts that involve the transfer of financial risk.
- [AG8.](#) [Financial guarantee contracts are treated as financial instruments unless an entity elects to treat them as insurance contracts in accordance with this paragraph and also complies with the requirements of paragraph AG9. An entity may make this election in the following instances:](#)
- [\(a\) If an entity previously applied accounting applicable to insurance contracts and treated financial guarantee contracts as insurance contracts, it may continue to treat such contracts either as insurance contracts or as financial instruments in accordance with this IPSAS.](#)
 - [\(b\) If an entity previously did not apply accounting applicable to insurance contracts, it may elect to treat financial guarantee contracts either as insurance contracts or financial instruments on the initial adoption of this IPSAS.](#)
- [In both \(a\) and \(b\) above, the election is made on a contract by contract basis, and the choice is irrevocable.](#)
- [AG9.](#) [In accordance with paragraph 3\(c\), an entity treats financial guarantee contracts as financial instruments unless it elects to treat such contracts as insurance contracts in accordance with the international or national standard dealing with insurance contracts. An entity is permitted to treat a financial guarantee contract as an insurance contract using a national accounting standard only if that standard requires the recognition of insurance liabilities at an amount that is not less than the current estimates of all contractual cash flows, and of related cash flows e.g. those cash flows related to claim handling costs and from embedded options and guarantees.](#)

Definitions (paragraphs 9–12)

Financial Assets and Financial Liabilities

AG108. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognized in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a check or similar instrument against the balance in favor of a creditor in payment of a financial liability. Unissued currency does not meet the definition of a financial instrument. An entity applies paragraph 13 of IPSAS 12, “Inventories” in accounting for any unissued currency. Currency issued as legal tender from the perspective of the issuer, is not addressed in this Standard.

AG119. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

- (a) Accounts receivable and payable;
- (b) Notes receivable and payable;
- (c) Loans receivable and payable; and
- (d) Bonds receivable and payable.

In each case, one party’s contractual right to receive (or obligation to pay) cash is matched by the other party’s corresponding obligation to pay (or right to receive).

AG129. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.

AG134. ‘Perpetual’ debt instruments (such as ‘perpetual’ bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 per cent applied to a stated par or principal amount of CU1,000. Assuming 8 per cent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.

AG142. A contractual right or contractual obligation to receive, deliver or exchange financial

instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument.

- AG153. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognized in the financial statements. Some of these contingent rights and obligations may be insurance contracts.
- AG164. Under IPSAS 13, "Leases" a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. An operating lease, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, a finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument (except as regards individual payments currently due and payable).
- AG175. Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.
- AG186. Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.
- AG197. Assets and liabilities in the public sector arise out of both contractual and non-contractual arrangements. Assets and liabilities arising out of non-contractual arrangements do not meet the definition of a financial asset or a financial liability.
- AG2048. An entity considers the substance rather than the legal form of an arrangement in determining whether it is a 'contract' for purposes of this Standard. Contracts, for the

purposes of this Standard, are generally evidenced by the following (although this may differ from jurisdiction to jurisdiction):

- Contracts involve willing parties entering into an arrangement;
- The terms of the contract create rights and obligations for the parties to the contract, and those rights and obligations need not result in equal performance by each party. For example, a donor funding arrangement creates an obligation for the donor to transfer resources to the recipient in terms of the agreement concluded, and establishes the right of the recipient to receive those resources. These types of arrangements may be contractual even though the recipient did not provide equal consideration in return i.e. the arrangement does not result in equal performance by the parties; and
- The remedy for non-performance is enforceable by law.

AG219. In the public sector, it is possible that contractual and non-contractual arrangements are non-exchange in nature. Assets and liabilities arising from non-exchange revenue transactions are accounted for in accordance with Non-contractual, non-exchange revenue transactions are initially recognized and measured in accordance with IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers).” If non-exchange revenue transactions are contractual, an entity assesses if the assets or liabilities arising from such transactions are financial instruments by using paragraphs 10 and AG10–AG18 of this Standard, and otherwise meet the definition of a financial asset, the principles in this Standard are also applied. An entity uses the guidance in this Standard and IPSAS 23 in assessing whether a non-exchange transaction gives rise to a liability or an equity instrument (contribution from owners).

AG220. An entity would particularly consider the classification requirements of this Standard in determining whether an inflow of resources as part of a contractual non-exchange revenue transaction is in substance a liability or an equity instrument.

AG234. Statutory obligations can be accounted for in a number of ways:

- Obligations to pay income taxes are accounted for in accordance with the international or national accounting standard dealing with income taxes.
- Obligations to provide social benefits are accounted for in accordance with IPSAS 3 “Accounting Policies, Changes in Accounting Estimates and Errors” and IPSAS 19, “Provisions, Contingent Liabilities and Contingent Assets.”
- Other statutory obligations are accounted for in accordance with IPSAS 19.

AG242. Constructive obligations, as defined in IPSAS 19, also do not arise from contracts and are therefore not financial liabilities.

Equity Instruments

AG253. It is not common for entities in the public sector to have contributed capital comprising equity instruments, for example, shares and other forms of unitized capital. Where entities do issue equity instruments, the ownership and use of those instruments

may be restricted by legislation. For example, legislation may stipulate that shares in a public sector entity may only be owned by another public sector entity and may therefore not be used as consideration for the settlement of transactions.

AG264. Contributed capital in the public sector may also be evidenced by transfers of resources between parties. [The issuance of equity instruments in respect of a transfer of resources is not essential for the transfer to meet the definition of contributed capital.](#) Transfers of resources that result in an interest in the net assets/equity of an entity are distinguished from other transfers of resources because they may be evidenced by the following:

- A formal designation of a transfer of resources (or a class of such transfers) by the parties to the transaction as forming part of an entity's net assets/equity, either before the contribution occurs or at the time of the contribution. For example, on establishing a new entity, the budget office of the department of finance may deem that the initial transfers of resources to an entity establish an interest in the net assets/equity of an entity rather than provide funding to meet operational requirements.
- A formal agreement, in relation to the transfer, establishing or increasing an existing financial interest in the net assets/equity of an entity that can be sold, transferred or redeemed.

Even though transfers of resources may be evidenced by a designation or formal agreement, an entity assesses the nature of transfers of resources based on their substance and not merely their legal form.

AG275. For the purposes of this Standard, the term “equity instrument” may be used to denote the following:

- A form of unitized capital such as ordinary or preference shares;
- Transfers of resources (either designated or agreed as such between the parties to the transaction) that evidence a residual interest in the net assets of another entity; and/or
- Financial liabilities in the legal form of debt that, in substance, represent an interest in an entity's net assets.

Puttable Instruments

AG286. Where an entity's contributed capital is comprised of shares or other forms of unitized capital, these instruments may take a number of forms, for example non-puttable ordinary shares, some puttable instruments (see paragraphs 15 and 16), some instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (see paragraphs 17 and 18), some types of preference shares (see paragraphs AG497 and AG5048), and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed

amount of cash or another financial asset. An entity's obligation to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity (except as stated in paragraph 27). However, if such a contract contains an obligation for the entity to pay cash or another financial asset (other than a contract classified as an equity instrument in accordance with paragraphs 15 and 16 or paragraphs 17 and 18), it also gives rise to a liability for the present value of the redemption amount (see paragraph AG5149(a)). An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obliged to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

- AG297. A purchased call option or other similar contract acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset is not a financial asset of the entity (except as stated in paragraph 27). Instead, any consideration paid for such a contract is deducted from net assets/equity.

The class of instruments that is subordinate to all other classes (paragraphs 15(b) and 17(b))

- AG3028. One of the features of paragraphs 15 and 17 is that the financial instrument is in the class of instruments that is subordinate to all other classes.

- AG3129. When determining whether an instrument is in the subordinate class, an entity evaluates the instrument's claim on liquidation as if it were to liquidate on the date when it classifies the instrument. An entity shall reassess the classification if there is a change in relevant circumstances. For example, if the entity issues or redeems another financial instrument, this may affect whether the instrument in question is in the class of instruments that is subordinate to all other classes.

- AG320. An instrument that has a preferential right on liquidation of the entity is not an instrument with an entitlement to a pro rata share of the net assets of the entity. For example, an instrument has a preferential right on liquidation if it entitles the holder to a fixed dividend on liquidation, in addition to a share of the entity's net assets, when other instruments in the subordinate class with a right to a pro rata share of the net assets of the entity do not have the same right on liquidation.

- AG334. If an entity has only one class of financial instruments, that class shall be treated as if it were subordinate to all other classes.

Total expected cash flows attributable to the instrument over the life of the instrument (paragraph 15(e))

- AG342. The total expected cash flows of the instrument over the life of the instrument must be substantially based on the surplus or deficit, change in the recognised net assets or fair value of the recognised and unrecognised net assets of the entity over the life of the instrument. Surplus or deficit and the change in the recognised net assets shall be

measured in accordance with relevant IPSASs.

Transactions entered into by an instrument holder other than as owner of the entity (paragraphs 15 and 17)

- AG353. The holder of a puttable financial instrument or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation may enter into transactions with the entity in a role other than that of an owner. For example, an instrument holder also may be an employee of the entity. Only the cash flows and the contractual terms and conditions of the instrument that relate to the instrument holder as an owner of the entity shall be considered when assessing whether the instrument should be classified as an equity instrument under paragraph 15 or paragraph 17.
- AG364. An example is a limited partnership that has limited and general partners. Some general partners may provide a guarantee to the entity and may be remunerated for providing that guarantee. In such situations, the guarantee and the associated cash flows relate to the instrument holders in their role as guarantors and not in their roles as owners of the entity. Therefore, such a guarantee and the associated cash flows would not result in the general partners being considered subordinate to the limited partners, and would be disregarded when assessing whether the contractual terms of the limited partnership instruments and the general partnership instruments are identical.
- AG375. Another example, is a surplus or deficit sharing arrangement that allocates surpluses and deficits to the instrument holders on the basis of services rendered or business generated during the current and previous years. Such arrangements are transactions with instrument holders in their role as non-owners and should not be considered when assessing the features listed in paragraph 15 or paragraph 17. However, such arrangements that allocate surpluses and deficits to instrument holders based on the nominal amount of their instruments relative to others in the class represent transactions with the instrument holders in their roles as owners and should be considered when assessing the features listed in paragraph 15 or paragraph 17.
- AG386. The cash flows and contractual terms and conditions of a transaction between the instrument holder (in the role as a non-owner) and the issuing entity must be similar to an equivalent transaction that might occur between a non-instrument holder and the issuing entity.

No other financial instrument or contract with total cash flows that substantially fixes or restricts the residual return to the instrument holder (paragraphs 16 and 18)

- AG397. A condition for classifying an equity instrument as a financial instrument—that otherwise meets the criteria in paragraph 15 or paragraph 17 is that the entity has no other financial instrument or contract that has (a) total cash flows based substantially on the surplus or deficit, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity and (b) the effect

of substantially restricting or fixing the residual return. The following instruments, when entered into on normal commercial terms with unrelated parties, are unlikely to prevent instruments that otherwise meet the criteria in paragraph 15 or paragraph 17 from being classified as equity instruments:

- (a) Instruments with total cash flows substantially based on specific assets of the entity.
- (b) Instruments with total cash flows based on a percentage of revenue.
- (c) Contracts designed to reward individual employees for services rendered to the entity.
- (d) Contracts requiring the payment of an insignificant percentage of profit for services rendered or goods provided.

Derivative Financial Instruments

AG4038 Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and, accordingly, are within the scope of this Standard.

AG4139 Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favorable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavorable. However, they generally¹ do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favorable or unfavorable.

AG420. A put or call option to exchange financial assets or financial liabilities (i.e. financial instruments other than an entity's own equity instruments) gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forgo potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability, respectively. The

¹ This is true of most, but not all derivatives, e.g. in some cross-currency interest rate swaps principal is exchanged on inception (and re-exchanged on maturity).

financial instrument underlying an option contract may be any financial asset, including shares in other entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the financial asset under potentially favorable conditions and the writer's obligation to exchange the financial asset under potentially unfavorable conditions are distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and of the writer's obligation are not affected by the likelihood that the option will be exercised.

- AG434. Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver CU1,000,000 cash in exchange for CU1,000,000 face amount of fixed rate government bonds, and the other party (the seller) promises to deliver CU1,000,000 face amount of fixed rate government bonds in exchange for CU1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above CU1,000,000, the conditions will be favorable to the purchaser and unfavorable to the seller; if the market price falls below CU1,000,000, the effect will be the opposite. The purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.
- AG442. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments, note issuance facilities and letters of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardized and traded on an exchange.

Contracts to Buy or Sell Non-Financial Items (paragraphs 4–6)

- AG453. Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial

asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (for example, an option, futures or forward contract on oil) are not financial instruments. Many commodity contracts are of this type. Some are standardized in form and traded on organized markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments (see paragraph 4).

- AG464. A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on credit.
- AG475. Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.
- AG486. The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

Presentation

Liabilities and Net Assets/Equity (paragraphs 13–32)

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraphs 21–24)

AG497. Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient surpluses or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

AG5048 . When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

- (a) A history of making distributions;
- (b) An intention to make distributions in the future;
- (c) A possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
- (d) The amount of the issuer's reserves;
- (e) An issuer's expectation of a surplus or deficit for a period; or
- (f) An ability or inability of the issuer to influence the amount of its surplus or deficit for the period.

Settlement in the Entity's Own Equity Instruments (paragraphs 25–29)

AG5149 . As noted in paragraph AG253, it is not common for entities in the public sector to issue equity instruments comprising shares or other forms of unitized capital; and where such instruments do exist, their use and ownership is usually restricted in

legislation. As a result of the capital structure of public sector entities generally being different from private sector entities, and the legislative environment in which public sector entities operate, transactions that are settled in an entity's own equity instruments are not likely to occur as frequently in the public sector as in the private sector. However, where such transactions do occur, the following examples may assist in illustrating how to classify different types of contracts on an entity's own equity instruments:

- (a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument (except as stated in paragraph 27). Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from net assets/equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognizes a financial liability for the present value of the redemption amount (with the exception of instruments that have all the features and meet the conditions in paragraph 15 and 16 or paragraphs 17 and 18). One example is an entity's obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.
- (b) An entity's obligation to purchase its own shares for cash gives rise to a financial liability for the present value of the redemption amount even if the number of shares that the entity is obliged to repurchase is not fixed or if the obligation is conditional on the counterparty exercising a right to redeem (except as stated in paragraphs 15 and 16 or paragraphs 17 and 18). One example of a conditional obligation is an issued option that requires the entity to repurchase its own shares for cash if the counterparty exercises the option.
- (c) A contract that will be settled in cash or another financial asset is a financial asset or financial liability even if the amount of cash or another financial asset that will be received or delivered is based on changes in the market price of the entity's own equity instruments (except as stated in paragraphs 15 and 16 or paragraphs 17 and 18). One example is a net cash-settled share option.

A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (e.g. a commodity price) is a financial asset or a financial liability. An example is a written option to buy oil that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than oil. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed

amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.

Contingent Settlement Provisions (paragraph 30)

AG529. Paragraph 30 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Treatment in Consolidated Financial Statements

AG534. In consolidated financial statements, an entity presents non-controlling interests—i.e. the interests of other parties in the net assets/equity and revenue of its controlled entities in accordance with IPSAS 1 and IPSAS 6. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the economic entity and the holders of the instrument in determining whether the economic entity as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a controlled entity issues a financial instrument and a controlling entity or other entity within the economic entity agrees additional terms directly with the holders of the instrument (for example, a guarantee), the economic entity may not have discretion over distributions or redemption. Although the controlled entity may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the economic entity and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the economic entity as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

AG542. Some types of instruments that impose a contractual obligation on the entity are classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. Classification in accordance with those paragraphs is an exception to the principles otherwise applied in this Standard to the classification of an instrument and cannot be applied by analogy to other instruments. This exception is not extended to the classification of non-controlling interests in the consolidated financial statements. Therefore, instruments classified as equity instruments in accordance with either paragraphs 15 and 16 or paragraphs 17 and 18 in the separate or individual financial

statements that are non-controlling interests are classified as liabilities in the consolidated financial statements of the economic entity.

Compound Financial Instruments (paragraphs 33–37)

AG553. Paragraph 33 applies only to issuers of non-derivative compound financial instruments. Paragraph 33 does not deal with compound financial instruments from the perspective of holders. IPSAS ~~29-XX (ED-38)~~ deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain the features of both debt and equity instruments.

AG564. Compound financial instruments are not common in the public sector because of the capital structure of public sector entities. The following discussion does, however, illustrate how a compound financial instrument would be analyzed into its component parts. A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivative features. Paragraph 33 requires the issuer of such a financial instrument to present the liability component and net assets/equity component separately in the statement of financial position, as follows:

- (a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. On initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.
- (b) The equity instrument is an embedded option to convert the liability into net assets/equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. This option has value on initial recognition even when it is out of the money.

AG575. On conversion of a convertible instrument at maturity, the entity derecognizes the liability component and recognizes it as net assets/equity. The original net assets/equity component remains as net assets/equity (although it may be transferred from one line item within net assets/equity to another). There is no gain or loss on conversion at maturity.

AG586. When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued, in accordance with paragraphs 33–37.

AG597. Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

- (a) The amount of gain or loss relating to the liability component is recognized in surplus or deficit; and
- (b) The amount of consideration relating to the net assets/equity component is recognized in net assets/equity.

AG6058. An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favorable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognized as a loss in surplus or deficit.

Treasury Shares (paragraphs 38 and 39)

AG6159. An entity's own equity instruments are not recognized as a financial asset regardless of the reason for which they are reacquired. Paragraph 38 requires an entity that reacquires its own equity instruments to deduct those equity instruments from net assets/equity. However, when an entity holds its own equity instruments on behalf of others, for example, a financial institution holding its own equity instruments on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's statement of financial position.

Interest, Dividends or Similar Distributions, Losses and Gains (paragraphs 40–46)

AG620. The following example illustrates the application of paragraph 40 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognized in surplus or deficit and classified as interest expense. Any dividends paid relate to the net assets/equity component and, accordingly, are recognized as a distribution of surplus or deficit. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of ordinary shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (for example, a commodity). However, if any unpaid dividends or similar distributions are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends or similar distributions are classified as interest expense.

Offsetting a Financial Asset and a Financial Liability (paragraphs 47–55)

AG634. To offset a financial asset and a financial liability, an entity must have a currently

enforceable legal right to set off the recognized amounts. An entity may have a conditional right to set off recognized amounts, such as in a master netting agreement or in some forms of non-recourse debt, but such rights are enforceable only on the occurrence of some future event, usually a default of the counterparty. Thus, such an arrangement does not meet the conditions for offset.

AG6⁴². The Standard does not provide special treatment for so-called ‘synthetic instruments’, which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesizes a fixed rate long-term debt. Each of the individual financial instruments that together constitute a ‘synthetic instrument’ represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a ‘synthetic instrument’ is an asset and another is a liability, they are not offset and presented in an entity’s statement of financial position on a net basis unless they meet the criteria for offsetting in paragraph 47.

Appendix B

Members' Shares in Co-Operative Entities and Similar Instruments

This appendix is an integral part of IPSAS ~~28XX (ED-37)~~.

Introduction

- B1. Co-operatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a co-operative as a society endeavouring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in a co-operative are often characterised as members' shares, units or the like, and are referred to below as 'members' shares'. This Appendix applies to financial instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity and does not apply to financial instruments that will or may be settled in the entity's own equity instruments.
- B2. IPSAS ~~28XX (ED-37)~~ establishes principles for the classification of financial instruments as financial liabilities or net assets/equity. In particular, those principles apply to the classification of puttable instruments that allow the holder to put those instruments to the issuer for cash or another financial instrument. The application of those principles to members' shares in co-operative entities and similar instruments is difficult. This guidance is provided to illustrate the application of the principles in IPSAS ~~28XX (ED-37)~~ to members' shares and similar instruments that have certain features, and the circumstances in which those features affect the classification as liabilities or net assets/equity.
- B3. Many financial instruments, including members' shares, have characteristics of equity instruments, including voting rights and rights to participate in dividend or similar distributions. Some financial instruments give the holder the right to request redemption for cash or another financial asset, but may include or be subject to limits on whether the financial instruments will be redeemed. The following paragraphs outline how those redemption terms should be evaluated in determining whether the financial instruments should be classified as liabilities or net assets/equity.

Application of IPSASs to Members' Shares in Co-Operative Entities and Similar Instruments

- B4. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or an equity instrument. Those terms and conditions include relevant local laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

- B5. Members' shares that would be classified as equity instruments if the members did not have a right to request redemption are equity instruments if either of the conditions described in paragraphs B6 and B7 is present or the members' shares have all the features and meet the conditions in paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS ~~28XX (ED-37)~~. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.
- B6. Members' shares are equity instruments if the entity has an unconditional right to refuse redemption of the members' shares.
- B7. Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, e.g. unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity instruments. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity instruments.
- B8. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph B6 or the members' shares have all the features and meet the conditions in paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS ~~28XX (ED-37)~~. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and net assets/equity.
- B9. At initial recognition, the entity shall measure its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the entity measures the fair value of the financial liability for redemption at no less than the maximum amount payable under the redemption provisions of its governing charter or applicable law discounted from the first date that the amount could be required to be paid (see example 3).
- B10. As required by paragraph 40 of IPSAS ~~28XX (ED-37)~~, distributions to holders of equity instruments are recognised directly in net assets/equity, net of any income tax benefits. Interest, dividends or similar distributions and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends or similar distributions, interest or otherwise.
- B11. When a change in the redemption prohibition leads to a transfer between financial liabilities and net assets/equity, the entity shall disclose separately the amount, timing and reason for the transfer.

B12. The following examples illustrate the application of the preceding paragraphs.

Illustrative Examples

The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability and that the financial instrument does not have all the features or does not meet the conditions in paragraph 15 and 16 or paragraphs 17 and 18 of IPSAS ~~28XX (ED-37)~~.

Unconditional right to refuse redemption (paragraph B6)

Example 1

Facts

B13. The entity's charter states that redemptions are made at the sole discretion of the entity. The charter does not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board has the right to do so.

Classification

B14. The entity has the unconditional right to refuse redemption and the members' shares are equity instruments. IPSAS ~~28XX (ED-37)~~ establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph AG5048 of IPSAS ~~28XX (ED-37)~~ states:

When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

- (a) A history of making distributions;
- (b) An intention to make distributions in the future;
- (c) A possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
- (d) The amount of the issuer's reserves;
- (e) An issuer's expectation of a surplus or deficit for a period; or
- (f) An ability or inability of the issuer to influence the amount of its surplus or deficit for the period.

Example 2

Facts

- B15. The entity's charter states that redemptions are made at the sole discretion of the entity. However, the charter further states that approval of a redemption request is automatic unless the entity is unable to make payments without violating local regulations regarding liquidity or reserves.

Classification

- B16. The entity does not have the unconditional right to refuse redemption and the members' shares are classified as a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in IPSAS ~~28XX (ED-37)~~, result in the classification of the financial instrument as equity instruments. Paragraph AG4⁹⁷ of IPSAS ~~28XX (ED-37)~~ states:

Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient surpluses or reserves, does not negate the obligation.* [Emphasis added]

Prohibitions against redemption (paragraphs B7 and B8)

Example 3

Facts

- B17. A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:
- (a) January 1, 20X1 100,000 shares at CU10 each (CU1,000,000);
 - (b) January 1, 20X2 100,000 shares at CU20 each (a further CU2,000,000, so that the total for shares issued is CU3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

- B18. The entity's charter states that cumulative redemptions cannot exceed 20 per cent of the highest number of its members' shares ever outstanding. At December 31, 20X2 the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On January 1, 20X3 the entity

amends its governing charter and increases the permitted level of cumulative redemptions to 25 per cent of the highest number of its members' shares ever outstanding.

Classification

Before the governing charter is amended

- B19. Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 52 of IPSAS ~~29XX (ED 38)~~, which states: 'The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand ...' Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.
- B20. On January 1, 20X1 the maximum amount payable under the redemption provisions is 20,000 shares at CU10 each and accordingly the entity classifies CU200,000 as financial liability and CU800,000 as equity instruments. However, on January 1, 20X2 because of the new issue of shares at CU20, the maximum amount payable under the redemption provisions increases to 40,000 shares at CU20 each. The issue of additional shares at CU20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 per cent of the total shares in issue (200,000), measured at CU20, or CU800,000. This requires recognition of an additional liability of CU600,000. In this example no gain or loss is recognized. Accordingly the entity now classifies CU800,000 as financial liabilities and CU2,200,000 as equity instruments. This example assumes these amounts are not changed between January 1, 20X1 and December 31, 20X2.

After the governing charter is amended

- B21. Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on January 1, 20X3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 52 of IPSAS ~~28XX (ED 38)~~. It therefore transfers on January 1, 20X3 from net assets/equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity instruments. In this example the entity does not recognize a gain or loss on the transfer.

Example 4

Facts

- B22. Local law governing the operations of co-operatives, or the terms of the entity's governing charter, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 per cent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is

CU1,000,000. At the end of the reporting period the balance of paid-in capital is CU900,000.

Classification

- B23. In this case, CU750,000 would be classified as equity instruments and CU150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 22(b) of IPSAS ~~28XX (ED 37)~~ states in part:

... a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18.

- B24. The redemption prohibition described in this example is different from the restrictions described in paragraphs 23 and AG4⁹⁷ of IPSAS ~~28XX (ED 37)~~. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, i.e. they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (e.g. given its cash resources, surpluses or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-in capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

- B25. The facts of this example are as stated in example 4. In addition, at the end of the reporting period, liquidity requirements imposed in the local jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the end of the reporting period is that the entity cannot pay more than CU50,000 to redeem the members' shares.

Classification

- B26. As in example 4, the entity classifies CU750,000 as equity instruments and CU150,000 as a financial liability. This is because the amount classified as a liability is based on the

entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 23 and AG4~~97~~ of IPSAS ~~28XX~~ (~~ED-37~~) apply in this case.

Example 6

Facts

- B27. The entity's governing charter prohibits it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been CU12,000 and no member's shares have been redeemed.

Classification

- B28. The entity classifies CU12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity instruments. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7

Facts

- B29. The entity is a co-operative bank. Local law governing the operations of co-operative banks state that at least 50 per cent of the entity's total 'outstanding liabilities' (a term defined in the regulations to include members' share accounts) has to be in the form of members' paid-in capital. The effect of the regulation is that if all of a co-operative's outstanding liabilities are in the form of members' shares, it is able to redeem them all. On December 31, 20X1 the entity has total outstanding liabilities of CU200,000, of which CU125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the entity's charter.

Classification

- B30. In this example members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 23 and AG4~~97~~ of IPSAS

28XX (ED-37). The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, i.e. they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (CU125,000) if it repaid all of its other liabilities (CU75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, i.e. the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Appendix C

Amendments to other IPSASs

IPSAS 1, “Presentation of Financial Statements”

An additional paragraph is inserted after paragraph 7 as follows:

Definitions

7A. The following terms are described in IPSAS 28, “Financial Instruments: Presentation” and are used in this Standard with the meaning specified in IPSAS 28:

- (a) Puttable financial instrument classified as an equity instrument (described in paragraphs 15 and 16 of IPSAS 28);
- (b) An instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and is classified as an equity instrument (described in paragraphs 17 and 18 of IPSAS 28).

An additional paragraph is inserted after paragraph 95 as follows:

Information to be Presented either on the Face of the Statement of Financial Position or in the Notes

95A. If an entity has reclassified

- (a) A puttable financial instrument classified as an equity instrument, or
- (b) An instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and is classified as an equity instrument
 - (i) between financial liabilities and net assets/equity, it shall disclose the amount reclassified into and out of each category (financial liabilities or net assets/equity), and the timing and reason for that reclassification.

An additional header and paragraph are inserted after paragraph 148C as follows:

Puttable financial instruments classified as net assets/equity

148D. For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere):

- (a) summary quantitative data about the amount classified as net assets/equity;
- (b) its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;
- (c) the expected cash outflow on redemption or repurchase of that class of financial instruments; and

- (d) information about how the expected cash outflow on redemption or repurchase was determined.

Two additional sub-paragraphs are inserted after sub-paragraph 150(d) as follows:

Other Disclosures

150. An entity shall disclose the following, if not disclosed elsewhere in information published with the financial statements:

...

- (e) the name of the controlling entity and the controlling entity of the economic entity; and
- (f) if it is a limited life entity, information regarding the length of its life.

A new paragraph is inserted after paragraph 154 as follows:

- 154A.** IPSAS 28, “Financial Instruments: Presentation” amended paragraph 150 and inserted paragraphs 7A, 95A and 148D. An entity shall apply the amendments for annual financial statements covering periods beginning on or after April 1, 2013. If an entity applies IPSAS 28 for a period beginning before April 1, 2013, the amendments shall also be applied for that earlier period.

IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”

Paragraph 37 is amended as follows:

Contributions from Owners

37. Contributions from owners are defined in IPSAS 1. For a transaction to qualify as a contribution from owners, it will be necessary to satisfy the characteristics identified in that definition. In determining whether a transaction satisfies the definition of a contribution from owners, the substance rather than the form of the transaction is considered. Paragraph 38 indicates the form that contributions from owners may take. If, despite the form of the transaction, the substance is clearly that of a loan or another kind of liability, or revenue, the entity recognizes it as such and makes an appropriate disclosure in the notes to the general purpose financial statements, if material. For example, if a transaction purports to be a contribution from owners, but specifies that the reporting entity will pay fixed distributions to the transferor, with a return of the transferor’s investment at a specified future time, the transaction is more characteristic of a loan. For contractual arrangements, an entity also considers the guidance in IPSAS 28, “Financial Instruments: Presentation” when distinguishing liabilities from contributions from owners.

A new paragraph is inserted after paragraph 125 as follows:

- 125A.** IPSAS 28, “Financial Instruments: Presentation” amended paragraph 37. An entity shall apply the amendment for annual financial statements covering periods beginning on or after April 1, 2013. If an entity applies IPSAS 28 for a period

beginning before April 1, 2013, the amendment shall also be applied for that earlier period.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, ~~the proposed International Public Sector Accounting Standard~~ IPSAS 28.

Introduction

- BC1. This Basis for Conclusions summarizes the International Public Sector Accounting Standards Board's (IPSASB) considerations in reaching the conclusions in IPSAS ~~28XX (ED-37)~~, "Financial Instruments: Presentation." As this IPSAS is primarily drawn from IAS 32, "Financial Instruments: Presentation" issued by the International Accounting Standards Board (IASB), the Basis for Conclusions outlines only those areas where the IPSAS ~~28XX (ED-37)~~ departs from the main requirements of IAS 32.
- BC2. This project on financial instruments is a key part of the IPSASB's convergence program, which aims to converge IPSASs with International Financial Reporting Standards (IFRSs). The IPSASB acknowledges that there are other aspects of financial instruments, in so far as they relate to the public sector, which are not addressed in IAS 32. These may be addressed by future projects of the IPSASB. In particular, the IPSASB acknowledges that future projects may be required to address:
- Certain transactions undertaken by central banks; and
 - Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature.
- BC3. In developing this IPSAS, the IPSASB agreed to retain the existing text of IAS 32, making changes to ensure consistency with the terminology and presentational requirements of other IPSASs, and deal with any public sector specific issues through additional Application Guidance.
- BC4. In September 2007 the IASB issued amendments to IAS 1, "Presentation of Financial Statements" which introduced "comprehensive income" into the presentation of financial statements. As the IPSASB has not yet considered comprehensive income, along with some of the other amendments proposed in IAS 1, those amendments have not been included in IPSAS ~~28XX (ED-37)~~.

Scope

Insurance and Financial Guarantee Contracts

- BC5. IAS 32 excludes all insurance contracts from the scope of IAS 32, except for financial guarantee contracts where the issuer elects to apply International Financial Reporting Standard 4, "Insurance Contracts" (IFRS 4) in recognizing and measuring such contracts. The scope of IPSAS ~~28XX (ED-37)~~ also excludes all insurance contracts, except that:
- ~~All financial guarantee contracts by way of non-exchange transactions are to be treated as financial instruments in terms of IPSAS XX (ED-37), IPSAS XX (ED~~

~~38), “Financial Instruments: Recognition and Measurement” and IPSAS XX (ED 39), “Financial Instruments: Disclosure” (see below paragraph BC6);~~

- Financial guarantee contracts ~~by way of exchange transactions~~ are to be treated as financial instruments unless an entity elects to treat such contracts as insurance contracts in accordance with the international or national accounting standard dealing with insurance contracts; and
- Contracts that are insurance contracts but involve the transfer of financial risk may be treated as financial instruments in accordance with IPSAS ~~28XX (ED 37)~~, IPSAS ~~29XX (ED 38)~~ and IPSAS ~~30XX (ED 39)~~.

Treating Financial Guarantees as Financial Instruments

BC6. Under IAS 32, financial guarantee contracts should be treated as financial instruments, unless an issuer elects to apply IFRS 4 to those contracts. Unlike in the private sector, many financial guarantee contracts are issued in the public sector by way of a non-exchange transaction, i.e. at no or nominal consideration. So as to enhance the comparability of financial statements and, given the significance of financial guarantee contracts issued ~~by way of non-exchange transactions at no or nominal consideration~~ in the public sector, the IPSASB ~~had proposed that such guarantees should be treated as financial instruments and entities should not be permitted to treat them as insurance contracts. believes it is appropriate to deal definitively with the accounting for these contracts by proposing a single accounting treatment. The IPSASB concluded that financial guarantee contracts issued at no or nominal consideration should be accounted for as financial instruments rather than insurance contracts.~~

BC7.- In response to this proposal, some respondents agreed that the treatment of financial guarantee contracts issued through non-exchange transactions as financial instruments, rather than as insurance contracts, is appropriate because the business models for exchange and non-exchange insurance contracts are different. Others argued that entities should be allowed to treat such guarantees as insurance contracts or financial instruments using an election similar to that in IFRS 4.

BC8. The IPSASB concluded that the same accounting treatment should be applied to financial guarantee contracts, regardless of whether they are issued through exchange or non-exchange transactions, because the underlying liability that should be recognised in an entity’s financial statements does not differ. The IPSASB agreed that entities should be permitted a choice of treating financial guarantee contracts either as insurance contracts or financial instruments subject to certain conditions.

BC9. In evaluating the circumstances under which an entity may elect to treat financial guarantee contracts as insurance contracts, the IPSASB considered the requirements of IFRS 4. The election to treat insurance contracts as financial instruments or insurance contracts under IFRS 4 is available only to those entities that previously explicitly asserted that they deem such contracts to be insurance contracts. The IPSASB, however, recognised that not all entities that have adopted IPSAS accrual accounting also apply IFRS 4. It acknowledged that it should also consider scenarios where, for example,

entities applied accrual accounting but did not recognise assets and liabilities relating to insurance contracts, as well as those entities that previously did not apply accrual accounting. Consequently, the IPSAS agreed that the existing requirements in IFRS 4 were too onerous and would need to be modified in the context of this IPSAS.

BC10. The IPSASB therefore agreed that entities that previously:

- (a) Applied insurance accounting and treated financial guarantee contracts as insurance contracts, could continue to treat those guarantees as insurance contracts or as financial instruments; and
- (b) Did not apply insurance accounting would be allowed a choice of treating financial guarantee contracts either as insurance contracts or financial instruments on initial adoption of this IPSAS.

In both instances, the election is irrevocable.

BC11. The IPSASB considered whether entities should be allowed to elect to treat financial guarantees as insurance contracts on a contract by contract basis or, whether entities should be required to make an accounting policy choice. It was agreed that the choice should be made on an individual contract basis to allow entities within an economic entity to treat financial guarantees as insurance contracts or financial instruments, based on the nature of their businesses.

BC12. The IPSASB agreed, as a precondition for allowing entities to treat financial guarantees as insurance contracts, that the accounting practices applied by entities for insurance contracts should meet certain requirements. The IPSASB agreed that if entities elected to treat financial guarantee contracts as insurance contracts, that they must apply either IFRS 4 or a national accounting standard that requires insurance liabilities to be recognised at a minimum value. That minimum value is determined as the contractual and related cash flows from an entity's insurance contracts.

Option to Treat Insurance Contracts that Transfer Financial Risk as Financial Instruments

BC137. IPSAS 15 allowed entities to account for ~~contracts~~instruments that are insurance contracts that result in the transfer of financial risk, as financial instruments. In the absence of an IPSAS on insurance contracts, the IPSASB concluded that it should allow, but not require, entities to apply IPSAS ~~28XX (ED 37)~~ to such contracts.

Identifying Contractual Financial Guarantees

BC148. Financial instruments in IPSAS ~~28XX (ED 37)~~ are defined as: "...any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity." As arrangements in the public sector may arise through statutory powers, the IPSASB developed additional application guidance to identify when distinguish contractual or non-contractual financial guarantees are contractual. The IPSASB concluded that, to be within the scope of IPSAS ~~28XX (ED 37)~~, financial guarantees should have the key features of a contractual arrangement. It also concluded

that an entity should distinguish the right to issue guarantees, which is often conferred on an entity through statutory or similar means, and the actual issuing of the guarantee in favour of a third party, irrespective of whether that party is explicitly or implicitly identified. A statutory right to issue guarantees, of itself, is not within the scope of this Standard.:

Definitions

Contractual Arrangements

BC159. The IPSASB noted that, in certain jurisdictions, public sector entities are precluded from entering into formal contracts, but do enter into arrangements that have the substance of contracts. These arrangements may be known by another term, for example, a ‘government order’. To assist entities in identifying contracts, which either have the substance or legal form of a contract, the IPSASB considered it appropriate to issue additional Application Guidance explaining the factors an entity should consider in assessing whether an arrangement is contractual or non-contractual.

BC160. Consideration was given as to whether the term “binding arrangement” should be used to describe the arrangements highlighted in paragraph BC159. The term “binding arrangement” has not been defined, but has been used in IPSASs to describe arrangements that are binding on the parties, but do not take the form of a documented contract, such as an arrangement between two government departments that do not have the power to contract. The IPSASB concluded that the term “binding arrangements,” as used in IPSASs, embraces a wider set of arrangements than those identified in paragraph BC159 and therefore concluded that it should not be used in this IPSAS ~~28XX (ED-37)~~.

Contractual Non-Exchange Revenue Transactions

BC174. IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” prescribes the initial recognition, initial measurement and disclosure of assets and liabilities arising out of non-exchange revenue transactions. ~~In acknowledging that certain non-exchange revenue transactions may be contractual in nature, there is an overlap between the requirements of IPSAS XX (ED-37) and IPSAS 23. The IPSASB considered the interaction between this IPSAS and IPSAS 23.~~

BC18. In considering whether assets and liabilities that arise from non-exchange revenue transactions are financial instruments, the IPSASB identified that the following basic requirements should be fulfilled:

- The arrangement is contractual in nature; and
- The arrangement gives rise to a contractual right or obligation to receive or deliver cash or another financial asset, or exchange financial assets under favourable or unfavourable conditions.

BC19. The IPSASB concluded that assets arising from non-exchange revenue transactions could meet these requirements. In particular, it noted that the nature of arrangements with donors may be contractual in nature, and may be settled by transferring cash or another

financial asset from the donor to the recipient. In these instances, assets arising from non-exchange revenue transactions are financial assets.

BC~~2012~~. The IPSASB ~~agreed~~~~concluded~~ that, for financial assets arising from non-exchange transactions, an entity should apply the requirements of IPSAS 23 in conjunction with IPSAS ~~28XX (ED 37)~~. In particular, an entity considers the principles in IPSAS ~~28XX (ED 37)~~ in considering whether an inflow of resources from a non-exchange revenue transaction results in a liability or a transaction that evidences a contribution from owners~~residual interest in the net assets of the entity~~.

BC21. The IPSASB considered whether the liabilities arising from non-exchange revenue transactions are financial liabilities. Liabilities are recognized in IPSAS 23 when an entity receives an inflow of resources that are subject to specific conditions. Conditions on a transfer of resources are imposed on an entity by a transferor and require that the resources are used in a certain way, often to provide goods and services to third parties, or are returned to the transferor. This gives rise to an obligation to perform in terms of the agreement. At initial recognition, an entity recognizes the resources as an asset and, where they are subject to conditions, recognizes a corresponding liability.

BC22. The IPSASB considered whether the liability recognized at initial recognition is in the nature of a financial liability or another liability, e.g. a provision. The IPSASB agreed that, at the time the asset is recognized, the liability is not usually a financial liability as the entity's obligation is to fulfil the terms and conditions of the arrangement by utilizing the resources as intended, usually by providing goods and services to third parties over a period of time. If after initial recognition, the entity cannot fulfil the terms of the arrangement and is required to return the resources to the transferor, an entity would assess at this stage whether the liability is a financial liability considering the requirements set out in paragraph BC18 and the definitions of a financial instrument and a financial liability.

BC23. The IPSASB also noted that other liabilities may arise from non-exchange revenue transactions after initial recognition. For example, an entity may receive resources under an arrangement that requires the resources to be returned only after the occurrence or non-occurrence of a future event. An entity assesses whether other liabilities arising from non-exchange revenue transactions are financial instruments by considering whether the requirements in paragraph BC18 have been fulfilled and the definitions of a financial instrument and a financial liability have been met.

Other

Interpretations developed by the International Financial Reporting Interpretations Committee

BC~~2143~~. The IPSASB considered whether IFRIC 2, "Members' Shares in Co-operative Entities and Similar Instruments" and IFRIC 11, "IFRS 2 – Group and Treasury Share Transactions" were relevant for the types of instruments entered into by governments and entities in the public sector.

BC~~25~~44. The IPSASB considered that IFRIC 11 is not relevant for the types of instruments entered into in the public sector as it deals with share-based payment transactions. While share-based payments may be common in Government Business Enterprises (GBE's), they do not occur frequently within entities that are not GBE's. As a result, the IPSASB has not included any principles from IFRIC 11 in IPSAS ~~28XX (ED-37)~~.

BC~~26~~45. IFRIC 2 provides guidance on the application of IAS 32 to members' shares in co-operative entities and similar instruments. There is a strong link between IAS 32 and IFRIC 2 in relation to puttable financial instruments and obligations arising on liquidation. As the text of IAS 32 that deals with puttable financial instruments and obligations arising on liquidation has been retained in IPSAS ~~28XX (ED-37)~~, IFRIC 2 would provide additional guidance to users of IPSAS ~~28XX (ED-37)~~ in applying those principles to members' interests in co-operative entities. Therefore, the principles and examples from IFRIC 2 have been included in IPSAS ~~28XX (ED-37)~~ as an authoritative appendix.

Illustrative Examples

These examples accompany, but are not part of, IPSAS ~~28XX~~ (ED-37).

Accounting for contracts on equity instruments of an entity

IE1. The following examples illustrate the application of paragraphs 13-32 and IPSAS ~~29XX~~ (ED-38) to the accounting for contracts on an entity's own equity instruments. In these examples, monetary amounts are denominated in 'currency units' (CU).

Example 1: Forward to buy shares

IE2. This example illustrates the journal entries for forward purchase contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (i.e. the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	February 1, 20X2
Maturity date	January 31, 20X3
Market price per share on February, 1 20X2	CU100
Market price per share on December, 31 20X2	CU110
Market price per share on January, 31 20X3	CU106
Fixed forward price to be paid on January, 31 20X3	CU104
Present value of forward price on February, 1 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on February, 1 20X2	CU0
Fair value of forward on December, 31 20X2	CU6,300
Fair value of forward on January, 31 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

IE3. In this subsection, the forward purchase contract on the entity's own shares will be settled net in cash, i.e. there is no receipt or delivery of the entity's own shares upon settlement of the forward contract.

On February 1, 20X2, Entity A enters into a contract with Entity B to receive the fair value of 1,000 of Entity A's own outstanding ordinary shares as of January, 31, 20X3 in

exchange for a payment of CU104,000 in cash (i.e. CU104 per share) on January 31, 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

February 1, 20X2

The price per share when the contract is agreed on February 1, 20X2 is CU100. The initial fair value of the forward contract on February 1, 20X2 is zero.

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

December 31, 20X2

On December 31, 20X2, the market price per share has increased to CU110 and, as a result, the fair value of the forward contract has increased to CU6,300.

Dr Forward asset	CU6,300	
		Cr Gain
		CU6,300

To record the increase in the fair value of the forward contract.

January 31, 20X3

On January 31, 20X3, the market price per share has decreased to CU106. The fair value of the forward contract is CU2,000 ($[\text{CU106} \times 1,000] - \text{CU104,000}$).

On the same day, the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 to Entity B and Entity B has an obligation to deliver CU106,000 ($\text{CU106} \times 1,000$) to Entity A, so Entity B pays the net amount of CU2,000 to Entity A.

Dr Loss	CU4,300	
		Cr Forward asset
		CU4,300

To record the decrease in the fair value of the forward contract (i.e. $\text{CU4,300} = \text{CU6,300} - \text{CU2,000}$).

Dr Cash	CU2,000	
		Cr Forward asset
		CU2,000

To record the settlement of the forward contract.

(b) Shares for shares ('net share settlement')

- IE4. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a) above, except for recording the settlement of the forward contract, as follows:

January 31, 20X3

The contract is settled net in shares. Entity A has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) worth of its shares to Entity B and Entity B has an obligation to deliver

CU106,000 ($\text{CU106} \times 1,000$) worth of shares to Entity A. Thus, Entity B delivers a net amount of CU2,000 ($\text{CU106,000} - \text{CU104,000}$) worth of shares to Entity A, i.e. 18.9 shares ($\text{CU2,000}/\text{CU106}$).

Dr Net assets/equity	CU2,000	
		CU2,000
Cr Forward asset		

To record the settlement of the forward contract.

(c) Cash for shares ('gross physical settlement')

- IE5. Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of Entity A's shares. Similarly to (a) and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has an obligation to pay CU104,000 in cash to Entity B ($\text{CU104} \times 1,000$) and Entity B has an obligation to deliver 1,000 of Entity A's outstanding shares to Entity A in one year. Entity A records the following journal entries.

February 1, 20X2

Dr Net assets/equity	CU100,000	
		CU100,000
Cr Liability		

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IPSAS [29XX \(ED-38\)](#), paragraph AG824).

December 31, 20X2

Dr Interest expense	CU3,660	
		CU3,660
Cr Liability		

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

January 31, 20X3

Dr Interest expense	CU340	
		CU340
Cr Liability		

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

Entity A delivers CU104,000 in cash to Entity B and Entity B delivers 1,000 of Entity A's shares to Entity A.

Dr Liability	CU104,000	
		CU104,000
Cr Cash		

To record the settlement of the obligation to redeem Entity A's own shares for cash.

(d) Settlement options

- IE6. The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the forward repurchase contract is a financial asset or a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognises a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the forward contract as a derivative.

Example 2: Forward to sell shares

- IE7. This example illustrates the journal entries for forward sale contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by receiving cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (i.e. the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	February 1, 20X2
Maturity date	January 31, 20X3
Market price per share on-February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU110
Market price per share on January 31, 20X3	CU106
Fixed forward price to be paid on January 31, 20X3	CU104
Present value of forward price on February 1, 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on February 1, 20X2	CU0
Fair value of forward on December 31, 20X2	(CU6,300)
Fair value of forward on January 31, 20X3	(CU2,000)

(a) Cash for cash ('net cash settlement')

- IE8. On February 1, 20X2, Entity A enters into a contract with Entity B to pay the fair value of 1,000 of Entity A's own outstanding ordinary shares as of January, 31 20X3 in exchange for CU104,000 in cash (i.e. CU104 per share) on January 31, 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

February 1, 20X2

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

December 31, 20X2

Dr Loss	CU6,300	
	Cr Forward liability	CU6,300

To record the decrease in the fair value of the forward contract.

January 31, 20X3

Dr Forward liability	CU4,300	
	Cr Gain	CU4,300

To record the increase in the fair value of the forward contract (i.e. $CU4,300 = CU6,300 - CU2,000$).

The contract is settled net in cash. Entity B has an obligation to deliver CU104,000 to Entity A, and Entity A has an obligation to deliver CU106,000 ($CU106 \times 1,000$) to Entity B. Thus, Entity A pays the net amount of CU2,000 to Entity B.

Dr Forward liability	CU2,000	
	Cr Cash	CU2,000

To record the settlement of the forward contract.

(b) Shares for shares ('net share settlement')

- IE9. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a), except:

January 31, 20X3

The contract is settled net in shares. Entity A has a right to receive CU104,000 ($CU104 \times 1,000$) worth of its shares and an obligation to deliver CU106,000 ($CU106 \times 1,000$) worth of its shares to Entity B. Thus, Entity A delivers a net amount of CU2,000 ($CU106,000 - CU104,000$) worth of its shares to Entity B, i.e. 18.9 shares ($CU2,000/CU106$).

Dr Forward liability	CU2,000	
	Cr Net assets/equity	CU2,000

To record the settlement of the forward contract. The issue of the entity's own shares is treated as a transaction in net assets/equity.

(c) Shares for cash ('gross physical settlement')

- IE10. Assume the same facts as in (a), except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of the entity's own shares. Similarly to (a)

and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has a right to receive CU104,000 in cash ($\text{CU104} \times 1,000$) and an obligation to deliver 1,000 of its own shares in one year. Entity A records the following journal entries.

February 1, 20X2

No entry is made on February, 1. No cash is paid or received because the forward has an initial fair value of zero. A forward contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash or another financial asset meets the definition of an equity instrument because it cannot be settled otherwise than through the delivery of shares in exchange for cash.

December 31, 20X2

No entry is made on December, 31 because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

January 31, 20X3

On January 31, 20X3, Entity A receives CU104,000 in cash and delivers 1,000 shares.

Dr Cash	CU104,000	
		CU104,000
Cr Net assets/equity		

To record the settlement of the forward contract.

(d) Settlement options

- IE11. The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the forward contract is a financial asset or a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognises a derivative asset or liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 3: Purchased call option on shares

- IE12. This example illustrates the journal entries for a purchased call option right on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for the entity's own shares. It also discusses the effect of settlement options (see (d) below):

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3

(European terms, i.e. it can be exercised only at maturity)

Exercise right holder	Reporting entity (Entity A)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU104
Market price per share on January 31, 20X3	CU104
Fixed exercise price to be paid on January 31, 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU3,000
Fair value of option on January 31, 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

- IE13. On February 1, 20X2, Entity A enters into a contract with Entity B that gives Entity B the obligation to deliver, and Entity A the right to receive the fair value of 1,000 of Entity A's own ordinary shares as of January 31, 20X3 in exchange for CU102,000 in cash (i.e. CU102 per share) on January 31, 20X3, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

February 1, 20X2

The price per share when the contract is agreed on February 1, 20X2 is CU100. The initial fair value of the option contract on February 1, 20X2 is CU5,000, which Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU102 exceeds the market price per share of CU100 and it would therefore not be economic for Entity A to exercise the option. In other words, the call option is out of the money.

Dr Call option asset	CU5,000	
	Cr Cash	CU5,000

To recognise the purchased call option.

December 31, 20X2

On December 31, 20X2, the market price per share has increased to CU104. The fair value of the call option has decreased to CU3,000, of which CU2,000 is intrinsic value $([CU104 - CU102] \times 1,000)$, and CU1,000 is the remaining time value.

Dr Loss	CU2,000	
	Cr Call option asset	CU2,000

To record the decrease in the fair value of the call option.

January 31, 20X3

On January 31, 20X3, the market price per share is still CU104. The fair value of the call option has decreased to CU2,000, which is all intrinsic value $([CU104 - CU102] \times 1,000)$ because no time value remains.

Dr Loss	CU1,000	
	Cr Call option asset	CU1,000

To record the decrease in the fair value of the call option.

On the same day, Entity A exercises the call option and the contract is settled net in cash. Entity B has an obligation to deliver CU104,000 $(CU104 \times 1,000)$ to Entity A in exchange for CU102,000 $(CU102 \times 1,000)$ from Entity A, so Entity A receives a net amount of CU2,000.

Dr Cash	CU2,000	
	Cr Call option asset	CU2,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

- IE14. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a) except for recording the settlement of the option contract as follows:

January 31, 20X3

Entity A exercises the call option and the contract is settled net in shares. Entity B has an obligation to deliver CU104,000 $(CU104 \times 1,000)$ worth of Entity A's shares to Entity A in exchange for CU102,000 $(CU102 \times 1,000)$ worth of Entity A's shares. Thus, Entity B delivers the net amount of CU2,000 worth of shares to Entity A, i.e. 19.2 shares $(CU2,000/CU104)$.

Dr Net assets/equity	CU2,000	
	Cr Call option asset	CU2,000

To record the settlement of the option contract. The settlement is accounted for as a treasury share transaction (i.e. no gain or loss).

(c) Cash for shares ('gross physical settlement')

- IE15. Assume the same facts as in (a) except that settlement will be made by receiving a fixed number of shares and paying a fixed amount of cash, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity A has a right to receive 1,000 of Entity A's own outstanding shares

in exchange for CU102,000 ($\text{CU102} \times 1,000$) in cash, if Entity A exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr Net assets/equity	CU5,000	
		Cr Cash
		CU5,000

To record the cash paid in exchange for the right to receive Entity A's own shares in one year for a fixed price. The premium paid is recognised in net assets/equity.

December 31, 20X2

No entry is made on December 31 because no cash is paid or received and a contract that gives a right to receive a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

January 31, 20X3

Entity A exercises the call option and the contract is settled gross. Entity B has an obligation to deliver 1,000 of Entity A's shares in exchange for CU102,000 in cash.

Dr Net assets/equity	CU102,000	
		Cr Cash
		CU102,000

To record the settlement of the option contract.

(d) Settlement options

- IE16. The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the call option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognises a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 4: Written call option on shares

- IE17. This example illustrates the journal entries for a written call option obligation on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3

(European terms, i.e. it can be

	exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU104
Market price per share on January 31, 20X3	CU104
Fixed exercise price to be paid on January 31, 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU3,000
Fair value of option on January 31, 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

- IE18. Assume the same facts as in Example 3(a) above except that Entity A has written a call option on its own shares instead of having purchased a call option on them. Accordingly, on February 1, 20X2 Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A's own ordinary shares as of January 31, 20X3 in exchange for CU102,000 in cash (i.e. CU102 per share) on January 31, 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

February 1, 20X2

Dr Cash	CU5,000	
	Cr Call option obligation	CU5,000

To recognise the written call option.

December 31, 20X2

Dr Call option obligation	CU2,000	
	Cr Gain	CU2,000

To record the decrease in the fair value of the call option.

January 31, 20X3

Dr Call option obligation	CU1,000	
	Cr Gain	CU1,000

To record the decrease in the fair value of the option.

On the same day, Entity B exercises the call option and the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) to Entity B in exchange for CU102,000 ($\text{CU102} \times 1,000$) from Entity B, so Entity A pays a net amount of CU2,000.

Dr Call option obligation	CU2,000	
		Cr Cash
		CU2,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

- IE19. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a), except for recording the settlement of the option contract, as follows:

December 31, 20X3

Entity B exercises the call option and the contract is settled net in shares. Entity A has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) worth of Entity A's shares to Entity B in exchange for CU102,000 ($\text{CU102} \times 1,000$) worth of Entity A's shares. Thus, Entity A delivers the net amount of CU2,000 worth of shares to Entity B, i.e. 19.2 shares ($\text{CU2,000}/\text{CU104}$).

Dr Call option obligation	CU2,000	
		Cr Net assets/equity
		CU2,000

To record the settlement of the option contract. The settlement is accounted for as a transaction in net assets/equity.

(c) Cash for shares ('gross physical settlement')

- IE20. Assume the same facts as in (a) except that settlement will be made by delivering a fixed number of shares and receiving a fixed amount of cash, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity B has a right to receive 1,000 of Entity A's own outstanding shares in exchange for CU102,000 ($\text{CU102} \times 1,000$) in cash, if Entity B exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr Cash	CU5,000	
		Cr Net assets/equity
		CU5,000

To record the cash received in exchange for the obligation to deliver a fixed number of Entity A's own shares in one year for a fixed price. The premium received is recognised in net assets/equity. Upon exercise, the call would result in the issue of a fixed number of shares in exchange for a fixed amount of cash.

December 31, 20X2

No entry is made on December 31 because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

January 31, 20X3

Entity B exercises the call option and the contract is settled gross. Entity A has an obligation to deliver 1,000 shares in exchange for CU102,000 in cash.

Dr Cash	CU102,000	
		CU102,000
Cr Net assets/equity		

To record the settlement of the option contract.

(d) Settlement options

- IE21. The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the call option is a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognises a derivative liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 5: Purchased put option on shares

- IE22. This example illustrates the journal entries for a purchased put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3
	(European terms, i.e. it can be exercised only at maturity)
Exercise right holder	Reporting entity (Entity A)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU95
Market price per share on January 31, 20X3	CU95
Fixed exercise price to be paid on January 31, 20X3	CU98
Number of shares under option contract	1,000

Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU4,000
Fair value of option on January 31, 20X3	CU3,000

(a) Cash for cash ('net cash settlement')

- IE23. On February 1, 20X2, Entity A enters into a contract with Entity B that gives Entity A the right to sell, and Entity B the obligation to buy the fair value of 1,000 of Entity A's own outstanding ordinary shares as of January 31, 20X3 at a strike price of CU98,000 (i.e. CU98 per share) on January 31, 20X3, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

February, 1 20X2

The price per share when the contract is agreed on February 1, 20X2 is CU100. The initial fair value of the option contract on February 1, 20X2 is CU5,000, which Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU98 is less than the market price per share of CU100. Therefore it would not be economic for Entity A to exercise the option. In other words, the put option is out of the money.

Dr Put option asset	CU5,000	
		CU5,000
Cr Cash		

To recognise the purchased put option.

December 31, 20X2

On December 31, 20X2 the market price per share has decreased to CU95. The fair value of the put option has decreased to CU4,000, of which CU3,000 is intrinsic value $[(CU98 - CU95) \times 1,000]$ and CU1,000 is the remaining time value.

Dr Loss	CU1,000	
		CU1,000
Cr Put option asset		

To record the decrease in the fair value of the put option.

January 31, 20X3

On January 31, 20X3 the market price per share is still CU95. The fair value of the put option has decreased to CU3,000, which is all intrinsic value $[(CU98 - CU95) \times 1,000]$ because no time value remains.

Dr Loss	CU1,000	
		CU1,000
Cr Put option asset		

To record the decrease in the fair value of the option.

On the same day, Entity A exercises the put option and the contract is settled net in cash. Entity B has an obligation to deliver CU98,000 to Entity A and Entity A has an obligation to deliver CU95,000 ($\text{CU}95 \times 1,000$) to Entity B, so Entity B pays the net amount of CU3,000 to Entity A.

Dr Cash	CU3,000	
	Cr Put option asset	CU3,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

- IE24. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as shown in (a), except:

January 31, 20X3

Entity A exercises the put option and the contract is settled net in shares. In effect, Entity B has an obligation to deliver CU98,000 worth of Entity A's shares to Entity A, and Entity A has an obligation to deliver CU95,000 worth of Entity A's shares ($\text{CU}95 \times 1,000$) to Entity B, so Entity B delivers the net amount of CU3,000 worth of shares to Entity A, i.e. 31.6 shares ($\text{CU}3,000/\text{CU}95$).

Dr Net assets/equity	CU3,000	
	Cr Put option asset	CU3,000

To record the settlement of the option contract.

(c) Cash for shares ('gross physical settlement')

- IE25. Assume the same facts as in (a) except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of Entity A's shares, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity B has an obligation to pay CU98,000 in cash to Entity A ($\text{CU}98 \times 1,000$) in exchange for 1,000 of Entity A's outstanding shares, if Entity A exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr Net assets/equity	CU5,000	
	Cr Cash	CU5,000

To record the cash received in exchange for the right to deliver Entity A's own shares in one year for a fixed price. The premium paid is recognised directly in net assets/equity. Upon exercise, it results in the issue of a fixed number of shares in exchange for a fixed price.

December 31, 20X2

No entry is made on December 31 because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of Entity A.

January 31, 20X3

Entity A exercises the put option and the contract is settled gross. Entity B has an obligation to deliver CU98,000 in cash to Entity A in exchange for 1,000 shares.

Dr Cash	CU98,000	
		Cr Net assets/equity
		CU98,000

To record the settlement of the option contract.

(d) Settlement options

- IE26. The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the put option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognises a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 6: Written put option on shares

- IE27. This example illustrates the journal entries for a written put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3
	(European terms, i.e. it can be exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU95
Market price per share on January 31, 20X3	CU95
Fixed exercise price to be paid on January 31, 20X3	CU98
Present value of exercise price on February 1, 20X2	CU95
Number of shares under option contract	1,000

Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU4,000
Fair value of option on January 31, 20X3	CU3,000

(a) Cash for cash ('net cash settlement')

- IE28. Assume the same facts as in Example 5(a) above, except that Entity A has written a put option on its own shares instead of having purchased a put option on its own shares. Accordingly, on February 1 20X2, Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A's outstanding ordinary shares as of January 31, 20X3 in exchange for CU98,000 in cash (i.e. CU98 per share) on January 31, 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

February 1, 20X2

Dr Cash	CU5,000	
	Cr Put option liability	CU5,000

To recognise the written put option.

December 31, 20X2

Dr Put option liability	CU1,000	
	Cr Gain	CU1,000

To record the decrease in the fair value of the put option.

January 31, 20X3

Dr Put option liability	CU1,000	
	Cr Gain	CU1,000

To record the decrease in the fair value of the put option.

On the same day, Entity B exercises the put option and the contract is settled net in cash. Entity A has an obligation to deliver CU98,000 to Entity B, and Entity B has an obligation to deliver CU95,000 (CU95 × 1,000) to Entity A. Thus, Entity A pays the net amount of CU3,000 to Entity B.

Dr Put option liability	CU3,000	
	Cr Cash	CU3,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

- IE29. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those in (a), except for the following:

January 31, 20X3

Entity B exercises the put option and the contract is settled net in shares. In effect, Entity A has an obligation to deliver CU98,000 worth of shares to Entity B, and Entity B has an obligation to deliver CU95,000 worth of Entity A's shares ($CU95 \times 1,000$) to Entity A. Thus, Entity A delivers the net amount of CU3,000 worth of Entity A's shares to Entity B, i.e. 31.6 shares ($3,000/95$).

Dr Put option liability	CU3,000	
		CU3,000
Cr Net assets/equity		

To record the settlement of the option contract. The issue of Entity A's own shares is accounted for as a transaction in net assets/equity.

(c) Cash for shares ('gross physical settlement')

- IE30. Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of shares, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity A has an obligation to pay CU98,000 in cash to Entity B ($CU98 \times 1,000$) in exchange for 1,000 of Entity A's outstanding shares, if Entity B exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr Cash	CU5,000	
		CU5,000
Cr Net assets/equity		

To recognise the option premium received of CU5,000 in net assets/equity.

Dr Net assets/equity	CU95,000	
		CU95,000
Cr Liability		

To recognise the present value of the obligation to deliver CU98,000 in one year, i.e. CU95,000, as a liability.

December 31, 20X2

Dr Interest expense	CU2,750	
		CU2,750
Cr Liability		

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

January 31, 20X3

Dr Interest expense	CU250	
Cr Liability		CU250

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

On the same day, Entity B exercises the put option and the contract is settled gross. Entity A has an obligation to deliver CU98,000 in cash to Entity B in exchange for CU95,000 worth of shares ($CU95 \times 1,000$).

Dr Liability	CU98,000	
Cr Cash		CU98,000

To record the settlement of the option contract.

(d) Settlement options

- IE31. The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the written put option is a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognises a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the put option as a derivative liability.

Entities such as mutual funds and co-operatives whose share capital is not net assets/equity

Example 7: Entities with no net assets/equity

- IE32. The following example illustrates a format of a statement of financial performance and statement of financial position that may be used by entities such as mutual funds that do not have net assets/equity. Other formats are possible.

Statement of financial performance for the year ended December 31, 20X1

	20X1	20X0
	CU	CU
Revenue	2,956	1,718
Total Revenue	2,956	1,718
Expenses (classified by nature or function)	(644)	(614)
Finance costs		
– other finance costs	(47)	(47)
– distributions to unitholders	(50)	(50)
Total Expenses	(741)	(711)
Surplus for the year	2,215	1,007

Change in net assets attributable to unitholders	2,215	1,007

Statement of financial position at December 31, 20X1

		20X1		20X0
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IPSAS 1)	91,374		78,484	
Total non-current assets		91,374		78,484
Current assets (classified in accordance with IPSAS 1)	1,422		1,769	
Total current assets		1,422		1,769
Total assets		92,796		80,253
LIABILITIES				
Current liabilities (classified in accordance with IPSAS 1)	647		66	
Total current liabilities		(647)		(66)
Non-current liabilities excluding net assets attributable to unitholders (classified in accordance with IPSAS 1)	280		136	
		(280)		(136)
Net assets attributable to unitholders		91,869		80,051

Example 8: Entities with some net assets/equity

IE33. The following example illustrates a format of a statement of financial performance and statement of financial position that may be used by entities whose share capital is not net assets/equity because the entity has an obligation to repay the share capital on demand. Other formats are possible.

Statement of financial performance for the year ended December 31, 20X1

	20X1	20X0
	CU	CU
Revenue	472	498
Total Revenue	<u>472</u>	<u>498</u>
Expenses (classified by nature or function)	(367)	(396)
Finance costs		
– other finance costs	(4)	(4)
– distributions to members	<u>(50)</u>	<u>(50)</u>
Total Expenses	<u>(421)</u>	<u>(450)</u>
Surplus for the year	<u>51</u>	<u>48</u>
Change in net assets attributable to members	<u>51</u>	<u>48</u>

Statement of financial position at December 31, 20X1

	20X1	20X0
	CU	CU
ASSETS		
Non-current assets (classified in accordance with IPSAS 1)	<u>908</u>	<u>830</u>
Total non-current assets	908	830
Current assets (classified in accordance with IPSAS 1)	<u>383</u>	<u>350</u>
Total current assets	<u>383</u>	<u>350</u>
Total assets	<u>1,291</u>	<u>1,180</u>
LIABILITIES		
Current liabilities (classified in accordance with IPSAS 1)	372	338
Share capital repayable on demand	<u>202</u>	<u>161</u>
Total current liabilities	(574)	(499)
Total assets less current liabilities	<u>717</u>	<u>681</u>
Non-current liabilities (classified in	<u>187</u>	<u>196</u>

accordance with IPSAS 1)

(187)

(196)

**OTHER COMPONENTS OF NET
ASSETS/EQUITY^(a)**

Reserves e.g. revaluation surplus, accumulated
surplus etc

530

485

530

485

717

681

MEMORANDUM NOTE – Total members' interests

Share capital repayable on demand

202

161

Reserves

530

485

732

646

(a) In this example, the entity has no obligation to deliver a share of its reserves to its members.

Accounting for compound financial instruments

Example 9: Separation of a compound financial instrument on initial recognition

- IE34. Paragraph 33 describes how the components of a compound financial instrument are separated by the entity on initial recognition. The following example illustrates how such a separation is made.
- IE35. An entity issues 2,000 convertible bonds at the start of year 1. The bonds have a three-year term, and are issued at par with a face value of CU1,000 per bond, giving total proceeds of CU2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9 per cent.
- IE36. The liability component is measured first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the net assets/equity component. The present value of the liability component is calculated using a discount rate of 9 per cent, the market interest rate for similar bonds having no conversion rights, as shown below.

CU

Present value of the principal – CU2,000,000 payable at the end of
three years

1,544,367

Present value of the interest – CU120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Net assets/equity component (by deduction)	151,878
Proceeds of the bond issue	2,000,000

Example 10: Separation of a compound financial instrument with multiple embedded derivative features

- IE37. The following example illustrates the application of paragraph 36 to the separation of a compound financial instrument with multiple embedded derivative features into the liability and net assets/equity component.
- IE38. Assume that the proceeds received on the issue of a callable convertible bond are CU60. The value of a similar bond without a call or equity conversion option is CU57. Based on an option pricing model, it is determined that the value to the entity of the embedded call feature in a similar bond without an equity conversion option is CU2. In this case, the value allocated to the liability component under paragraph 36 is CU55 (CU57 – CU2) and the value allocated to the net assets/equity component is CU5 (CU60 – CU55).

Example 9: Repurchase of a convertible instrument

- IE39. The following example illustrates how an entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of the liability and the net assets/equity components in the financial statements, i.e. no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.
- IE40. On January 1, 20X0, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 maturing on December 31, 20X9. The debenture is convertible into ordinary shares of Entity A at a conversion price of CU25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.
- IE41. In the financial statements of Entity A the carrying amount of the debenture was allocated on issue as follows:

	CU
Liability component	
Present value of 20 half-yearly interest payments of CU50, discounted at 11%	597
Present value of CU1,000 due in 10 years, discounted at 11%, compounded half-yearly	343
	<hr/> 940
Net assets/equity component	
(difference between CU1,000 total proceeds and CU940 allocated above)	<hr/> 60
Total proceeds	<hr/> <hr/> 1,000

IE42. On January 1, 20X5 the convertible debenture has a fair value of CU1,700.

IE43. Entity A makes a tender offer to the holder of the debenture to repurchase the debenture for CU1,700, which the holder accepts. At the date of repurchase, Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

IE44. The repurchase price is allocated as follows:

	Carrying value	Fair value	Difference
	CU	CU	CU
Liability component:			
Present value of 10 remaining half-yearly interest payments of CU50, discounted at 11% and 8%, respectively	377	405	
Present value of CU1,000 due in 5 years, discounted at 11% and 8%, compounded half-yearly, respectively	585	676	
	<hr/> 962	<hr/> 1,081	<hr/> (119)
Net assets/equity component	60	619 ^(a)	(559)
Total	<hr/> 1,022	<hr/> 1,700	<hr/> (678)

(a) this amount represents the difference between the fair value amount allocated to the liability component and the repurchase price of CU1,700.

IE45. Entity A recognises the repurchase of the debenture as follows:

Dr Liability component	CU962	
Dr Debt settlement expense (surplus or deficit)	CU119	
Cr Cash		CU1,081

To recognise the repurchase of the liability component.

Dr Net assets/equity

CU619

Cr Cash

CU619

To recognise the cash paid for the net assets/equity component.

- IE46. The net assets/equity component remains as net assets/equity, but may be transferred from one line item within net assets/equity to another.

Example 11: Amendment of the terms of a convertible instrument to induce early conversion

- IE47. The following example illustrates how an entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.
- IE48. On January 1, 20X0, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 with the same terms as described in Example 9. On January 1, 20X1, to induce the holder to convert the convertible debenture promptly, Entity A reduces the conversion price to CU20 if the debenture is converted before March 1, 20X1 (i.e. within 60 days).
- IE49. Assume the market price of Entity A's ordinary shares on the date the terms are amended is CU40 per share. The fair value of the incremental consideration paid by Entity A is calculated as follows:

*Number of ordinary shares to be issued to debenture holders under **amended** conversion terms:*

Face amount	CU1,000
New conversion price	<u>/CU20 per share</u>
Number of ordinary shares to be issued on conversion	<u><u>50 shares</u></u>

*Number of ordinary shares to be issued to debenture holders under **original** conversion terms:*

Face amount	CU1,000
Original conversion price	<u>/CU25 per share</u>
Number of ordinary shares to be issued on conversion	40 Shares

Number of incremental ordinary shares issued upon conversion

10 Shares

*Value of **incremental** ordinary shares issued upon conversion*

CU40 per share x 10 incremental shares	<u><u>CU400</u></u>
--	---------------------

- IE50. The incremental consideration of CU400 is recognised as a loss in surplus or deficit.

Comparison with IAS 32

IPSAS ~~28XX (ED 37)~~, “Financial Instruments: Presentation” is drawn primarily from IAS 32, “Financial Instruments: Presentation” (issued originally in 2003, including amendments up to December 31, 2008). The main differences between IPSAS ~~28XX (ED 37)~~ and IAS 32 are as follows:

- IAS 32 allows entities to treat financial guarantee contracts as insurance contracts where entities have previously asserted that such contracts are insurance contracts and not financial instruments. IPSAS ~~28 XX (ED 37)~~ distinguishes requires financial guarantee contracts arising from non-exchange transactions and financial guarantee contracts arising from exchange transactions. IPSAS ~~XX (ED 37)~~ requires financial guarantee contracts arising from non-exchange transactions to be treated as financial instruments in accordance with IPSAS ~~XX (ED 37)~~. IAS 32 does not make this distinction allows a similar election, except that entities need not have explicitly asserted that financial guarantees are insurance contracts.
- In certain instances, IPSAS ~~28XX (ED 37)~~ uses different terminology from IAS 32. The most significant examples are the use of the terms “statement of financial performance” and “net assets/equity.” The equivalent terms in IAS 32 are “statement of comprehensive income or separate income statement (if presented)” and “equity.”
- IPSAS ~~28XX (ED 37)~~ does not distinguish between “revenue” and “income.” IAS 32 distinguishes between “revenue” and “income,” with “income” having a broader meaning than the term “revenue.”
- IPSAS ~~28XX (ED 37)~~ contains additional Application Guidance dealing with the identification of arrangements that are, in substance, contractual.
- IPSAS 28 contains additional Application Guidance on when assets and liabilities arising from non-exchange revenue transactions are a financial instrument.
- Principles from IFRIC 2, “Members’ Shares in Co-operative Entities and Similar Instruments” have been included as an Appendix in IPSAS ~~28XX (ED 37)~~.
- The transitional provisions in IPSAS ~~28XX (ED 37)~~ differ from those in IAS 32. This is because IPSAS ~~28XX (ED 37)~~ provides transitional provisions for those entities applying this Standard for the first time or those applying accrual accounting for the first time.



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*International Public Sector Accounting Standard
(IPSAS) 29*

Financial Instruments: Recognition
and Measurement



IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 39, “Financial Instruments: Recognition and Measurement,” IFRIC 9, “Reassessment of Embedded Derivatives” and IFRIC 16, “Hedges of a Net Investment in a Foreign Operation” published by the International Accounting Standards Board (IASB). Extracts from IAS 39, IFRIC 9 and IFRIC 16 are reproduced in this publication of the International Public Sector Accounting Standards Board of the International Federation of Accountants with the permission of the International Accounting Standards Committee Foundation (IASCF).

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IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

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International Public Sector Accounting Standard (IPSAS) 29, “Financial Instruments: Recognition and Measurement” is set out in paragraphs 1–126 and Appendices A–D. All the paragraphs have equal authority. IPSAS 29 should be read in the context of its objective, the Basis for Conclusions, and the “Preface to International Public Sector Accounting Standards.” 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.

Introduction

- IN1. IPSAS ~~29XX (ED-38)~~ prescribes recognition and measurement principles for financial instruments and is primarily drawn from IAS 39, “Financial Instruments: Recognition and Measurement” (as at December 31, 2008, including certain amendments published by the IASB as part of its “Improvements to IFRSs” issued in April 2009 including final and certain proposed amendments published up to December 31, 2008).

Scope

- IN2. Financial instruments are contractual arrangements that result in a financial asset for one entity and a financial liability or equity instrument in another. Rights and obligation arising out of non-contractual arrangements, such as through the exercise of legislation or through constructive obligations, are not financial instruments. The recognition and measurement of rights and obligations arising out of these transactions are addressed in other IPSASs.
- IN3. Many contracts meet the definition of a financial asset or a financial liability. Some of these are accounted for either by using other IPSASs, or accounted for partly using other IPSASs and partly using IPSAS ~~29XX (ED-38)~~. Some examples include rights and obligations arising from employee benefits, lease receivables and finance lease payables.
- IN4. IPSAS ~~29XX (ED-38)~~ does not apply to insurance contracts, except certain financial guarantee contracts and embedded derivatives included in insurance contracts. An entity is however permitted to apply this Standard to insurance contracts that involve the transfer of financial risk.
- IN5. Commitments to provide credit under specified conditions (loan commitments) are excluded from the scope of this Standard, with three exceptions. Notably, commitments to provide a loan at a below market interest rate are within the scope of IPSAS ~~29XX (ED-38)~~. Most other loan commitments are accounted for using IPSAS 19, “Provisions, Contingent Liabilities and Contingent Assets.”
- IN6. IPSAS ~~29XX (ED-38)~~ applies to contracts for the purchase or sale of a non-financial item if the contract can be settled net in cash or another financial instrument, or by exchanging financial instruments. If the contracts were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with an entity’s expected purchase, sale or usage requirements, IPSAS ~~29XX (ED-38)~~ does not apply.

Initial Recognition and Derecognition

- IN7. An entity recognizes financial assets and financial liabilities when it becomes a party to the contractual provisions of the instrument. Regular way purchases of financial assets can either be recognized using trade or settlement date accounting, while derivatives are always recognized using trade date accounting. Regular way purchases of financial assets are contracts that involve the exchange of the underlying instrument within a time frame established in the marketplace concerned.

IN8. An entity derecognizes regular way purchases and sales of financial assets either using trade or settlement date accounting. Financial assets are derecognized using the following steps:

- Consolidate all controlled entities and special purpose entities.
- Determine whether the derecognition principles are applied to an asset as a whole, or to a part of an asset.
- Assess whether the rights to the cash flows have expired.
- Assess whether the rights to receive the cash flows have been transferred to another party.
- Assess whether an obligation has been assumed to pay the cash flows from the asset to another party.
- Assess whether the entity has transferred substantially all the risks and rewards of ownership to another party.
- If substantially all the risks and rewards of ownership have not been transferred to another party, assess whether control has been retained.

IN9. A financial liability is derecognized when the liability has been extinguished. An existing liability is derecognized and a new liability recognized when:

- (a) An entity exchanges debt instruments with another entity, and the terms of the instruments are substantially different; and
- (b) The terms of an existing debt instrument are substantially modified.

When an entity has its debt waived, an entity considers the requirements in this Standard along with the requirements in IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” dealing with debt forgiveness.

Initial and Subsequent Measurement

IN10. Financial assets and financial liabilities are initially measured at fair value. Where an entity subsequently measures financial assets and financial liabilities at fair value, transaction costs are not included in the amount initially recognized.

IN11. An entity subsequently measures financial assets using four categories:

- Financial assets at fair value through surplus or deficit – assets are subsequently measured at fair value with changes in fair value recognized in surplus or deficit.
- Held-to-maturity investments – assets are measured at amortized cost less impairment losses. Impairment losses are recognized in surplus or deficit.
- Loans and receivables – assets are measured at amortized cost less impairment losses. Impairment losses are recognized in surplus or deficit.
- Available-for-sale financial assets – assets are measured at fair value, with changes in fair value recognized directly in net assets/equity. Impairment losses incurred on

available-for-sale instruments are recognized in surplus or deficit and not in net assets/equity.

- IN12. Investments in equity instruments that cannot be measured at fair value, because fair value cannot be determined reliably, are measured at cost less impairment losses.
- IN13. Financial liabilities are measured at amortized cost, except for financial liabilities at fair value through surplus or deficit, financial guarantees, loan commitments and liabilities arising from transfers of financial assets.
- IN14. An entity may only reclassify financial instruments between the various categories under certain circumstances.

Hedge Accounting

- IN15. IPSAS [29XX \(ED-38\)](#) prescribes principles for hedge accounting. Hedge accounting aims to reduce the volatility of an entity's financial performance by offsetting gains and losses on certain instruments. An entity may elect to apply hedge accounting, but only if prescribed conditions are met.

Objective

1. The objective of this Standard is to establish principles for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in IPSAS ~~28XX (ED-37)~~, “Financial Instruments: Presentation”. Requirements for disclosing information about financial instruments are in IPSAS ~~30XX (ED-39)~~, “Financial Instruments: Disclosures.”

Scope

2. This Standard shall be applied by all entities to all types of financial instruments, except:
 - (a) Those interests in controlled entities, associates and joint ventures that are accounted for under IPSAS 6, “Consolidated and Separate Financial Statements,” IPSAS 7, “Investments in Associates” or IPSAS 8, “Interests in Joint Ventures.” However, entities shall apply this Standard to an interest in a controlled entity, associate or joint venture that according to IPSAS 6, IPSAS 7 or IPSAS 8 is accounted for under this Standard. Entities shall also apply this Standard to derivatives on an interest in a controlled entity, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in IPSAS ~~28XX (ED-37)~~.
 - (b) Rights and obligations under leases to which IPSAS 13, “Leases” applies. However:
 - (i) Lease receivables recognized by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 17–39, 67, 68, 72 and Appendix A paragraphs AG51–AG67 and AG11~~76~~–AG12~~65~~);
 - (ii) Finance lease payables recognized by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 41–44 and Appendix A paragraphs AG72–AG80); and
 - (iii) Derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 11–15 and Appendix A paragraphs AG40–AG46).
 - (c) Employers’ rights and obligations under employee benefit plans, to which IPSAS 25, “Employee Benefits” applies.
 - (d) Financial instruments issued by the entity that meet the definition of an equity instrument in IPSAS ~~28XX (ED-37)~~ (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 15 and 16 or 17 and 18 of IPSAS ~~28XX (ED-37)~~. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.
 - (e) Rights and obligations arising under:

- (i) An insurance contract, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 10; or
- (ii) A contract that is within the scope of the international or national accounting standard dealing with insurance contracts because it contains a discretionary participation feature.

This Standard applies to a derivative that is embedded in an insurance contract if the derivative is not itself an insurance contract (see paragraphs 11–15 and Appendix A paragraphs AG40–AG46 of this Standard). ~~Moreover, if an entity issues financial guarantee contracts through exchange transactions and has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or the relevant international or national accounting standard dealing with insurance contracts to such financial guarantee contracts. An entity applies this Standard to financial guarantee contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them.~~ Notwithstanding (i) above, an entity may apply this Standard to other financial instruments that take the form of insurance contracts which involve the transfer of financial risk.

- (f) Any forward contracts ~~between an acquirer and seller that results from an agreement entered before the acquisition date (i.e. before the date on which the acquirer obtains control over the acquiree) between an acquirer and a vendor in an entity combination~~ to buy or sell an acquiree that will result in an entity combination at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction. ~~and at a specified price (or on a specified basis).~~
- (g) Loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets" to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 17–44 and Appendix A paragraphs AG51–AG80).
- (h) Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share based payment applies, except for contracts within the scope of paragraphs 4–6 of this Standard, to which this Standard applies.

- (i) **Rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognizes as a provision in accordance with IPSAS 19, or for which, in an earlier period, it recognized a provision in accordance with IPSAS 19.**
 - (j) **The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions, to which IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)” applies.**
- 3. **The following loan commitments are within the scope of this Standard:**
 - (a) **Loan commitments that the entity designates as financial liabilities at fair value through surplus or deficit. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.**
 - (b) **Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in installments (for example, a mortgage construction loan that is paid out in installments in line with the progress of construction).**
 - (c) **Commitments to provide a loan at a below-market interest rate. Paragraph 49(d) specifies the subsequent measurement of liabilities arising from these loan commitments.**
- 4. **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements.**
- 5. **There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:**
 - (a) **When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;**
 - (b) **When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);**

- (c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
- (d) When the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

- 6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.
- 7. **This Standard applies to all public sector entities other than Government Business Enterprises.**
- 8. The "Preface to International Public Sector Accounting Standards" issued by the International Public Sector Accounting Standards Board (IPSASB) explains that Government Business Enterprises (GBEs) apply International Financial Reporting Standards, which are IFRSs issued by the International Accounting Standards Board (IASB). GBEs are defined in IPSAS 1, "Presentation of Financial Statements."

Definitions

- 9. The terms defined in IPSAS 28XX (ED-37) are used in this Standard with the meanings specified in paragraph 9 of IPSAS 28XX (ED-37). IPSAS 28XX (ED-37) defines the following terms:
 - Financial instrument;
 - Financial asset;
 - Financial liability;
 - Equity instrument;and provides guidance on applying those definitions.
- 10. **The following terms are used in this Standard with the meanings specified:**

Definition of a derivative

A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–6) with all three of the following characteristics:

- (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the “underlying”);
- (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- (c) It is settled at a future date.

Definitions of four categories of financial instruments

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

- (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:
 - (i) It is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
 - (ii) On initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - (iii) It is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
- (b) Upon initial recognition it is designated by the entity as at fair value through surplus or deficit. An entity may use this designation only when permitted by paragraph 13 or when doing so results in more relevant information, because either
 - (i) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases; or
 - (ii) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in IPSAS 20, “Related Party

Disclosures”), for example the entity’s governing body and chief executive officer.

In IPSAS ~~30XX (ED 39)~~, paragraphs 11–13 and AG4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through surplus or deficit, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through surplus or deficit is consistent with the entity’s documented risk management or investment strategy.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 48(c) and Appendix A paragraphs AG11~~32~~ and AG11~~43~~), shall not be designated as at fair value through surplus or deficit.

It should be noted that paragraphs 50, 51, 52 and Appendix A paragraphs AG10~~10~~–AG11~~54~~, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG29–AG38) other than:

- (a) Those that the entity upon initial recognition designates as at fair value through surplus or deficit;
- (b) Those that the entity designates as available for sale; and
- (c) Those that meet the definition of loans and receivables.

An entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:

- (a) Are so close to maturity or the financial asset’s call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset’s fair value;
- (b) Occur after the entity has collected substantially all of the financial asset’s original principal through scheduled payments or prepayments; or
- (c) Are attributable to an isolated event that is beyond the entity’s control, is non-recurring and could not have been reasonably anticipated by the entity.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:

- (a) Those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through surplus or deficit;
- (b) Those that the entity upon initial recognition designates as available for sale; or
- (c) Those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through surplus or deficit.

Definition of a financial guarantee contract

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

Definitions relating to recognition and measurement

The amortized cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest revenue or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IPSAS 9, “Revenue from Exchange Transactions”), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected

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

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

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction¹.

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

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG26). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Definitions relating to hedge accounting

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

A **forecast transaction** is an uncommitted but anticipated future transaction.

A **hedging instrument** is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 81–86 and Appendix A paragraphs AG1276–AG13029 elaborate on the definition of a hedging instrument).

A **hedged item** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 87–94 and Appendix A paragraphs AG1310–AG1410 elaborate on the definition of hedged items).

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG1454–AG1565).

Terms defined in other International Public Sector Accounting 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.

¹ Paragraphs 50–52 and AG1010–AG1154 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.

Embedded Derivatives

11. An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that 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 from that instrument, is not an embedded derivative, but a separate financial instrument.
12. **An embedded derivative shall be separated from the host contract 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 contract (see Appendix A paragraphs AG43 and AG46);**
 - (b) **A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and**
 - (c) **The hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in surplus or deficit (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through surplus or deficit is not separated).**

If an embedded derivative is separated, the host contract shall be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative shall be presented separately in the statement of financial position.

13. **Notwithstanding paragraph 12, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through surplus or deficit unless:**
 - (a) **The embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or**
 - (b) **It is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortized cost.**
14. **If an entity is required by this Standard to separate an embedded derivative from its host contract, 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 (combined) contract as at fair value through surplus or deficit. Similarly, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of fair value through surplus or deficit category, that reclassification is prohibited. In such circumstances the hybrid (combined) contract remains classified as at fair value through surplus or deficit in its entirety.

15. If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 14 applies and the hybrid (combined) instrument is designated as at fair value through surplus or deficit.

Recognition and Derecognition

Initial Recognition

16. **An entity shall recognize a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 40 with respect to regular way purchases of financial assets.)**

Derecognition of a Financial Asset

17. In consolidated financial statements, paragraphs 18–25 and Appendix A paragraphs AG49–AG67 are applied at a consolidated level. Hence, an entity first consolidates all controlled entities in accordance with IPSAS 6 and the international or national accounting standard or interpretation dealing with the consolidation of special purpose entities, and then applies paragraphs 18–25 and Appendix A paragraphs AG49–AG67 to the resulting economic entity.
18. **Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 19–25, 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 19–25 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 19–25 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 19–25 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.
- (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 19–25 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 19–25 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 19–25 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 19–28, 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.

19. An entity shall derecognize a financial asset when, and only when:

- (a) The contractual rights to the cash flows from the financial asset expire or are waived; or
- (b) It transfers the financial asset as set out in paragraphs 20 and 21 and the transfer qualifies for derecognition in accordance with paragraph 22.

(See paragraph 40 for regular way sales of financial assets.)

20. 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 21.
- 21. When an entity retains the contractual rights to receive the cash flows of a financial asset (the ‘original asset’), but assumes a contractual obligation to pay those cash flows to one or more entities (the ‘eventual recipients’), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met:
 - (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
 - (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
 - (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IPSAS 2, “Cash Flow Statements”) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.
- 22. When an entity transfers a financial asset (see paragraph 20), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:
 - (a) If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.
 - (b) If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognize the financial asset.
 - (c) If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:
 - (i) If the entity has not retained control, it shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.

- (ii) **If the entity has retained control, it shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 32).**
- 23. The transfer of risks and rewards (see paragraph 22) 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 (for example, 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 (for example, 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 21).
- 24. 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 is 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.
- 25. Whether the entity has retained control (see paragraph 22(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 (see paragraph 22(a) and (c)(i))

- 26. **If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognize either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognized at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognized for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 29.**
- 27. **If, as a result of a transfer, a financial asset is derecognized in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new**

financial liability, or a servicing liability, the entity shall recognize the new financial asset, financial liability or servicing liability at fair value.

28. On derecognition of a financial asset in its entirety, the difference between:

- (a) The carrying amount; and**
- (b) The sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognized directly in net assets/equity (see paragraph 64(b));**

shall be recognized in surplus or deficit.

29. If the transferred asset is part of a larger financial asset (for example, when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 18(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognized. The difference between:

- (a) The carrying amount allocated to the part derecognized; and**
- (b) The sum of (i) the consideration received for the part derecognized (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognized directly in net assets/equity (see paragraph 64(b));**

shall be recognized in surplus or deficit. A cumulative gain or loss that had been recognized in net assets/equity is allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts.

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

Transfers that do not Qualify for Derecognition (see paragraph 22(b))

31. If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognize the transferred asset in its entirety and shall

recognize a financial liability for the consideration received. In subsequent periods, the entity shall recognize any revenue on the transferred asset and any expense incurred on the financial liability.

Continuing Involvement in Transferred Assets (see paragraph 22(c)(ii))

- 32. If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognize the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:**
- (a) When the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ("the guarantee amount").**
 - (b) When the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in 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 AG63).**
 - (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.**
- 33. When an entity continues to recognize an asset to the extent of its continuing involvement, the entity also recognizes an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:**
- (a) The amortized cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortized cost; or**
 - (b) Equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.**

34. The entity shall continue to recognize any revenue arising on the transferred asset to the extent of its continuing involvement and shall recognize any expense incurred on the associated liability.
35. For the purpose of subsequent measurement, recognized changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 64, and shall not be offset.
36. If an entity's continuing involvement is in only a part of a financial asset (for example, when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognize under continuing involvement, and the part it no longer recognizes on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 30 apply. The difference between:
- (a) The carrying amount allocated to the part that is no longer recognized; and
 - (b) The sum of (i) the consideration received for the part no longer recognized and (ii) any cumulative gain or loss allocated to it that had been recognized directly in net assets/equity (see paragraph 64(b));
- shall be recognized in surplus or deficit. A cumulative gain or loss that had been recognized in net assets/equity is allocated between the part that continues to be recognized and the part that is no longer recognized on the basis of the relative fair values of those parts.
37. If the transferred asset is measured at amortized cost, the option in this Standard to designate a financial liability as at fair value through surplus or deficit is not applicable to the associated liability.

All Transfers

38. If a transferred asset continues to be recognized, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any revenue~~income~~ arising from the transferred asset with any expense incurred on the associated liability (see IPSAS ~~28XX (ED-37)~~ paragraph 47).
39. 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 (for example, as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

- (b) If the transferee sells collateral pledged to it, it shall recognize the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.
- (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the transferee shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.
- (d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognize the collateral as an asset.

Regular Way Purchase or Sale of a Financial Asset

- 40. A regular way purchase or sale of financial assets shall be recognized and derecognized, as applicable, using trade date accounting or settlement date accounting (see Appendix A paragraphs AG68–AG71).

Derecognition of a Financial Liability

- 41. 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.
- 42. 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.
- 43. The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognized in surplus or deficit. Where an obligation is waived by the lender or assumed by a third party as part of a non-exchange transaction, an entity applies IPSAS 23.
- 44. If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognized and the part that is derecognized based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognized and (b) the consideration paid, including any non-cash assets

transferred or liabilities assumed, for the part derecognized shall be recognized in surplus or deficit.

Measurement

Initial Measurement of Financial Assets and Financial Liabilities

45. **When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, 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.**
46. When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortized cost, the asset is recognized initially at its fair value on the trade date (see Appendix A paragraphs AG68–AG71).

Subsequent Measurement of Financial Assets

47. For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 10:
 - (a) Financial assets at fair value through surplus or deficit;
 - (b) Held-to-maturity investments;
 - (c) Loans and receivables; and
 - (d) Available-for-sale financial assets.

These categories apply to measurement and surplus or deficit recognition under this Standard. The entity may use other descriptors for these categories or other categorizations when presenting information in the financial statements. The entity shall disclose in the notes the information required by IPSAS ~~30XX (ED 39)~~.

48. **After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:**
 - (a) **Loans and receivables as defined in paragraph 10, which shall be measured at amortized cost using the effective interest method;**
 - (b) **Held-to-maturity investments as defined in paragraph 10, which shall be measured at amortized cost using the effective interest method; and**
 - (c) **Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG11~~32~~ and AG11~~43~~).**

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 99–113. All financial assets

except those measured at fair value through surplus or deficit are subject to review for impairment in accordance with paragraphs 67–79 and Appendix A paragraphs AG11~~76~~–AG12~~65~~.

Subsequent Measurement of Financial Liabilities

49. After initial recognition, an entity shall measure all financial liabilities at amortized cost using the effective interest method, except for:
- (a) Financial liabilities at fair value through surplus or deficit. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.
 - (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 31 and 33 apply to the measurement of such financial liabilities.
 - (c) Financial guarantee contracts as defined in paragraph 10. After initial recognition, an issuer of such a contract shall (unless paragraph 49(a) or (b) applies) measure it at the higher of:
 - (i) The amount determined in accordance with IPSAS 19; and
 - (ii) The amount initially recognized (see paragraph 45) less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.
 - (d) Commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 49(a) applies) measure it at the higher of:
 - (i) The amount determined in accordance with IPSAS 19; and
 - (ii) The amount initially recognized (see paragraph 45) less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 99–113.

Fair Value Measurement Considerations

50. In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, IPSAS ~~28XX (ED 37)~~ or IPSAS ~~30XX (ED 39)~~, an entity shall apply paragraphs AG10~~10~~–AG11~~54~~ of Appendix A.
51. The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation

technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique 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.

52. 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.

Reclassifications

53. **An entity:**

- (a) **Shall not reclassify a derivative out of the fair value through surplus or deficit category while it is held or issued;**
- (b) **Shall not reclassify any financial instrument out of the fair value through surplus or deficit category if upon initial recognition it was designated by the entity as at fair value through surplus or deficit; and**
- (c) **May, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term (notwithstanding that the financial asset may have been acquired or incurred principally for the purpose of selling or repurchasing it in the near term), reclassify that financial asset out of the fair value through surplus or deficit category if the requirements in paragraph 55 or 57 are met.**

An entity shall not reclassify any financial instrument into the fair value through surplus or deficit category after initial recognition.

54. The following changes in circumstances are not reclassifications for the purposes of paragraph 53:
- (a) A derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such; and
 - (b) A derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.

55. A financial asset to which paragraph 53(c) applies (except a financial asset of the type described in paragraph 57) may be reclassified out of the fair value through surplus or deficit category only in rare circumstances.
56. If an entity reclassifies a financial asset out of the fair value through surplus or deficit category in accordance with paragraph [55](#), the financial asset shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognized in surplus or deficit shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable.
57. A financial asset to which paragraph 53(c) applies that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the fair value through surplus or deficit category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.
58. A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available-for-sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.
59. If an entity reclassifies a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 57 or out of the available-for-sale category in accordance with paragraph 58, it shall reclassify the financial asset at its fair value on the date of reclassification. For a financial asset reclassified in accordance with paragraph 57, any gain or loss already recognized in surplus or deficit shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable. For a financial asset reclassified out of the available-for-sale category in accordance with paragraph 58, any previous gain or loss on that asset that has been recognized directly in net assets/equity in accordance with paragraph 64(b) shall be accounted for in accordance with paragraph 63.
60. **If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 64(b).**
61. **Whenever sales or reclassification of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in paragraph 10, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 64(b).**
62. **If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 48(c) and 49), the asset or liability shall be remeasured at fair value, and**

the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 64.

63. If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 48(c) and 49) or because the ‘two preceding financial years’ referred to in paragraph 10 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortized cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortized cost, as applicable. Any previous gain or loss on that asset that has been recognized directly in net assets/equity in accordance with paragraph 64(b) shall be accounted for as follows:
- (a) In the case of a financial asset with a fixed maturity, the gain or loss shall be amortized to surplus or deficit over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortized cost and maturity amount shall also be amortized over the remaining life of the financial asset using the effective interest method, similar to the amortization of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognized directly in net assets/equity is recognized in surplus or deficit in accordance with paragraph 76.
 - (b) In the case of a financial asset that does not have a fixed maturity, the gain or loss shall remain in net assets/equity until the financial asset is sold or otherwise disposed of, when it shall be recognized in surplus or deficit. If the financial asset is subsequently impaired any previous gain or loss that has been recognized directly in net assets/equity is recognized in surplus or deficit in accordance with paragraph 76.

Gains and Losses

64. A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 99–113), shall be recognized, as follows.
- (a) A gain or loss on a financial asset or financial liability classified as at fair value through surplus or deficit shall be recognized in surplus or deficit.
 - (b) A gain or loss on an available-for-sale financial asset shall be recognized directly in net assets/equity through the statement of changes in net assets/equity (see IPSAS 1, “Presentation of Financial Statements”, except for impairment losses (see paragraphs 76–79) and foreign exchange gains and losses (see Appendix A paragraph AG1165), until the financial asset is derecognized, at which time the cumulative gain or loss previously recognized in net assets/equity shall be recognized in surplus or deficit. However, interest calculated using the effective interest method (see paragraph 10) is recognized

in surplus or deficit (see IPSAS 9). Dividends or similar distributions on an available-for-sale equity instrument are recognized in surplus or deficit when the entity's right to receive payment is established (see IPSAS 9).

65. For financial assets and financial liabilities carried at amortized cost (see paragraphs 48 and 49), a gain or loss is recognized in surplus or deficit when the financial asset or financial liability is derecognized or impaired, and through the amortization process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 87–94 and Appendix A paragraphs AG13¹⁰–AG14¹⁰) the accounting for the gain or loss shall follow paragraphs 99–113.
66. If an entity recognizes financial assets using settlement date accounting (see paragraph 40 and Appendix A paragraphs AG68 and AG71), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognized for assets carried at cost or amortized cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognized in surplus or deficit or in net assets/equity, as appropriate under paragraph 64.

Impairment and Uncollectibility of Financial Assets

67. An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 72 (for financial assets carried at amortized cost), paragraph 75 (for financial assets carried at cost) or paragraph 76 (for available-for-sale financial assets) to determine the amount of any impairment loss.
68. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognized. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:
 - (a) Significant financial difficulty of the issuer or obligor;
 - (b) A breach of contract, such as a default or delinquency in interest or principal payments;
 - (c) The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

- (d) It becoming probable that the borrower will enter bankruptcy or other financial reorganization;
 - (e) The disappearance of an active market for that financial asset because of financial difficulties; or
 - (f) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
 - (i) Adverse changes in the payment status of borrowers in the group (for example, an increased number of delayed payments; or
 - (ii) National or local economic conditions that correlate with defaults on the assets in the group (for example, an increase in the unemployment rate in the geographical area of the borrowers, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).
69. The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortized cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).
70. In addition to the types of events in paragraph 68, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.
71. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgment to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgment to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG1224). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Financial Assets Carried at Amortized Cost

72. **If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognized in surplus or deficit.**
73. An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 68). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.
74. **If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the previously recognized impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal shall be recognized in surplus or deficit.**

Financial Assets Carried at Cost

75. **If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 48(c) and Appendix A paragraphs AG11³² and AG11⁴³). Such impairment losses shall not be reversed.**

Available-For-Sale Financial Assets

76. **When a decline in the fair value of an available-for-sale financial asset has been recognized directly in net assets/equity and there is objective evidence that the asset**

is impaired (see paragraph 68), the cumulative loss that had been recognized directly in net assets/equity shall be removed from net assets/equity and recognized in surplus or deficit even though the financial asset has not been derecognized.

77. The amount of the cumulative loss that is removed from net assets/equity and recognized in surplus or deficit under paragraph 76 shall be the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss on that financial asset previously recognized in surplus or deficit.
78. Impairment losses recognized in surplus or deficit for an investment in an equity instrument classified as available for sale shall not be reversed through surplus or deficit.
79. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in surplus or deficit, the impairment loss shall be reversed, with the amount of the reversal recognized in surplus or deficit.

Hedging

80. If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 95–98 and Appendix A paragraphs AG1421–AG1443, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 99–113.

Hedging Instruments

Qualifying Instruments

81. This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 98 are met, except for some written options (see Appendix A paragraph AG1276). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.
82. For hedge accounting purposes, only instruments that involve 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. Although individual entities within an economic entity or divisions within an entity may enter into hedging transactions with other entities within the economic entity or divisions within the entity, any such transactions within the economic entity are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the economic entity. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the economic entity provided that they are external to the individual entity that is being reported on.

Designation of Hedging Instruments

83. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. 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 excluding change in its time value; and
 - (b) Separating the interest element and the spot price of a forward contract.

These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately. A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

84. A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.
85. A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.
86. Two or more derivatives, or proportions of them (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

Hedged Items

Qualifying Items

87. A hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk

only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

88. Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.
89. For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that 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. As an exception, the foreign currency risk of monetary item within an economic entity (for example, a payable/receivable between two controlled entities) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IPSAS 4, “The Effects of Changes in Foreign Exchange Rates”. In accordance with IPSAS 4, foreign exchange rate gains and losses on monetary items within an economic entity are not fully eliminated on consolidation when the monetary item is transacted between two entities within the economic entity that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated surplus or deficit.

Designation of Financial Items as Hedged Items

90. If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).
91. In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (for example, an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and

liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Designation of Non-Financial Items as Hedged Items

92. **If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.**

Designation of Groups of Items as Hedged Items

93. Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.
94. Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (for example, the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

Hedge Accounting

95. Hedge accounting recognizes the offsetting effects on surplus or deficit of changes in the fair values of the hedging instrument and the hedged item.
96. **Hedging relationships are of three types:**
 - (a) ***Fair value hedge:* a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, 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 (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect surplus or deficit.
 - (c) *Hedge of a net investment in a foreign operation* as defined in IPSAS 4.
97. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.
98. A hedging relationship qualifies for hedge accounting under paragraphs 99–113 if, and only if, all of the following conditions are met.
- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
 - (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG14~~54~~⁵⁵–AG15~~65~~⁶⁶) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
 - (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect surplus or deficit.
 - (d) The effectiveness of the hedge can be reliably measured, i.e. the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 48 and 49 and Appendix A paragraphs AG11~~32~~³³ and AG11~~43~~⁴⁴ for guidance on determining fair value).
 - (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Fair Value Hedges

99. If a fair value hedge meets the conditions in paragraph 98 during the period, it shall be accounted for as follows:
- (a) The gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with IPSAS 4 (for a non-derivative hedging instrument) shall be recognized in surplus or deficit; and

- (b) **The gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized in surplus or deficit. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in surplus or deficit applies if the hedged item is an available-for-sale financial asset.**
- 100. For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 99(b) may be met by presenting the gain or loss attributable to the hedged item either:
 - (a) In a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or
 - (b) In a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

The separate line items referred to in (a) and (b) above shall be presented next to financial assets or financial liabilities. Amounts included in these line items shall be removed from the statement of financial position when the assets or liabilities to which they relate are derecognized.
- 101. If only particular risks attributable to a hedged item are hedged, recognized changes in the fair value of the hedged item unrelated to the hedged risk are recognized as set out in paragraph 64.
- 102. **An entity shall discontinue prospectively the hedge accounting specified in paragraph 99 if:**
 - (a) **The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy);**
 - (b) **The hedge no longer meets the criteria for hedge accounting in paragraph 98; or**
 - (c) **The entity revokes the designation.**
- 103. **Any adjustment arising from paragraph 99(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used (or, in the case of a portfolio hedge of interest rate risk, to the separate line item in the statement of financial position described in paragraph 100) shall be amortized to surplus or deficit. Amortization may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortization begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortizing using a recalculated effective interest rate is not practicable, the adjustment shall be amortized using a**

straight-line method. The adjustment shall be amortized fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

104. When an unrecognized firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognized as an asset or liability with a corresponding gain or loss recognized in surplus or deficit (see paragraph 99(b)). The changes in the fair value of the hedging instrument are also recognized in surplus or deficit.
105. When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognized in the statement of financial position.

Cash Flow Hedges

106. **If a cash flow hedge meets the conditions in paragraph 98 during the period, it shall be accounted for as follows:**
 - (a) **The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) shall be recognized directly in net assets/equity through the statement of changes in net assets/equity; and**
 - (b) **The ineffective portion of the gain or loss on the hedging instrument shall be recognized in surplus or deficit.**
107. More specifically, a cash flow hedge is accounted for as follows:
 - (a) The separate component of net assets/equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
 - (i) The cumulative gain or loss on the hedging instrument from inception of the hedge; and
 - (ii) The cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;
 - (b) Any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognized in surplus or deficit; and
 - (c) If an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 83, 84 and 98(a)), that excluded component of gain or loss is recognized in accordance with paragraph 64.
108. **If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognized directly in net assets/equity in accordance with paragraph 106 shall be**

reclassified into surplus or deficit in the same period or periods during which the hedged forecast ~~cash flow~~~~transaction~~ affects surplus or deficit (such as in the periods that interest revenue or interest expense is recognized). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify into surplus or deficit the amount that is not expected to be recovered.

109. If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:
 - (a) It reclassifies the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106 into surplus or deficit in the same period or periods during which the asset acquired or liability assumed affects surplus or deficit (such as in the periods that depreciation or inventories are recognized as an expense). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify from net assets/equity into surplus or deficit the amount that is not expected to be recovered.
 - (b) It removes the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106, and includes them in the initial cost or other carrying amount of the asset or liability.
110. An entity shall adopt either (a) or (b) in paragraph 109 as its accounting policy and shall apply it consistently to all hedges to which paragraph 109 relates.
111. For cash flow hedges other than those covered by paragraphs 108 and 109, amounts that had been recognized directly in net assets/equity shall be recognized in surplus or deficit in the same period or periods during which the hedged forecast cash flows affects surplus or deficit (for example, when a forecast sale occurs).
112. In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 106–111:
 - (a) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109 or 111 applies.
 - (b) The hedge no longer meets the criteria for hedge accounting in paragraph 98. In this case, the cumulative gain or loss on the hedging instrument that

remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109 or 111 applies.

- (c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that has been recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall be recognized in surplus or deficit. A forecast transaction that is no longer highly probable (see paragraph 98(c)) may still be expected to occur.
- (d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 108, 109 or 111 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized directly in net assets/equity shall be recognized in surplus or deficit.

Hedges of a Net Investment

113. Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IPSAS 4), shall be accounted for similarly to cash flow hedges:
- (a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) shall be recognized directly in net assets/equity through the statement of changes in net assets/equity (see IPSAS 1); and
 - (b) The ineffective portion shall be recognized in surplus or deficit.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognized directly in net assets/equity shall be recognized in surplus or deficit in accordance with paragraphs 56–57 of IPSAS 4 on disposal of the foreign operation.

Transitional Provisions

114. This Standard shall be applied retrospectively except as specified in paragraphs 115–123. The opening balance of accumulated surplus or deficit for the earliest prior period presented and all other comparative amounts shall be adjusted as if this Standard had always been in use unless restating the information would be impracticable. If restatement is impracticable, the entity shall disclose that fact and indicate the extent to which the information was restated.

115. When this Standard is first applied, an entity is permitted to designate a financial asset, including those that may have been recognized previously, as available for sale. For any such financial asset the entity shall recognize all cumulative changes in fair value in a separate component of net assets/equity until subsequent derecognition or impairment, when the entity shall transfer that cumulative gain or loss to surplus or deficit. For financial assets that were previously recognized, the entity shall also:
- (a) Restate the financial asset using the new designation in the comparative financial statements; and
 - (b) Disclose the fair value of the financial assets at the date of designation and their classification and carrying amount in the previous financial statements.
116. When this Standard is first applied, an entity is permitted to designate a financial asset or a financial liability, including those that may have been recognized previously, at fair value through surplus or deficit that meet the criteria for designation in paragraphs 10, 13, 14, 15, 51, AG7–AG16, AG47 and AG48. Where an entity previously recognized financial assets and financial liabilities, the following apply:
- (a) Notwithstanding paragraph 111, any financial assets and financial liabilities designated as at fair value through surplus or deficit in accordance with this subparagraph that were previously designated as the hedged item in fair value hedge accounting relationships shall be de-designated from those relationships at the same time they are designated as at fair value through surplus or deficit.
 - (b) Shall disclose the fair value of any financial assets or financial liabilities designated in accordance with subparagraph (a) at the date of designation and their classification and carrying amount in the previous financial statements.
 - (c) Shall de-designate any financial asset or financial liability previously designated as at fair value through surplus or deficit if it does not qualify for such designation in accordance with those paragraphs. When a financial asset or financial liability will be measured at amortized cost after de-designation, the date of de-designation is deemed to be its date of initial recognition.
 - (d) Shall disclose the fair value of any financial assets or financial liabilities de-designated in accordance with subparagraph (c) at the date of de-designation and their new classifications.
117. An entity shall restate its comparative financial statements using the new designations in paragraph 116 provided that, in the case of a financial asset, financial liability, or group of financial assets, financial liabilities or both, designated as at fair value through surplus or deficit, those items or groups would have met the criteria in paragraph 10(b)(i), 10(b)(ii) or 13 at the beginning of the comparative period or, if acquired after the beginning of the comparative period, would have met the criteria in paragraph 10(b)(i), 10(b)(ii) or 13 at the date of initial recognition.

118. Except as permitted by paragraph 119, an entity shall apply the derecognition requirements in paragraphs 17–39 and Appendix A paragraphs AG51–AG67 prospectively. If an entity derecognized financial assets under another basis of accounting as a result of a transaction that occurred before the adoption of this Standard and those assets would not have been derecognized under this Standard, it shall not recognize those assets.
119. Notwithstanding paragraph 118, an entity may apply the derecognition requirements in paragraphs 17–39 and Appendix A paragraphs AG51–AG67 retrospectively from a date of the entity's choosing, provided that the information needed to apply this Standard to assets and liabilities derecognized as a result of past transactions was obtained at the time of initially accounting for those transactions.
120. Notwithstanding paragraph 114, an entity may apply the requirements in the last sentence of paragraph AG10~~87~~, and paragraph AG10~~98~~, in either of the following ways:
- (a) Prospectively to transactions entered into after the adoption of this Standard; or
 - (b) Retrospectively from a date of the entity's choosing, provided that the information needed to apply this Standard to assets and liabilities as a result of past transactions was obtained at the time of initially accounting for those transactions.
121. An entity shall not adjust the carrying amount of non-financial assets and non-financial liabilities to exclude gains and losses related to cash flow hedges that were included in the carrying amount before the beginning of the financial year in which this Standard is first applied. At the beginning of the financial period in which this Standard is first applied, any amount recognized directly in net assets/equity) for a hedge of a firm commitment that under this Standard is accounted for as a fair value hedge shall be reclassified as an asset or liability, except for a hedge of foreign currency risk that continues to be treated as a cash flow hedge.
122. If an entity has designated as the hedged item an external forecast transaction that:
- (a) Is denominated in the functional currency of the entity entering into the transaction;
 - (b) Gives rise to an exposure that will have an effect on consolidated surplus or deficit (i.e. is denominated in a currency other than the economic entity's presentation currency); and
 - (c) Would have qualified for hedge accounting had it not been denominated in the functional currency of the entity entering into it;
- it may apply hedge accounting in the consolidated financial statements in the period(s) before the date of first application of this:

123. An entity need not apply paragraph AG13~~43~~ to comparative information relating to periods before the date of application of the last sentence of paragraph 89 and paragraph AG13~~32~~.

Effective Date

124. An entity shall apply this ~~International Public Sector Accounting~~ Standard for annual financial statements covering periods beginning on or after April 1, 2013. Earlier application is encouraged. If an entity ~~adopts~~ applies this Standard for a period beginning before April 1, 2013, it shall disclose that fact.
125. An entity shall not apply this ~~International Public Sector Accounting~~ Standard before April 1, 2013, unless it also applies IPSAS ~~28XX (ED-37)~~ and IPSAS ~~30XX (ED-39)~~.
126. When an entity adopts the accrual basis of accounting, as defined by IPSASs, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Appendix A

Application Guidance

This appendix is an integral part of IPSAS 29.

Scope (paragraphs 2–8)

- AG1. This Standard does not change the requirements relating to employee benefit plans that comply with the international or national accounting standard on accounting and reporting by retirement benefit plans and royalty agreements based on the volume of sales or service revenues that are accounted for under IPSAS 9.

Investments in Controlled Entities, Associates and Joint Ventures

- AG2. Sometimes, an entity makes what it views as a “strategic investment” in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor entity uses IPSAS 7 to determine whether the equity method of accounting is appropriate for such an investment. Similarly, the investor entity uses IPSAS 8 to determine whether proportionate consolidation or the equity method is appropriate for such an investment. If neither the equity method nor proportionate consolidation is appropriate, the entity applies this Standard to that strategic investment.

Insurance Contracts

- AG3. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise from insurance contracts. An entity does however apply this Standard to:

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

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

- AG4. 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 of financial instruments using IPSAS 28 if the issuer has previously asserted explicitly that it regards financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply

either this Standard or the international or national accounting standard on insurance contracts to such financial guarantee contracts. If this Standard applies paragraph 45 requires the issuer to recognize a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through surplus or deficit or unless paragraphs 31–39 and AG62–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 IPSAS 19; and
 - (ii) The amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9 (see paragraph 49(c)).
- (b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts. Such guarantees are derivatives and the issuer applies this Standard to them.
- (c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies IPSAS 9 in determining when it recognizes the revenue from the guarantee and from the sale of goods.

AG5. 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.

Rights and Obligations Arising from Non-Exchange Revenue Transactions

AG6. Rights and obligations (assets and liabilities) may arise from non-exchange revenue transactions, for example, an entity may receive cash from a multi-lateral agency to perform certain activities. Where the performance of those activities is subject to conditions, an asset and a liability is recognized simultaneously. Where the asset is a financial asset, it is recognized in accordance with IPSAS 23, and initially measured in accordance with IPSAS 23 and this IPSAS. A liability that is initially recognized as a result of conditions imposed on the use of an asset is outside the scope of this IPSAS and is dealt with in IPSAS 23. After initial recognition, if circumstances indicate that recognition of a liability in accordance with IPSAS 23 is no longer appropriate, an entity considers whether a financial liability should be recognized in accordance with this IPSAS. Other liabilities that may arise from non-exchange revenue transactions are recognized and measured in accordance with this IPSAS if they meet the definition of a financial liability in IPSAS 28.

Definitions (paragraphs 9 and 10)

Designation as at Fair Value through Surplus or Deficit

AG7. Paragraph 10 of 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.

AG8. 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 17(b) of IPSAS 3, “Accounting Policies, Changes in Accounting Estimates and Errors” requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity’s financial position, financial performance or cash flows. In the case of designation as at fair value through surplus or deficit, paragraph 10 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 10, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Paragraph 10(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise

AG9. Under IPSAS 29, measurement of a financial asset or financial liability and classification of recognized changes in its value are determined by the item’s classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) when, for example, in the absence of designation as at fair value through surplus or deficit, a financial asset would be classified as available for sale (with most changes in fair value recognized directly in net assets/equity) and a liability the entity considers related would be measured at amortized cost (with changes in fair value not recognized). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through surplus or deficit.

AG10. 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 10(b)(i).

- (a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realized and/or unrealized investment returns of a specified pool of the insurer’s assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through surplus or deficit means that

changes in the fair value of the financial assets are recognized in surplus or deficit in the same period as related changes in the value of the liabilities.

- (b) An entity has liabilities under insurance contracts whose measurement incorporates current information, and financial assets it considers related that would otherwise be classified as available for sale or measured at amortized cost.
- (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. However, only some of the instruments would be measured at fair value through surplus or deficit (i.e. are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 98 are not met.
- (d) 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 the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:
 - (i) The entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale with fixed rate debentures whose changes in fair value tend to offset each other. Reporting both the assets and the debentures at fair value through surplus or deficit corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes reported in net assets/equity and the debentures at amortized cost.
 - (ii) 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 recognition of gains and losses that would otherwise result from measuring them both at amortized cost and recognizing a gain or loss each time a bond is repurchased.

AG11. 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.

AG12. 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 CU100² 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.

Paragraph 10(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy

- AG13. An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both 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, rather than on the nature of its financial instruments.
- AG14. 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 10(b)(ii).
- (a) The entity is a venture capital organization, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest, dividends or similar distributions and changes in fair value. IPSAS 7 and IPSAS 8 allow such investments to be excluded from their scope provided they are measured at fair value through surplus or deficit. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of IPSAS 7 or IPSAS 8.
 - (b) 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. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.
 - (c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio

² In this Standard, monetary amounts are denominated in “currency units” (CU).

so as to maximize its total return (i.e. interest, dividends or similar distributions and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, net assets/equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 10(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 10(b)(ii) may be met when the insurer's objective is to maximize total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realized in a shorter period (e.g. a year) or are subject to the insurer's discretion.

- AG15. 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 instruments as at fair value through surplus or deficit on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.
- AG16. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 10(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system within an entity as approved by the entity's key management personnel—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 10(b)(ii).

Effective Interest Rate

- AG17. In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.
- AG18. When applying the effective interest method, an entity generally amortizes any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the 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 instrument. In such a case, the appropriate amortization period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortized to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortized over the expected life of the instrument.

- AG19. For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.
- AG20. If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 103. The adjustment is recognized in surplus or deficit as revenue or expense. If a financial asset is reclassified in accordance with paragraph 55, 57 or 58, and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognized as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

Derivatives

- AG21. 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 CU1,000³ 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.
- AG22. 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 (see paragraphs 4-6).
- AG23. 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

³ In this Standard, monetary amounts are denominated in "currency units" (CU).

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.

- AG24. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognized as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 40 and AG68–AG71).
- AG25. 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.

Transaction Costs

- AG26. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Financial Assets and Financial Liabilities Held for Trading

- AG27. 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.
- AG28. Financial liabilities held for trading include:
- (a) Derivative liabilities that are not accounted for as hedging instruments;
 - (b) Obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);
 - (c) Financial liabilities that are incurred with an intention to repurchase them in the near term (e.g. a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
 - (d) Financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-

term profit-taking.

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

Held-to-Maturity Investments

- AG29. An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:
- (a) The entity intends to hold the financial asset for an undefined period;
 - (b) The entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or
 - (c) The issuer has a right to settle the financial asset at an amount significantly below its amortized cost.
- AG30. A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.
- AG31. The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalized transaction costs in determining whether the carrying amount would be substantially recovered.
- AG32. A financial asset that is puttable (i.e. the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.
- AG33. For most financial assets, fair value is a more appropriate measure than amortized cost.

The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 10 precludes the use of the exception for a reasonable period of time.

- AG34. A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.
- AG35. Sales before maturity could satisfy the condition in paragraph 10—and therefore not raise a question about the entity's intention to hold other investments to maturity—if they are attributable to any of the following:
- (a) A significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 67 and 68), the deterioration in creditworthiness is often regarded as significant.
 - (b) A change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest revenue).
 - (c) A major entity combination or major disposition (such as a sale of a segment that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the entity combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).
 - (d) A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment.
 - (e) A significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.
 - (f) A significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.
- AG36. An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

- (a) It does not have the financial resources available to continue to finance the investment until maturity; or
- (b) It is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity—see paragraph AG31)

AG37. Circumstances other than those described in paragraphs AG29–AG36 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

AG38. An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognized, but also at the end of each subsequent reporting period.

Loans and Receivables

AG39. Any non-derivative financial asset with fixed or determinable payments (including loan assets, receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph AG103) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 10 and AG29–AG38). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through surplus or deficit, or available for sale.

Embedded Derivatives (paragraphs 11–13)

AG40. 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 characteristics of the net assets/equity 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.

AG41. 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.

AG42. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity instruments (see IPSAS 28) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument 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.

AG43. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 12(a)) in the following examples. In these examples, assuming the conditions in paragraph 12(b) and (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) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under IPSAS 27, in which case it is excluded from the scope of this Standard).
- (c) 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.
- (d) 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.
- (e) 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 oil)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under IPSAS 27).
- (g) 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 the option's exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument or the carrying amount of the host insurance contract. From the

perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the element of net assets/equity under IPSAS 28.

- (h) 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.

AG44. An example of a hybrid instrument 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 12 because the host contract is a debt instrument under paragraph AG40 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG43(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.

AG45. 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 combined instrument 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.

AG46. 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 combined instrument can be settled in such a way that the holder would not recover substantially all of its recognized investment or the embedded derivative could at least double the holder’s initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.
- (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly,

provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

- (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g. a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because IPSAS 4 requires foreign currency gains and losses on monetary items to be recognized in surplus or deficit.
- (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
 - (i) The functional currency of any substantial party to that contract;
 - (ii) The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
 - (iii) A currency that is commonly used in contracts to purchase or sell non financial items in the economic environment in which the transaction takes place (e.g. a relatively stable and liquid currency that is commonly used in local 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) contingent rentals based on related sales or (iii) contingent rentals 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

- AG47. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 12 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 instrument to be designated as at fair value through surplus or deficit.
- AG48. Such designation may be used whether paragraph 12 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 13 would not justify designating the hybrid (combined) instrument as at fair value through surplus or deficit in the cases set out in paragraph 12(a) and (b) because doing so would not reduce complexity or increase reliability.

Recognition and Derecognition (paragraphs 16–44)

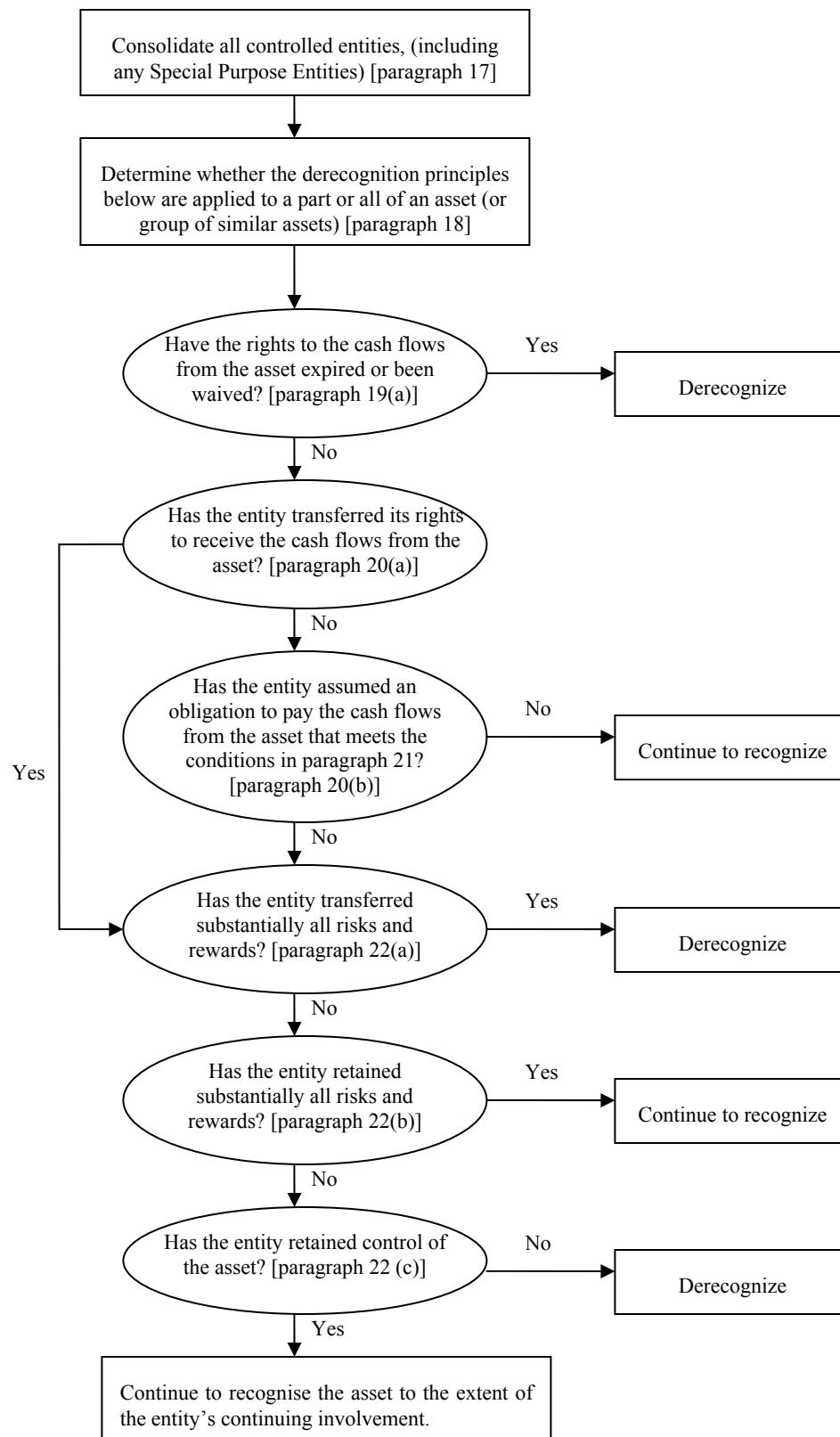
Initial Recognition (paragraph 16)

- AG49. As a consequence of the principle in paragraph 16, an entity recognizes all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG64). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset (see paragraph AG65).
- AG50. The following are examples of applying the principle in paragraph 16:
- (a) Unconditional receivables and payables are recognized as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
 - (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognized until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognize an asset (and the entity that places the order does not recognize a liability) at the time of the commitment but, rather, 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 under paragraphs 4–6, its net fair value is recognized as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognized firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognized as an asset or liability after the inception of the hedge (see paragraphs 104 and 105).

- (c) A forward contract that is within the scope of this Standard (see paragraphs 2–6) is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognized as an asset or liability.
- (d) Option contracts that are within the scope of this Standard (see paragraphs 2–6) are recognized as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

Derecognition of a Financial Asset (paragraphs 17–39)

AG51. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognized.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 20(b))

AG52. The situation described in paragraph 20(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 special purpose entity (SPE) or 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 21 and 22 are met.

AG53. In applying paragraph 21, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated SPE 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 22)

AG54. 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).

AG55. 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.

AG56. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognize the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the Transfer of Control

- AG57. 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.
- AG58. 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).
- AG59. 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

- AG60. 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 29, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognized and the part that continues to be recognized. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognized at fair value.

- AG61. In estimating the fair values of the part that continues to be recognized and the part that is derecognized for the purposes of applying paragraph 29, an entity applies the fair value measurement requirements in paragraphs 50–52 and AG101–AG115 in addition to paragraph 30.

Transfers that do not Qualify for Derecognition

- AG62. The following is an application of the principle outlined in paragraph 31. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognized because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognized in its entirety and the consideration received is recognized as a liability.

Continuing Involvement in Transferred Assets

- AG63. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 32.

All assets

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

Assets measured at amortized cost

- (b) If a put option obligation written by an entity or call option right held by an entity

prevents a transferred asset from being derecognized and the entity measures the transferred asset at amortized cost, the associated liability is measured at its cost (i.e. the consideration received) adjusted for the amortization of any difference between that cost and the amortized cost of the transferred asset at the expiration date of the option. For example, assume that the amortized cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortized cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognized in surplus or deficit using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognized in surplus or deficit.

Assets measured at fair value

- (c) If a call option right retained by an entity prevents a transferred asset from being derecognized and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (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 derecognized and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price).

If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognized and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and

the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognizes an asset of CU100 (the fair value of the asset) and a liability of CU96 $[(CU100 + CU1) - CU5]$. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

All Transfers

- AG64. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognizing both the derivative and either the transferred asset or the liability arising from the transfer would result in recognizing the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognized as a derivative asset.
- AG65. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset. The transferee derecognizes the cash or other consideration paid and recognizes a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

Examples

- AG66. The following examples illustrate the application of the derecognition principles of this Standard.
- (a) *Repurchase agreements and securities lending.* If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its statement of financial position, for example, as a loaned asset or repurchase receivable.
 - (b) *Repurchase agreements and securities lending—assets that are substantially the same.* If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognized

because the transferor retains substantially all the risks and rewards of ownership.

- (c) *Repurchase agreements and securities lending—right of substitution.* If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognized because the transferor retains substantially all the risks and rewards of ownership.
- (d) *Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognizes the asset because it has transferred substantially all the risks and rewards of ownership.
- (e) *Wash sale transaction.* The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognized.
- (f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognized. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.* If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognized. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) *A not readily obtainable asset subject to a put option written by an entity that is*

neither deeply in the money nor deeply out of the money. If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognized to the extent of the transferor's continuing involvement (see paragraph AG64). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognized.

- (j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
- (k) *Cash settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG59 and (g), (h) and (i) above).
- (l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.
- (m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of

the amount of the assets that is subject to the call option.

- (n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
- (o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
- (p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) *Amortizing interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortizing interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortizes so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognize all of the transferred asset or continues to recognize the transferred asset to the extent of its continuing involvement. Conversely, if the amortization of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

AG67. 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 amortized cost is CU10,000. It enters into a transaction in which, in return for a payment of CU9,115, the transferee obtains the right to CU9,000 of any collections of principal plus interest thereon at 9.5 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 per cent \times 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 30 as follows:

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

The entity computes its gain or loss on the sale of the 90 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 recognizes the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognizes an asset of CU1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of CU1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, i.e. CU1,000 plus the fair value of the subordination of CU65). The entity uses all of the above information to account for the transaction as follows:

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

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

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

Regular Way Purchase or Sale of a Financial Asset (paragraph 40)

- AG68. A regular way purchase or sale of financial assets is recognized using either trade date accounting or settlement date accounting as described in paragraphs AG70 and AG71. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraph 10. For this purpose assets that are held for trading form a separate category from assets designated at fair value through surplus or deficit.
- AG69. 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.
- AG70. 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.
- AG71. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognized for assets carried at cost or amortized cost; it is recognized in surplus or deficit for assets classified as financial assets at fair value through surplus or deficit; and it is recognized in net assets/equity for assets classified as available for sale.

Derecognition of a Financial Liability (paragraphs 41–44)

- AG72. 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.)
- AG73. 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.
- AG74. 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.

- AG75. If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognize the debt obligation unless the condition in paragraph AG72(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognizes a new debt obligation to the third party.
- AG76. If a third party assumes an obligation of an entity, and the entity provides either no or only nominal consideration to that third party in return, an entity applies the derecognition requirements of this Standard as well as paragraphs 84 to 87 of IPSAS 23.
- AG77. Lenders will sometimes waive their right to collect debt owed by a public sector entity, for example, a national government may cancel a loan owed by a local government. This waiver of debt would constitute a legal release of the debt owing by the borrower to the lender. Where an entity's obligations have been waived as part of a non-exchange transaction it applies the derecognition requirements of this Standard as well as paragraphs 84 to 87 of IPSAS 23.
- AG78. Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognize a new liability if the derecognition criteria in paragraphs 17–39 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognized, and the entity recognizes a new liability relating to the transferred assets.
- AG79. For the purpose of paragraph 42, 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 recognized as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.
- AG80. 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 this circumstance the debtor:
- (a) Recognizes a new financial liability based on the fair value of its obligation for the guarantee; and
 - (b) Recognizes a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Measurement (paragraphs 45–86)

Non-Exchange Revenue Transactions

AG81. The initial recognition and measurement of assets and liabilities resulting from non-exchange revenue transactions is dealt with in IPSAS 23. Assets resulting from non-exchange revenue transactions can arise out of both contractual and non-contractual arrangements (see IPSAS 28 paragraphs AG20 and AG21). Where these assets arise out of contractual arrangements and otherwise meet the definition of a financial instrument, they are:

- (a) Initially recognised in accordance with IPSAS 23;
- (b) Initially measured:
 - (i) at fair value using the principles in IPSAS 23; and
 - (ii) taking account of transaction costs that are directly attributable to the acquisition of the financial asset in accordance with paragraph 45 of this IPSAS, where the asset is subsequently measured other than at fair value through surplus or deficit.

(See paragraphs IE46 to IE50 accompanying this Standard.)

Initial Measurement of Financial Assets and Financial Liabilities (paragraph 45)

AG82. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also paragraph AG108). 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 AG106–AG112). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated 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.

AG83. 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 up-front fee as compensation, the entity recognizes the loan at its fair value, i.e. net of the fee it receives. The entity accretes the discount to surplus or deficit using the effective interest rate method.

Concessionary Loans

AG84. Concessionary loans are granted to or received by an entity at below market terms. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education and housing loans granted to low income families. Entities may

receive concessionary loans, for example, from development agencies and other government entities.

- AG85. 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.
- AG86. 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 IPSAS 29.
- AG87. As concessionary loans are granted or received at below market terms, the transaction price on initial recognition of the loan may not be its fair value. At initial recognition, an entity therefore analyzes the substance of the loan granted or received into its component parts, and accounts for those components using the principles in paragraphs AG88 and AG89 below.
- AG88. An entity firstly assesses whether the substance of the concessionary loan is in fact a loan, a grant, a contribution from owners or a combination thereof, by applying the principles in IPSAS 28 and paragraphs 42 to 58 of IPSAS 23. If an entity has determined that the transaction, or part of the transaction, is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition. An entity determines the fair value of the loan by using the principles in AG101 to AG115. 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 AG82).
- AG89. Any difference between the fair value of the loan and the transaction price (the loan proceeds) is treated as follows:
- (a) Where the loan is received by an entity, the difference is accounted for in accordance with IPSAS 23.
 - (b) Where the loan is granted by an entity, the difference is treated as an expense in surplus or deficit at initial recognition, except where the loan is deemed to be a transaction with owners, in their capacity as owners. Where the loan is deemed to be a transaction with owners, for example, where a controlling entity provides a concessionary loan to a controlled entity, the difference may represent a capital contribution, i.e. an investment in an entity, rather than an expense.

Illustrative examples are provided in paragraph IG54 of IPSAS 23 as well as paragraphs IE40 to IE41 accompanying this Standard.

- AG90. After initial recognition, an entity subsequently measures concessionary loans using the categories of financial instruments defined in paragraph 10.

Non-Exchange Revenue Transactions

- AG91. The initial recognition and measurement of assets and liabilities resulting from non-exchange revenue transactions is dealt with in IPSAS 23. Assets resulting from non-exchange revenue transactions can arise out of both contractual and non-contractual arrangements (see IPSAS 28 paragraphs AG20 and AG21). Where these assets arise out of contractual arrangements and otherwise meet the definition of a financial instrument, they are:
- (a) Initially recognised in accordance with IPSAS 23;
 - (c) Initially measured:
 - (i) at fair value using the principles in IPSAS 23; and
 - (ii) taking account of transaction costs that are directly attributable to the acquisition of the financial asset in accordance with paragraph 45 of this IPSAS, where the asset is subsequently measured other than at fair value through surplus or deficit

(See illustrative example 6.)

Valuing Financial Guarantees Issued Through a Non-Exchange Transaction

- AG92. Only contractual financial guarantees (or guarantees that are in substance, contractual) are within the scope of this Standard (See AG3 and AG4 of IPSAS 28). Non-contractual guarantees are not within the scope of this Standard as they do not meet the definition of a financial instrument. This IPSAS prescribes recognition and measurement requirements only for the issuer of financial guarantee contracts.
- AG93. In paragraph 10 a “financial guarantee contract” is defined as “a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.” Under the requirements of this Standard, financial guarantee contracts, like other financial assets and financial liabilities, are required to be initially recognized at fair value. Paragraphs 50-52 of this Standard provide commentary and guidance on determining fair value and this is complemented by Application Guidance in paragraphs AG101-AG115. Subsequent measurement for financial guarantee contracts is at the higher of the amount determined in accordance with IPSAS 19, “Provisions, Contingent Liabilities and Contingent Assets” and the amount initially recognized less, when appropriate, cumulative amortization in accordance with IPSAS 9, “Revenue from Exchange Transactions.”

- AG94. In the public sector, guarantees are frequently provided by way of non-exchange transactions, i.e. at no or nominal consideration. This type of guarantee is provided generally to further the entity's economic and social objectives. Such purposes include supporting infrastructure projects, supporting corporate entities at times of economic distress, guaranteeing the bond issues of entities in other tiers of governments and the loans of employees to finance motor vehicles that are to be used for performance of their duties as employees. Where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an exchange transaction and whether the consideration represents a fair value. If the consideration does represent a fair value, entities should recognize the financial guarantee at the amount of the consideration. Subsequent measurement should be at the higher of the amount determined in accordance with IPSAS 19 and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9. Where the entity concludes that the consideration is not a fair value, an entity determines the carrying value at initial recognition in the same way as if no consideration had been paid.
- AG95. 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
- AG96. Where there is no active market for a directly equivalent guarantee contract; the entity considers whether a valuation technique other than observation of an active market is available and provides a reliable measure of fair value. Such a valuation technique may rely on mathematical models which consider financial risk. For example, National Government W guarantees a bond issue of Municipality X. As Municipality X has a government guarantee backing its bond issue, its bonds have a lower coupon than if they were not secured by a government guarantee. This is because the guarantee lowers the risk profile of the bonds for investors. The guarantee fee could be determined by using the credit spread between what the coupon rate would have been had the issue not been backed by a government guarantee and the rate with the guarantee in place. Where a fair value is obtainable either by observation of an active market or through

another valuation technique the entity recognizes the financial guarantee at that fair value in the statement of financial position and recognizes an expense of an equivalent amount in the statement of financial performance. When using a valuation technique that is not based on observation of an active market an entity needs to satisfy itself that the output of any model is reliable and understandable.

- AG97. If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition. The entity assesses whether a present obligation has arisen as a result of a past event related to a financial guarantee contract whether it is probable that such a present obligation will result in a cash outflow in accordance with the terms of the contract and whether a reliable estimate can be made of the outflow. It is possible, that a present obligation related to a financial guarantee contract will arise at initial recognition where, for example, an entity enters into a financial guarantee contract to guarantee loans to a large number of small enterprises and, based on past experience, is aware that a high proportion of these enterprises will default.

Subsequent Measurement of Financial Assets (paragraphs 47 and 48)

- AG98. If a financial instrument that was previously recognized as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 49.
- AG99. The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognized at CU102. The end of the reporting period occurs 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 asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognized in net assets/equity. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortized to surplus or deficit using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognized in surplus or deficit when the asset is derecognized or becomes impaired.
- AG100. Instruments that are classified as loans and receivables are measured at amortized cost without regard to the entity's intention to hold them to maturity.

Fair Value Measurement Considerations (paragraphs 50–52)

- AG101. 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.

- AG102. 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

- AG103. 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.
- AG104. 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.
- AG105. 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

- AG106. 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.
- AG107. 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.
- AG108. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition, in an exchange transaction, is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.
- AG109. The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. The application of paragraph AG108 may result in no gain or loss being recognized on the initial recognition of a financial asset or financial liability. In such a case, IPSAS 29 requires that a gain or loss shall be recognized after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.
- AG110. 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.

- AG111. 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.
- AG112. In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

No Active Market: Equity Instruments

- AG113. The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 48(c) and 49) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
- AG114. There are many situations in which the variability in the range of reasonable fair value

estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 48(c) and 49) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

Inputs to Valuation Techniques

- AG115. 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 52.)
- (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.

Gains and Losses (paragraphs 64–66)

- AG116. An entity applies IPSAS 4 to financial assets and financial liabilities that are monetary items in accordance with IPSAS 4 and denominated in a foreign currency. Under IPSAS 4, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognized in surplus or deficit. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 106–112) or a hedge of a net investment (see paragraph 113). For the purpose of recognizing foreign exchange gains and losses under IPSAS 4, a monetary available-for-sale financial asset is treated as if it were carried at amortized cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortized cost are recognized in surplus or deficit and other changes in carrying amount are recognized in accordance with paragraph 64(b). For available-for-sale financial assets that are not monetary items under IPSAS 4 (for example, equity instruments), the gain or loss that is recognized directly in net assets/equity under paragraph 64(b) includes any related foreign exchange component. 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 recognized in surplus or deficit.

Impairment and Uncollectibility of Financial Assets (paragraphs 67–79)

Financial Assets Carried at Amortized Cost (paragraphs 72–74)

- AG117. Impairment of a financial asset carried at amortized cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortized cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of

financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 72 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortized cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

- AG118. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.
- AG119. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognizes an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period (paragraph 47 of IPSAS 19 contains guidance on how to determine the best estimate in a range of possible outcomes).
- AG120. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.
- AG121. Impairment losses recognized on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.
- AG122. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for

comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are 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 incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

- AG123. As an example of applying paragraph AG122, an entity may determine, on the basis of historical experience, that one of the main causes of default on loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognized for these "incurred but not reported" losses. However, it would not be appropriate to recognize an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.
- AG124. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.
- AG125. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g. for smaller balance loans) as long as they are consistent with the requirements in paragraphs 72–74 and AG120–AG124. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest Revenue After Impairment Recognition

- AG126. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest revenue is thereafter recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Hedging (paragraphs 80–113)

Hedging Instruments (paragraphs 81–86)

Qualifying Instruments (paragraphs 81 and 82)

- AG127. The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the surplus or deficit exposure of a hedged item. Therefore, 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). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce surplus or deficit exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.
- AG128. A held-to-maturity investment carried at amortized cost may be designated as a hedging instrument in a hedge of foreign currency risk.
- AG129. An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 48(c) and 49) cannot be designated as a hedging instrument.
- AG130. An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged items (paragraphs 87–94)

Qualifying items (paragraphs 87–89)

- AG131. A firm commitment to acquire an entity or an integrated set of activities in an entity combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general operational risks.
- AG132. An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognizes in surplus or deficit the investor's share of the associate's surplus or deficit, rather than 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 because consolidation recognizes in surplus or deficit the controlled entity's surplus or deficit, rather than 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.
- AG133. Paragraph 89 states that in consolidated financial statements the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in a cash flow hedge, provided 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. For this purpose an entity can be a controlling entity, controlled entity, associate, joint venture 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 the economic entity will affect consolidated surplus or deficit, the transaction 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 property, plant and equipment within the economic entity from the entity that constructed it to the entity that will use the property, plant and equipment in its operations may affect consolidated surplus or deficit. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognized for the plant and equipment may change if the forecast transaction within the economic entity is denominated in a currency other than the functional currency of the purchasing entity.

- AG134. If a hedge of a forecast transaction within the economic entity qualifies for hedge accounting, any gain or loss that is recognized directly in net assets/equity in accordance with paragraph 106(a) shall be reclassified into surplus or deficit in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated surplus or deficit.
- AG135. An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. 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, only cash flow losses that result from an increase in the price above the specified level are designated. 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 (paragraph 96(b)).

Designation of Financial Items as Hedged Items (paragraphs 90 and 91)

- AG136. If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below a market related interest rate, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at a market related rate and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g. only for changes that are attributable to changes in the

market rate). For example, in the case of a financial liability whose effective interest rate is 100 basis points below the market rate, an entity can designate as the hedged item the entire liability (i.e. principal plus interest at the market rate minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in the market rate. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG140.

- AG137. In addition, 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 portion 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 it first designates the hedged item. For example, assume 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 it as the hedged item for its then fair value of CU90, the effective yield would have been 9.5 per cent. Because the market rate is less than this effective yield, the entity can designate a portion of the market rate 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).
- AG138. Paragraph 90 permits an entity to designate something other than the entire fair value change or cash flow variability of a financial instrument. For example:
- (a) All of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or
 - (b) Some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all or only some risks (i.e. a 'portion' of the cash flows of the financial instrument may be designated for changes attributable to all or only some risks).
- AG139. To be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. For example:
- (a) For a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark interest rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable.
 - (b) Inflation is not separately identifiable and reliably measurable and cannot be designated as a risk or a portion of a financial instrument unless the requirements in (c) are met.

A contractually specified inflation portion of the cash flows of a recognized inflation-linked bond (assuming 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 portion.

Designation of Non-Financial Items as Hedged Items (paragraph 92)

- AG140. Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brent Crude oil using a forward contract to purchase Light Sweet Crude oil on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 98 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (e.g. a transaction in Brent Crude oil) and the hedging instrument (e.g. a transaction in Light Sweet Crude oil). If there is a valid statistical relationship between the two variables (i.e. between the unit prices of Brent Crude oil and Light Sweet Crude oil), the slope of the regression line can be used to establish the hedge ratio that will maximize expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximizes expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognized in surplus or deficit during the term of the hedging relationship.

Designation of Groups of Items as Hedged Items (paragraphs 93 and 94)

- AG141. A hedge of an overall net position (e.g. the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on surplus or deficit of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has CU100 of assets and CU90 of liabilities with risks and terms of a similar nature and hedges the net CU10 exposure, it can designate as the hedged item CU10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of CU100 and a firm commitment to make a sale in the foreign currency of CU90, it can hedge the net amount of CU10 by acquiring a derivative and designating it as a hedging instrument associated with CU10 of the firm

purchase commitment of CU100.

Hedge Accounting (paragraphs 95–113)

- AG142. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.
- AG143. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e. a hedge of a future transaction where the future cash flows being hedged are the future interest payments).
- AG144. A hedge of a firm commitment (e.g. a hedge of the change in fuel price relating to an unrecognized contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 97 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Assessing Hedge Effectiveness

- AG145. A hedge is regarded as highly effective only if both of the following conditions are met:
- (a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG140.
 - (b) The actual results of the hedge are within a range of 80–125 per cent. For example, if actual results are such that the loss on the hedging instrument is CU120 and the gain on the cash instrument is CU100, offset can be measured by $120/100$, which is 120 per cent, or by $100/120$, which is 83 per cent. In this example, assuming the hedge meets the condition in (a), the entity would conclude that the hedge has been highly effective.
- AG146. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual financial statements.
- AG147. This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some

cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

- AG148. If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG140.
- AG149. If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:
- (a) The forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;
 - (b) The fair value of the forward contract at inception is zero; and
 - (c) Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and recognized in surplus or deficit or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.
- AG150. Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.
- AG151. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general operational risks, and must ultimately affect the entity's surplus or deficit. A hedge of the risk of obsolescence of a physical asset or the risk of legislative changes relating to the rehabilitation of damage to the environment is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.
- AG152. Paragraph 83(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship

that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.

- AG153. If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG135, a designated one-sided risk does not include the time value of an option. Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.
- AG154. In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.
- AG155. In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.
- AG156. If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

- AG157. For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)–(i) and paragraphs AG158–AG175 below.
- (a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios (e.g. the entity may group its available-for-sale assets into a separate portfolio), in which case it applies the guidance below to each portfolio separately.
 - (b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the

periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.

- (c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG169(b).
- (d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g. a swap rate).
- (e) The entity designates one or more hedging instruments for each repricing time period.
- (f) Using the designations made in (c)–(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.
- (g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognizes the change in fair value of the hedged item as a gain or loss in surplus or deficit and in one of two line items in the statement of financial position as described in paragraph 100. The change in fair value need not be allocated to individual assets or liabilities.
- (h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognizes it as a gain or loss in surplus or deficit. The fair value of the hedging instrument(s) is recognized as an asset or liability in the statement of financial position.
- (i) Any ineffectiveness will be recognized in surplus or deficit as the difference between the change in fair value referred to in (g) and that referred to in (h) (effectiveness is measured using the same materiality considerations as in other IPSASs).

AG158. This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

AG159. The portfolio identified in paragraph AG157(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

AG160. In applying paragraph AG157(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to

market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortizing loans to time periods based on expected repricing dates. However, the methodology for such an allocation shall be in accordance with the entity's risk management procedures and objectives.

AG161. As an example of the designation set out in paragraph AG157(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates as the hedged item assets in the amount of CU20 (a portion of the assets is designated as the Standard permits an entity to designate any amount of the available qualifying assets or liabilities, i.e. in this example any amount of the assets between CU0 and CU100). The designation is expressed as an 'amount of a currency' (e.g. an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—i.e. all of the CU100 of assets in the above example—must be:

- (a) Items whose fair value changes in response to changes in the interest rate being hedged; and
- (b) Items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because paragraph 52 of the Standard specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG169(b) would be calculated as a percentage of

these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 per cent ($\text{CU30} / (\text{CU100} - \text{CU40}) = 50 \text{ per cent}$) of the liabilities with no demand feature.

AG162. The entity also complies with the other designation and documentation requirements set out in paragraph 98(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

- (a) Which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.
- (b) How the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.
- (c) The number and duration of repricing time periods.
- (d) How often the entity will test effectiveness and which of the two methods in paragraph AG169 it will use.
- (e) The methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph AG169(b).
- (f) When the entity tests effectiveness using the method described in paragraph AG169(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

The policies specified in designating and documenting the hedging relationship shall be in accordance with the entity's risk management procedures and objectives. Changes in policies shall not be made arbitrarily. They shall be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

AG163. The hedging instrument referred to in paragraph AG157(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG157(d). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because paragraph 86 of the Standard and paragraph AG127 do not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the

amount designated in paragraph AG157(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because paragraph 84 of the Standard does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

- AG164. When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG157(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 90 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 91 permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of *expected*, rather than *contractual*, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (e.g. to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph AG169. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (e.g. changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.
- AG165. The Standard does not specify the techniques used to determine the amount referred to in paragraph AG157(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.
- AG166. Paragraph 100-requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph AG157(g). Specific allocation to individual

assets (or liabilities) is not required.

AG167. Paragraph AG157(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

- (a) Actual repricing dates being different from those expected, or expected repricing dates being revised;
- (b) Items in the hedged portfolio becoming impaired or being derecognized;
- (c) The payment dates of the hedging instrument and the hedged item being different; and
- (d) Other causes (e.g. when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness (applying the same materiality considerations in other IPSASs) shall be identified and recognized in surplus or deficit.

AG168. Generally, the effectiveness of the hedge will be improved:

- (a) If the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behavior.
- (b) When the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behavior can be predicted more accurately.
- (c) When the repricing time periods used are narrower (e.g. 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduce the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.
- (d) The greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g. because of changes in prepayment expectations).

AG169. An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it shall calculate the amount of effectiveness either:

- (a) As the difference between the change in the fair value of the hedging instrument (see paragraph AG157(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or
- (b) Using the following approximation. The entity:

- (i) Calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.
- (ii) Applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.
- (iii) Calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG157(g).
- (iv) Recognizes ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG157(h)).

AG170. When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph AG164), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG169(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognized as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG169(b) are then repeated at the next date it tests effectiveness.

AG171. Items that were originally scheduled into a repricing time period may be derecognized because of earlier than expected prepayment or write-offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph AG157(g) that relates to the derecognized item shall be removed from the statement of financial position, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognized item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph AG157(g). When an item is derecognized, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognized item on a systematic and rational basis if the item was sold or became impaired.

AG172. In addition, any amount relating to a particular time period that has not been derecognized when the time period expires is recognized in surplus or deficit at that time (see paragraph 100). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported

in the single line item in the statement of financial position was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets attributable to period 1 have been either realized or rescheduled into other periods. Therefore, CU7 is derecognized from the statement of financial position and recognized in surplus or deficit. CU8 and CU10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG157(g).

- AG173. As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first repricing time period expires, CU110 of assets are derecognized because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG157(g) that relates to the first time period is removed from the statement of financial position, plus 10 per cent of the amount that relates to the second time period.
- AG174. If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognized, the amount included in the separate line item referred to in paragraph AG157(g) that relates to the reduction shall be amortized in accordance with paragraph 104.
- AG175. An entity may wish to apply the approach set out in paragraphs AG157–AG174 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with IPSAS 29. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 112(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG157–AG174 prospectively to subsequent accounting periods.

Appendix B

Reassessment of Embedded Derivatives

This appendix is an integral part of IPSAS 29.

Introduction

- B1. IPSAS 29 paragraph 11 describes an embedded derivative as ‘a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.’
- B2. IPSAS 29 paragraph 12 requires an embedded derivative to be separated from the host contract and accounted for as a derivative 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 contract;
 - (b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
 - (c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in surplus or deficit (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through surplus or deficit is not separated).
- B3. IPSAS 29 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives under the Standard. This appendix addresses whether:
 - (a) IPSAS 29 requires such an assessment to be made only when the entity first becomes a party to the contract, or if the assessment should be reconsidered throughout the life of the contract.
 - (b) A first-time adopter makes its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts this IPSAS for the first time.
- B4. This appendix applies to all embedded derivatives within the scope of IPSAS 29 except the acquisition of contracts with embedded derivatives in an entity combination or their possible reassessment at the date of acquisition.

Application of IPSAS 29 to the Reassessment of Embedded Derivatives

- B5. 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 either (a) a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract or (b) reclassification of a financial asset out of fair value

through surplus or deficit category, in which cases an assessment 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.

- B6. The assessment whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on reclassification of a financial asset out of the fair value through surplus or deficit category in accordance with paragraph B5 shall be made on the basis of the circumstances that existed when the entity first became a party to the contract.
- B7. On first time adoption of IPSAS 29, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph B5.

Appendix C

Hedges of a Net Investment in a Foreign Operation

This appendix is an integral part of IPSAS 29.

Introduction

- C1. Many reporting entities have investments in foreign operations (as defined in IPSAS 4 paragraph 10). Such foreign operations may be controlled entities, associates, joint ventures or branches. IPSAS 4 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognize foreign exchange differences directly in net assets/equity until it disposes of the foreign operation.
- C2. 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 are accounted for using the equity method, and financial statements in which venturers' interests in joint ventures are proportionately consolidated. 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.
- C3. IPSAS 29 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognized directly in net assets/equity and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.
- C4. 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 IPSAS 29. 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.
- C5. 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)
 - (i) IPSAS 29 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 a group, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting i.e. whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity within the economic entity, regardless of its functional currency, can hold the hedging instrument.
- (c) How an entity should determine what amount of the gain or loss recognized in net assets/equity should be recognized directly in surplus or deficit for both the hedging instrument and the hedged item as IPSAS 4 and IPSAS 29 require cumulative amounts recognized directly in net assets/equity relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be recognized directly when the controlling entity disposes of the foreign operation. It specifically addresses:
 - (i) When a foreign operation that was hedged is disposed of, what amounts from the controlling entity's foreign currency translation reserve in respect of the hedging instrument and of that foreign operation should be recognized in surplus or deficit in the controlling entity's consolidated financial statements;

- (ii) Whether the method of consolidation affects the determination of the amounts to be recognized in surplus or deficit.

Application of IPSAS 29 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

- C6. 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.
- C7. 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.
- C8. 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.
- C9. 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 (for example, both a direct and an indirect controlling entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate controlling entity. A hedging relationship designated by one controlling entity in its consolidated financial statements need not be maintained by another higher level controlling entity. However, if it is not maintained by the higher level controlling entity, the hedge accounting applied by the lower level controlling entity must be reversed before the higher level controlling entity's hedge accounting is recognized.

Where the Hedging Instrument can be Held

- C10. 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 (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of

IPSAS 29 paragraph 98 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.

- C11. For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the controlling entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognized in surplus or deficit, directly in net assets/equity, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognized in surplus or deficit or directly in net assets/equity. As part of the application of hedge accounting, the total effective portion of the change is included directly in net assets/equity. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

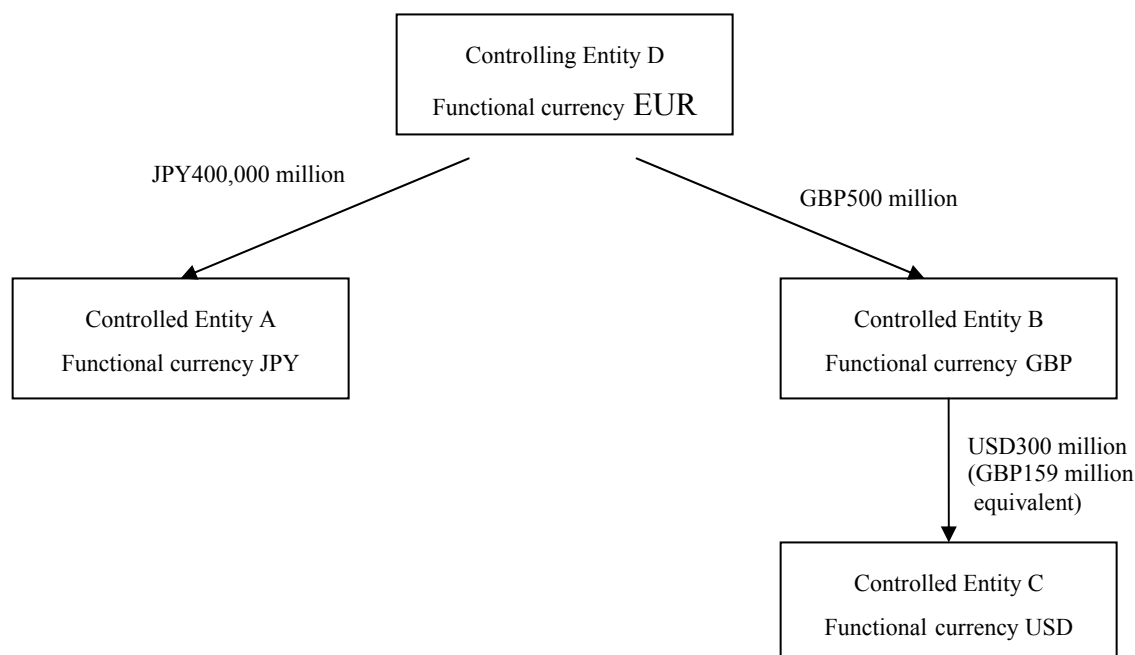
Disposal of a Hedged Foreign Operation

- C12. When a foreign operation that was hedged is disposed of, the amount reclassified to surplus or deficit from the foreign currency translation reserve in the consolidated financial statements of the controlling entity in respect of the hedging instrument is the amount that IPSAS 29 paragraph 113 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.
- C13. The amount recognized in surplus or deficit upon transfer from the foreign currency translation reserve in the consolidated financial statements of a controlling entity in respect of the net investment in that foreign operation in accordance with IPSAS 4 paragraph 57 is the amount included in that controlling entity's foreign currency translation reserve in respect of that foreign operation. In the ultimate controlling entity's consolidated financial statements, the aggregate net amount recognized in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate controlling entity uses the direct or the step-by-step method of consolidation, this may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation.
- C14. 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).
- C15. The use of the step-by-step method of consolidation may result in a different amount being recognized in surplus or deficit from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this

adjustment is not required by IPSAS 4. However, it is an accounting policy choice that should be followed consistently for all net investments.

Example

C16. 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 IPSAS 29, although this testing is not discussed. Controlling Entity D, being the ultimate controlling entity, presents its consolidated



financial statements in its functional currency of euro (EUR). Each of the controlled entities i.e. Controlled Entity A, Controlled Entity B and Controlled Entity C, is wholly owned. Controlling Entity D £500 million net investment in Controlled Entity B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Controlled Entity B's US\$300 million net investment in Controlled Entity C (functional currency US dollars (USD)). In other words, Controlled Entity B's net assets other than its investment in Controlled Entity C are £341 million.

Nature of Hedged Risk for which a Hedging Relationship may be Designated (paragraphs C6–C9)

C17. Controlling Entity D can hedge its net investment in each of Controlled Entities A, B and C for the foreign exchange risk between their respective functional currencies (Japanese yen (JPY), pounds sterling and US dollars) and euro. In addition, Controlled Entity D can hedge the USD/GBP foreign exchange risk between the functional currencies of Controlled Entity B and Controlled Entity C. In its consolidated financial statements, Controlled Entity B can hedge its net investment in Controlled Entity C for the foreign exchange risk

between their functional currencies of US dollars and pounds sterling. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Controlling Entity D could designate the forward foreign exchange risk.

Amount of Hedged item for which a Hedging Relationship may be Designated (paragraphs C6–C9)

- C18. 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.
- C19. 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.
- C20. In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Controlled Entity A would be recognized in Controlling Entity D's consolidated financial statements as follows:
- USD/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit, and
 - JPY/EUR spot foreign exchange rate change directly in net assets/equity.
- Instead of the designation in paragraph C19, in its consolidated financial statements Controlling Entity D can designate the US\$300 million external borrowing in Controlled Entity A as a hedge of the GBP/USD spot foreign exchange risk between Controlled Entity C and Controlled Entity B. In this case, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Entity A would instead be recognized in Controlled Entity D's consolidated financial statements as follows:
- The GBP/USD spot foreign exchange rate change in the foreign currency translation reserve relating to Controlled Entity C,
 - GBP/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit, and
 - JPY/EUR spot foreign exchange rate change directly in net assets/equity.
- C21. 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 C10 and C11)?

C22. As noted in paragraph C20, the total change in value in respect of foreign exchange risk of the US\$300 million external borrowing in Controlled Entity A would be recorded in both surplus or deficit (USD/JPY spot risk) and directly in net assets/equity (EUR/JPY spot risk) in Controlling Entity D's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in paragraph C19 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Controlling Entity D against the US dollar functional currency of Controlled Entity C, in accordance with the hedge documentation. The method of consolidation (i.e. direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts Recognized in Surplus or Deficit on Disposal of a Foreign Operation (paragraphs C12 and C13)

C23. When Controlled Entity C is disposed of, the amounts are recognized in surplus or deficit in Controlling Entity D's consolidated financial statements upon transfer from its foreign currency translation reserve (FCTR) are:

- (a) In respect of the US\$300 million external borrowing of Controlled Entity A, the amount that IPSAS 29 requires to be identified, i.e. the total change in value in respect of foreign exchange risk that was recognized directly in net assets/equity as the effective portion of the hedge; and
- (b) In respect of the US\$300 million net investment in Controlled Entity C, the amount determined by the entity's consolidation method. If Controlling Entity D uses the direct method, its FCTR in respect of Controlled Entity C will be determined directly by the EUR/USD foreign exchange rate. If Controlling Entity D uses the step-by-step method, its FCTR in respect of Controlled Entity C will be determined by the FCTR recognized by Controlled Entity B reflecting the GBP/USD foreign exchange rate, translated to Controlling Entity D's functional currency using the EUR/GBP foreign exchange rate. Controlling Entity D's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be recognized in surplus or deficit when it disposes of Controlled Entity C to be the amount that it would have recognized if it had always used the direct method, depending on its accounting policy.

Hedging More Than One Foreign Operation (paragraphs C7, C9 and C11)

C24. 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

C25. 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.

C26. 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 C25(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.

- C27. In the case described in paragraph C25(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 C20. Because the designation of the USD/GBP risk between Controlled entities B and C does not include the GBP/EUR risk, Controlled Entity D is also able to designate up to £500 million of its net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (GBP/EUR) between Controlling Entity D and Controlled Entity B.

Entity B Holds the USD Hedging Instrument

- C28. 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 C99) 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.
- C29. However, the accounting for Controlled Entity D's £159 million loan payable to Controlled Entity B must also be considered. If Controlling Entity D's loan payable is not considered part of its net investment in Controlled Entity B because it does not satisfy the conditions in IPSAS 4 paragraph 18, the GBP/EUR foreign exchange difference arising on translating it would be included in Controlling Entity D's consolidated surplus or deficit. If the £159 million loan payable to Controlled Entity B is considered part of Controlling Entity D's net investment, that net investment would be only £341 million and the amount Controlling Entity D could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.
- C30. 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 D

Amendments to other IPSASs

The references to “international or national accounting standards dealing with the recognition and measurement of financial instruments” are amended to “IPSAS 29, “Financial Instruments: Recognition and Measurement” in the following IPSASs:

- (a) IPSAS 1, “Presentation of Financial Statements” paragraphs 79, 82 and 101
- (b) IPSAS 4, “The Effects of Changes in Foreign Exchange Rates” paragraphs 3, 4, 31 and 61(a)
- (c) IPSAS 6, “Consolidated and Separate Financial Statements” paragraphs 22, 52, 61, and IG8
- (d) IPSAS 7, “Investments in Associates” paragraphs 1, 2, 20, 21, 24, 25, 37, 38 and 39
- (e) IPSAS 8, “Interests in Joint Ventures” paragraph 1, 2, 47 and 58
- (f) IPSAS 9, “Revenue from Exchange Transactions” paragraph 10(c)
- (g) IPSAS 26, “Impairment of Cash-Generating Assets” paragraphs 2(c) and 8

IPSAS 4, “The Effects of Changes in Foreign Exchange Rates”

Paragraph 5 is amended as follows:

- 5. This Standard does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. ~~Accordingly, entities may apply the relevant international or national accounting standards dealing with hedge accounting.~~ IPSAS 29, “Financial Instruments: Recognition and Measurement” applies to hedge accounting.

IPSAS 6, “Consolidated and Separate Financial Statements”

Paragraph 5(c) is amended as follows:

- 58. ...
 - (c) As financial instruments: in accordance with IPSAS 29, “Financial Instruments: Recognition and Measurement.”

IPSAS 9, “Revenue from Exchange Transactions”

Paragraph 10 of the appendix is amended as follows:

Appendix

10. *Financial service fees.*

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

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

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

- (i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IPSAS 29 is classified as a financial asset ‘at fair value through surplus or deficit’.*

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

- (ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of IPSAS 29.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of IPSAS 29, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related transaction costs (as defined in IPSAS 29), is deferred and recognized as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognized as revenue on expiry. Loan commitments that are within the

scope of IPSAS 29 are accounted for as derivatives and measured at fair value.

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

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

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

- (i) *Fees charged for servicing a loan.*

~~Fees charged by an entity for servicing a loan are recognized as revenue as the services are provided. If the entity sells a loan but retains the servicing of that loan at a fee which is lower than a normal fee for such services, part of the sales price of the loan is deferred and recognized as revenue as the servicing is provided.~~

- (ii) Commitment fees to originate ~~or purchase~~ a loan when the loan commitment is outside the scope of IPSAS 29.

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

- (iii) Investment management fees.

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

Incremental costs that are directly attributable to securing an investment management contract are recognized as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in IPSAS 29, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity’s contractual right to benefit from providing investment management services, and is amortized as the entity recognizes the related revenue. If the entity has a portfolio of investment

management contracts, it may assess their recoverability on a portfolio basis.

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

- (c) *Fees that are earned on the execution of a significant act, ~~which is much more significant than any other act.~~*

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

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

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

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

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

- (iii) *Loan syndication fees.*

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

IPSAS 12, “Inventories”

Paragraph 2(b) is amended as follows:

2. ...

- (b) Financial instruments (see IPSAS 28, “Financial Instruments: Presentation” and IPSAS 29, “Financial Instruments: Recognition and Measurement.”)

IPSAS 21, “Impairment of Non-Cash-Generating Assets”

Paragraph 2(c) is amended as follows:

2.

- (c) Financial assets that are included in the scope of ~~IPSAS 15, “Financial Instruments: Disclosure and Presentation”~~ IPSAS 29, “Financial Instruments: Recognition and Measurement.”

Paragraph 8 is amended as follows:

8. This Standard does not apply to financial assets that are included in the scope of ~~IPSAS 15–IPSAS 28~~. Impairment of these assets ~~will be dealt with in any IPSAS that the IPSASB develops on the basis of IAS 39, “Financial Instruments: Recognition and Measurement to deal with the recognition and measurement of financial instruments is dealt with in IPSAS 29, “Financial Instruments: Recognition and Measurement.”~~

IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”

Paragraph 4 is amended as follows:

4. This Standard addresses revenue arising from non-exchange transactions. Revenue arising from exchange transactions is addressed in IPSAS 9, “Revenue from Exchange Transactions”. While revenues received by public sector entities arise from exchange and non-exchange transactions, the majority of revenue of governments and other public sector entities is typically derived from non-exchange transactions such as:
- (a) Taxes; and
 - (b) Transfers (whether cash or non-cash), including grants, debt forgiveness, fines, bequests, gifts, donations, ~~and~~ goods and services in-kind, and the off-market portion of concessionary loans received.

Paragraph 10 is amended as follows:

10. There is a further group of non-exchange transactions where the entity may provide some consideration directly in return for the resources received, but that consideration does not approximate the fair value of the resources received. In these cases the entity determines whether there is a combination of exchange and non-exchange transactions, each component of which is recognized separately. For example, an entity receives CU6 million funding from a multi-lateral development agency. The agreement stipulates that the entity must repay CU5 million of the funding received over a period of 10 years, at 5% interest when the market rate for a similar loan is 11%. The entity has effectively received a CU1 million grant (CU6 million received less CU5 million to be repaid) and entered into CU5 million concessionary loan which attracts interest at 6% below the market interest rate for a similar loan. The CU1 million grant received, as well as the off-market portion of the interest payments in terms of the agreement, are non-exchange transactions. The contractual capital and interest payments over the period of the loan are exchange transactions.

Paragraph 87 is amended as follows:

87. Revenue arising from debt forgiveness is measured at the carrying amount of the debt forgiven. ~~fair value of the debt forgiven. This will normally be the carrying amount of the debt forgiven.~~

An additional header and paragraphs are inserted after paragraph 105 as follows:

Concessionary Loans

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

105B Where an entity determines that the difference between the transaction price (loan proceeds) and the fair value of the loan on initial recognition is non-exchange revenue, an entity recognizes the difference as revenue, except if a present obligation exists, e.g. where specific conditions imposed on the transferred assets by the recipient result in a present obligation. Where a present obligation exists, it is recognized as a liability. As the entity satisfies the present obligation, the liability is reduced and an equal amount of revenue is recognized.

An additional sub-paragraph is inserted after paragraph 106(c) as follows:

106.

(ca) The amount of liabilities recognized in respect of concessionary loans that are subject to conditions on transferred assets;

An additional paragraph is included under paragraph 125A:

125B IPSAS 29, “Financial Instruments: Recognition and Measurement” amended paragraphs 4, 10, 87, and 106, and inserted paragraphs 105A and 105B. An entity shall apply the amendments for annual financial statements covering periods beginning on or after April 1, 2013. If an entity applies IPSAS 29 for a period beginning before April 1, 2013, the amendments shall also be applied for that earlier period.

In the Implementation Guidance an additional example is inserted after paragraph IG53 as follows:

Implementation Guidance

Example 26: Concessionary Loans (paragraphs 105A to 105B)

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

- CU1 million of the funding need not be repaid, provided that the schools are built.
- CU5 million of the funding is to be repaid as follows:
 - Year 1: no capital to be repaid
 - Year 2: 10% of the capital to be repaid
 - Year 3: 20% of the capital to be repaid

Year 4: 30% of the capital to be repaid

Year 5: 40% of the capital to be repaid

- Interest is charged at 5% per annum over the period of the loan (assume interest is paid annually in arrears). The market rate of interest for a similar loan is 10%.
- To the extent that schools have not been built, the funding provided should be returned to the donor (assume that the donor has effective monitoring systems in place and has a past history of requiring any unspent funds to be returned).
- The entity built the following schools over the period of the loan:

Year 1: 1 school completed

Year 2: 3 schools completed

Year 3: 5 schools completed

Year 4: 10 schools completed

Analysis:

The entity has effectively received a grant of CU1 million and a loan of CU5 million (Note: An entity would consider whether the substance of the CU1 million is a contribution from owners or revenue; assume for purposes of this example that the CU1million is revenue). It has also received an additional grant of CU784,550 (which is the difference between the proceeds of the loan of CU5 million and the present value of the contractual cash flows of the loan, discounted using the market related rate of interest of 10%).

The grant of CU1 million + CU784,550 is accounted for in accordance with this Standard and, the loan with its related contractual interest and capital payments, in accordance with IPSAS 29.

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

<u>Dr Bank</u>	<u>CU6,000,000</u>
<u>Cr Loan</u>	<u>CU4,215,450</u>
<u>Cr Liability</u>	<u>CU1,784,550</u>

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

<u>Dr Liability</u>	<u>CU178,455</u>
<u>Cr Non-exchange revenue</u>	<u>CU178,455</u>

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

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

3. Year 2: the entity will recognize the following (assuming that the entity subsequently measures the concessionary loan at amortized cost):

Dr Liability CU356,910

Cr Non-exchange revenue CU356,910

(3/10 schools built X CU1,784,500 – CU178,455 already recognized)

4. Year 3: the entity will recognize the following:

Dr Liability CU356,910

Cr Non-exchange revenue CU356,910

(5/10 schools built X CU1,784,550 – CU535,365 already recognized)

5. Year 4: the entity will recognize the following:

Dr Liability CU892,275

Cr Non-exchange revenue CU892,275

(All schools built, CU1,784,550 – CU892,275)

If the concessionary loan was granted with no conditions, the entity would recognize the following on initial recognition:

Dr Bank CU6,000,000

Cr Loan CU4,215,450

Cr Non-exchange revenue CU1,784,550

IPSAS 26, “Impairment of Cash-Generating Assets”

Paragraph 2(c) is amended as follows:

- (c) Financial assets that are within the scope of ~~IPSAS 15, “Financial Instruments: Disclosure and Presentation”~~ IPSAS 29, “Financial Instruments: Recognition and Measurement”;

Paragraph 8 is amended as follows:

8. This Standard does not apply to financial assets that are included in the scope of ~~IPSAS 15~~ IPSAS 28. Impairment of these assets ~~will be dealt with in any IPSAS that the IPSASB develops to deal with the recognition and measurement of financial instruments~~ is dealt with in IPSAS 29, “Financial Instruments: Recognition and Measurement.”

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, ~~the proposed International Public Sector Accounting Standards~~ IPSAS 29.

Introduction

- BC1. This Basis for Conclusions summarizes the International Public Sector Accounting Standards Board's (IPSASB) considerations in reaching the conclusions in IPSAS ~~29XX (ED-38)~~, "Financial Instruments: Recognition and Measurement." As this IPSAS is based on IAS 39, "Financial Instruments: Recognition and Measurement" issued by the International Accounting Standards Board (IASB), the Basis for Conclusions outlines only those areas where IPSAS ~~29XX (ED-38)~~ deviates-departs from the main requirements of IAS 39~~2~~.
- BC2. This project on financial instruments forms part of the IPSASB's convergence program which aims to converge IPSASs with International Financial Reporting Standards (IFRSs). The IPSASB acknowledges that there are other aspects of financial instruments, insofar as they relate to the public sector, which are not addressed in IAS 39. These will be addressed by future projects of the IPSASB. In particular, the IPSASB acknowledges that future projects are required to address:
- Certain transactions undertaken by central banks; and
 - Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature.
- BC3. In developing this IPSAS, the IPSASB agreed to retain the existing text of IAS 39 wherever consistent with existing IPSASs, and deal with certain public sector specific issues through additional application guidance.
- BC4. In September 2007 the IASB issued amendments to IAS 1, "Presentation of Financial Statements" which introduced "comprehensive income" into the presentation of financial statements. As the IPSASB has not yet considered comprehensive income, along with some of the other amendments proposed in IAS 1, those amendments have not been included in IPSAS ~~29XX (ED-38)~~.
- ~~BC5. The text of IAS 39 as published at December 31, 2008, including C~~certain amendments to IAS 39 published-made by the IASB to IAS 39 during-in April 2009 2008-as part of its improvements project, have been included in the text of IPSAS ~~29XX (ED-38)~~ even though they have not been approved as final amendments by the IASB at the date of publication. These include:
- ~~• Amendments to the scope of IAS 39 along with the requirements for identifying embedded derivatives included in the annual improvements proposed in 2008.~~
 - ~~• Amendments to IAS 39 and IFRIC 9 relating to the classification of embedded derivatives published in December 2008.~~

Scope

BC56. Assets and liabilities may arise out of contractual non-exchange revenue transactions. The initial recognition and measurement of assets and liabilities arising out of non-exchange revenue transactions is addressed in IPSAS 23, “Revenue from Non-Exchange Transactions (Taxes and Transfers)”. IPSAS 23 ~~requires assets and liabilities to be measured initially at fair value. It~~ does not provide requirements and guidance for the subsequent measurement or derecognition of these assets and liabilities. The IPSASB considered the interaction between this IPSAS and IPSAS 23 for assets and liabilities that arise out of non-exchange revenue transactions that meet the definition of financial assets and financial liabilities.

BC6. The IPSASB agreed that where an asset acquired in a non-exchange transaction is a financial asset, an entity:

- Initially recognizes the asset using IPSAS 23; and
- Initially measures the asset using IPSAS 23 and, considers the requirements in this IPSAS to determine the appropriate treatment for any transaction costs incurred to acquire the asset.

As IPSAS 23 does not prescribe subsequent measurement or derecognition requirements for assets acquired in a non-exchange transactions, this IPSAS is applied to those assets if they are financial assets.

~~BC7. The IPSASB therefore considered the subsequent measurement and derecognition of such assets and liabilities and concluded that, where the assets and liabilities arise out of contractual arrangements and otherwise meet the definition of a financial instrument, IPSAS XX (ED 38) should be applied for subsequent measurement and derecognition.~~

BC7. For liabilities, the IPSASB agreed that liabilities arising from conditions imposed on a transfer of resources in accordance with IPSAS 23 are initially recognized and initially measured using that IPSAS, as these liabilities usually do not meet the definition of a financial liability at initial recognition (see IPSAS 28). After initial recognition, if circumstances indicate that the liability is a financial liability, an entity assesses if the liability recognized in accordance with IPSAS 23 should be derecognized and a financial liability recognized in accordance with this IPSAS.

BC8. The IPSASB agreed that other liabilities that arise from non-exchange revenue transactions, for example, the return of resources based on a restriction on the use of an asset, are recognized and measured in accordance with this IPSAS if they meet the definition of a financial liability.

Initial Measurement

BC9 The IPSASB acknowledged that there is an interaction between IPSAS 23 and this IPSAS for assets acquired through a non-exchange transaction that also meet the definition of a financial asset. IPSAS 23 requires that assets acquired in a non-exchange revenue transaction are measured initially at fair value. This IPSAS requires financial assets to be

measured initially at fair value, plus transaction costs, if the asset is not subsequently measured at fair value through surplus or deficit. The two measurement approaches are broadly consistent, except for the treatment of transaction costs.

BC10. The IPSASB concluded that it would be inappropriate for financial assets arising from non-exchange transactions to be measured differently from those arising from exchange transactions. Consequently, the IPSASB agreed that assets acquired in a non-exchange transaction should be measured initially at fair value using the requirements in IPSAS 23, but that this IPSAS should also be considered where transaction costs are incurred to acquire the asset.

Concessionary Loans

BC118. Concessionary loans can either be granted or received by an entity. They pose particular accounting issues because their terms are not market related. The IPSASB therefore considered how the off-market portion of a concessionary loan should be accounted for. In ED 38, ~~the IPSASB proposed~~ ~~concluded~~ that an entity should account for concessionary loans by analyzing the substance of the transaction into its component parts and accounting for each component separately and that. ~~The IPSASB therefore determined that the off-market portion of a concessionary loan should be accounted for as follows:~~

- The issuer of a concessionary loan accounts for the off-market portion of the loan as an expense in the year the loan is issued.
- The recipient of a concessionary loan accounts for the off-market portion of the loan in accordance with IPSAS 23.

BC12 Some respondents to ED 38 disagreed with the proposed treatment of concessionary loans because they do not believe that fair value is an appropriate measurement basis, while others disagreed with the proposed treatment of the off-market portion of concessionary loans as an expense.

BC13. Respondents who disagreed with fair value as a measurement basis cited practical difficulties in determining a fair value for concessionary loans and noted that because of these difficulties, fair values are often determined using estimates. In their view the use of such estimates would make the information potentially unreliable. Respondents suggested that, as an alternative to fair value, nominal cost or the lender's borrowing rate should be used as a measurement basis. The IPSASB however, takes the view that the use of fair value enables the most faithfully representative determination of the concession element of a concessionary loan. Also, because the loans granted at no or low interest are not unique to the public sector, the IPSASB was not persuaded that there is a public sector specific reason to depart from the fair value principles in IAS 39. They also noted that IPSAS 30 requires specific disclosures on the measurement of financial instruments, including those instances where unobservable market inputs have been used. Consequently, the IPSASB decided to retain fair value as a measurement basis for concessionary loans.

BC14. Respondents who disagreed with expensing the off-market portion of the concessionary loan, noted that because the off-market portion represents a subsidy, it may be more appropriate to recognize an asset initially and recognize an expense subsequently by reducing this asset as and when the conditions of the subsidy are met or on a time proportion basis-. The IPSASB, however, considered that the initial granting of the loan results in a commitment of resources, in the form of a loan and a subsidy, on day 1. The IPSASB was of the view that initial recognition of this subsidy as an expense on recognition of the transaction provides the most useful information for accountability purposes.

Financial Guarantees Issued Through a Non-Exchange Transaction at No or Nominal Consideration

BC159. The IPSASB acknowledged that in the public sector financial guarantee contracts are frequently issued through a non-exchange transaction, i.e. they are issued entered into by issuers for nonil consideration or for nominal consideration, often in order to further the issuer's broad social policy objectives, rather than for commercial purposes. While entities may issue guarantees at below fair value in the private sector, this is not common and is for commercial reasons, such as when a controlling entityparent issues a guarantee to a holder on behalf of a controlled entitysubsidiary. In the public sector the maximum credit risk exposure of such guarantees may be extremely large. Such guarantees are generally issued because an active market does not exist and, in some cases, it would be impossible for the guarantee to be provided by a private sector issuer because of the maximum extent of the credit risk exposure. The IPSASB considered the approach to measurement at initial recognition, and subsequent to initial recognition, for such financial guarantee contracts.

BC160. Where the financial guarantee contract is entered into for consideration, the IPSASB considered whether the amount of such consideration should be deemed to be a fair value. Application Guidance in IAS 39 states that "the fair value of a financial instrument on initial recognition is normally the transaction price." In the public sector the IPSASB considered that in many cases the transaction price related to a financial guarantee contract will not reflect fair value and that recognition at such an amount would be an inaccurate and misleading reflection of the issuer's exposure to financial risk. The IPSASB concluded that where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an exchange transaction and therefore represents a fair value. If the consideration does represent a fair value, the IPSASB concluded that entities should recognize the financial guarantee at the amount of the consideration and that subsequent measurement should be at the higher of the amount determined in accordance with IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets" and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9, "Revenue from Exchange Transactions." Where the transaction price is not a fair value, an entity should be required to determine measurement at initial recognition in the same way as if no consideration had been paid.

BC174. The IPSASB therefore considered the approach to the determination of measurement at initial recognition for financial guarantee contracts provided for no consideration or for a consideration that is not a fair value. The IPSASB identified a valuation hierarchy three levels that could be used in determining the fair value of initially measuring a financial guarantee contract provided for no consideration or for consideration that is not a fair value:

- Level One: An entity assesses whether the fair value of the financial guarantee contract can be determined by observing Observation of a price in an active market;
- Level Two: Where a price cannot be determined by observing a price in an active market, an entity uses a Vvaluation technique that does not directly relate to an active market; and
- Level Three: If fair value cannot be determined for a financial guarantee contract, an entity measures a financial guarantee contract at initial recognition and subsequently Measurement at initial recognition and subsequent measurement in accordance with IPSAS 19.

BC182. There may be cases where an active market exists for financial guarantee contracts equivalent to or similar to that issued. In such cases a fair value should be estimated through observation of that active market. Where no active market exists, the IPSASB considered whether an entity should be required to move immediately to Level Three and adopt an approach based on in accordance with IPSAS 19. The IPSASB noted that many valuation techniques are highly complex and, as noted in paragraphs AG1076 and AG1087 may give rise to a range of outcomes. It is arguable that the cost of developing such techniques exceeds the benefits to users of the information provided. An approach based on IPSAS 19 may provide a more reliable and understandable measure of an issuer's risk exposure as a result of entering into a financial guarantee contract. The IPSASB also acknowledged that where an entity does not recognize a liability in accordance with IPSAS 19, the entity makes the disclosures required for contingent liabilities in IPSAS 19 unless an outflow of resources is remote. The information provided to users on risk exposure related to financial guarantees provided at nil or nominal consideration also includes the credit risk disclosures in IPSAS ~~30XX (ED-39)~~, "Financial Instruments: Disclosures." Conversely, the IPSASB acknowledged that there are current IPSASs that require the use of experts, such as actuaries, to develop valuation techniques that are inherently complex, such as IPSAS 25, "Employee Benefits." On balance the IPSASB ~~concluded that, in the absence of an active market, entities should~~ be permitted to use a Level Two valuation technique that does not rely on an observable market where they are satisfied that such a technique provides a reliable and understandable method of determining a fair value for a financial guarantee contract entered into by an issuer by means of a non-exchange transaction where they consider that it is a reliable method of determining a fair value for a financial guarantee contract entered into by an issuer for nil or nominal consideration. This is particularly the case for non-standard guarantees where there is limited data available on defaults and credit risk.

Illustrative Examples

These examples accompany, but are not part of, IPSAS [29XX \(ED-38\)](#).

Example 1

Facts

- IE1. On January 1, 20X1 Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.
- IE2. For risk management purposes, Entity A analyzes the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (i.e. it has 60 separate monthly time periods).⁴ The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.
- IE3. This example deals only with the repricing time period expiring in three months' time, i.e. the time period maturing on March 31, 20X1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of CU100 million and liabilities of CU80 million into this time period. All of the liabilities are repayable on demand.
- IE4. Entity A decides, for risk management purposes, to hedge the net position of CU20 million and accordingly enters into an interest rate swap⁵ on January 1, 20X1, to pay a fixed rate and receive LIBOR, with a notional principal amount of CU20 million and a fixed life of three months.
- IE5. This example makes the following simplifying assumptions:
- (a) The coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;
 - (b) The coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and
 - (c) The interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only,

⁴ In this example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

⁵ This example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

because the variable leg is not exposed to changes in fair value due to changes in interest rates.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap.)

IE6. It is also assumed that Entity A tests effectiveness on a monthly basis.

IE7. The fair value of an equivalent non-prepayable asset of CU20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows:

	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
Fair value (asset) (CU)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

IE8. The fair value of the swap at various times during the period of the hedge is as follows:

	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb-28, 20X1	Mar 31, 20X1
Fair value (liability) (CU)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting treatment

IE9. On January 1, 20X1, Entity A designates as the hedged item an amount of CU20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (i.e. the CU20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 98(d) and AG16²⁴ of the Standard.

IE10. Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

End of month 1 (January 31, 20X1)

IE11. On January 31, 20X1 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as CU96 million.

IE12. The fair value of the designated interest rate swap with a notional principal of CU20 million is (CU47,408)⁶ (the swap is a liability).

⁶ See paragraph IE8.

IE13. Entity A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows.

- (a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (CU20 million ÷ CU100 million).
- (b) Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (CU96 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU19.2 million.
- (c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU19.2 million) that is attributable to changes in LIBOR. This is CU45,511 (CU47,408⁷ × (CU19.2 million ÷ CU20 million)).

IE14. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU172,097	
	Cr Surplus or deficit (interest revenue) ⁸		CU172,097
	<i>To recognize the interest received on the hedged amount (CU19.2 million).</i>		

Dr	Surplus or deficit (interest expense)	CU179,268	
	Cr Surplus or deficit (interest revenue)		CU179,268
	Cr Cash		Nil
	<i>To recognize the interest received and paid on the swap designated as the hedging instrument.</i>		

Dr	Surplus or deficit (loss)	CU47,408	
	Cr Derivative liability		CU47,408
	<i>To recognize the change in the fair value of the swap.</i>		

Dr	Separate line item in the statement of financial position	CU45,511	
	Cr Surplus or deficit (gain)		CU45,511
	<i>To recognize the change in the fair value of the hedged amount.</i>		

⁷ i.e. CU20,047,408 – CU 20,000,000, see paragraph IE7.

⁸ This example does not show how amounts of interest revenue and interest expense are calculated.

IE15. The net result on surplus or deficit (excluding interest revenue and interest expense) is to recognize a loss of (CU1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

Beginning of month 2

- IE16. On February 1, 20X1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold $8\frac{1}{3}$ per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.
- IE17. On this basis, Entity A computes that it has sold $8\frac{1}{3}$ per cent of the assets allocated to the three-month time period, i.e. CU8 million ($8\frac{1}{3}$ per cent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.⁹ On derecognition of the assets, Entity A also removes from the separate line item in the statement of financial position an amount that represents the change in the fair value of the hedged assets that it has now sold. This is $8\frac{1}{3}$ per cent of the total line item balance of CU45,511, i.e. CU3,793.
- IE18. Entity A makes the following accounting entries to recognize the sale of the asset and the removal of part of the balance in the separate line item in the statement of financial position:

Dr	Cash	CU8,018,400	
	Cr Asset		CU8,000,000
	Cr Separate line item in the statement of financial position		CU3,793
	Cr Surplus or deficit (gain)		CU14,607

To recognize the sale of the asset at fair value and to recognize a gain on sale.

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate no ineffectiveness arises.

- IE19. Entity A now has CU88 million of assets and CU80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now CU8 million and, accordingly, it designates CU8 million as the hedged amount.
- IE20. Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument CU8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of CU18,963.¹⁰ It also complies with the

⁹ The amount realized on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in IE7.

¹⁰ CU47,408 x 40 per cent.

other designation requirements in paragraphs 98(a) and AG16²⁴ of the Standard. The CU12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognized in surplus or deficit, or is designated as the hedging instrument in a different hedge.¹¹

- IE21. As at February 1, 20X1 and after accounting for the sale of assets, the separate line item in the statement of financial position is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6¹² million of assets. However, as at February 1, 20X1, Entity A is hedging only CU8 million of assets that have a cumulative change in fair value of CU18,963.¹³ The remaining separate line item in the statement of financial position of CU22,755¹⁴ relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortizes this amount over the remaining life of the time period, i.e. it amortizes CU22,755 over two months.
- IE22. Entity A determines that it is not practicable to use a method of amortization based on a recalculated effective yield and hence uses a straight-line method.

End of month 2 (February 28, 20X1)

- IE23. On February 28, 20X1 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of CU8 million is (CU9,518)¹⁵ (the swap is a liability). Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at February 28, 20X1 as CU8,009,518.¹⁶
- IE24. Entity A makes the following accounting entries relating to the hedge in this time period:

Dr	Cash	CU71,707	
	Cr	Surplus or deficit (interest revenue)	CU71,707
<i>To recognize the interest received on the hedged amount (CU8 million).</i>			
Dr	Surplus or deficit (interest expense)	CU71,707	
	Cr	Surplus or deficit(interest revenue)	CU62,115

¹¹ The entity could instead enter into an offsetting swap with a notional principle of CU12 million to adjust its position and designate as the hedging instrument all CU20 million of the existing swap and all CU12 million of the new offsetting swap.

¹² CU19.2 million – (8⅓ x CU19.2 million).

¹³ CU41,718 x (CU8 million/CU17.6 million).

¹⁴ CU41,718 – CU,963.

¹⁵ CU23,795 [see paragraph IE8]x(CU8 million/CU20 million).

¹⁶ CU20,023,795 [see paragraph IE7] x (CU8 million/CU20 million).

Cr Cash CU9,592

To recognize the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr Derivative liability CU9,445

Cr Surplus or deficit (gain) CU9,445

To recognize the change in the fair value of the portion of the swap designated as the hedging instrument (CU8 million) (CU9,518 – CU18,963).

Dr Surplus or deficit (loss) CU9,445

Cr Separate line item in the statement of financial position CU9,445

To recognize the change in the fair value of the hedged amount (CU8,009,518 – CU8,018,963).

IE25. The net effect on surplus or deficit (excluding interest revenue and interest expense) is nil reflecting that the hedge is fully effective.

IE26. Entity A makes the following accounting entry to amortize the line item balance for this time period:

Dr Surplus or deficit (loss) CU11,378

Cr Separate line item in the statement of financial position CU11,378 (a)

To recognize the amortization charge for the period.

(a) $CU22,755 \div 2$

End of month 3

IE27. During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On March 31, 20X1 the assets and the swap mature and all balances are recognized in surplus or deficit.

IE28. Entity A makes the following accounting entries relating to this time period:

Dr Cash CU8,071,707

Cr Asset (statement of financial position) CU8,000,000

Cr Surplus or deficit (interest revenue) CU71,707

To recognize the interest and cash received on maturity of the hedged amount (CU8 million).

Dr	Dr Surplus or deficit (interest expense)	CU71,707	
	Cr Surplus or deficit (interest-revenue)		CU62,115
Cr	Cash		CU9,592

To recognize the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,518	
	Cr Surplus or deficit (gain)		CU9,518

To recognize the expiry of the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Surplus or deficit (gain)	CU9,518	
	Cr Separate line item in the statement of financial position		CU9,518

To remove the remaining line item balance on expiry of the time period.

IE29. The net effect on surplus or deficit (excluding interest revenue and interest expense) is nil reflecting that the hedge is fully effective.

IE30. Entity A makes the following accounting entry to amortize the line item balance for this time period:

Dr	Surplus or deficit (loss)	CU11,377	
	Cr Separate line item in the statement of financial position		CU11,377 ^(a)

To recognize the amortization charge for the period.

(a) $CU22,755 \div 2$

Summary

IE31. The tables below summarize:

- (a) Changes in the separate line item in the statement of financial position;
- (b) The fair value of the derivative;
- (c) The surplus or deficit effect of the hedge for the entire three-month period of the hedge; and
- (d) Interest revenue and interest expense relating to the amount designated as hedged.

Description	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
	CU	CU	CU	CU	CU
Amount of asset hedged	20,000,000	19,200,000	8,000,000	8,000,000	8,000,000
(a) Changes in the separate line item in the statement of financial position					
Brought forward:					
Balance to be amortized	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortization	Nil	Nil	Nil	(11,378)	(11,377)
Carried forward:					
Balance to be amortized	Nil	Nil	22,755	11,377	Nil
Remaining balance	Nil	45,511	18,963	9,518	Nil
(b) The fair value of the derivative					
CU20,000,000	Nil	47,408	–	–	–
CU12,000,000	Nil	–	28,445	No longer designated as the hedging instrument.	
CU8,000,000	Nil	–	18,963	9,518	Nil
Total	Nil	47,408	47,408	9,518	Nil
(c) Effect of the hedge on surplus or deficit					
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	Nil	(1,897)	N/A	Nil	Nil
Amortization	Nil	Nil	N/A	(11,378)	(11,377)

Description	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
	CU	CU	CU	CU	CU

In addition, there is a gain on sale of assets of CU14,607 at February 1, 20X1.

(d) Interest revenue and interest expense relating to the amount designated as hedged

	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
	CU	CU	CU	CU	CU
Interest revenue					
– on the asset	Nil	172,097	N/A	71,707	71,707
– on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
– on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

Example 2—Disposal of a Foreign Operation

IE32. This example illustrates the application of paragraphs C12 and C13 of Appendix C in connection with the amount recognized in surplus or deficit on the disposal of a foreign operation.

Background

IE33. This example assumes the economic entity structure set out in the application guidance and that Entity D used a USD borrowing in Entity A to hedge the EUR/USD risk of the net investment in Entity C in Entity D's consolidated financial statements. 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 Entity C is €24 million (gain). This is matched exactly by the fall in value of the net investment in Entity C, when measured against the functional currency of Entity D (euro).

IE34. If the direct method of consolidation is used, the fall in the value of Entity D's net investment in Entity C of €24 million would be reflected totally in the foreign currency translation reserve relating to Entity C in Entity D's consolidated financial statements. However, because Entity D uses the step-by-step method, this fall in the net investment value in Entity C of €24 million would be reflected both in Entity B's foreign currency translation reserve relating to Entity C and in Entity D's foreign currency translation reserve relating to Entity B.

- IE35. The aggregate amount recognized in the foreign currency translation reserve in respect of 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 Entities B and C in 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

- IE36. When the investment in Entity C is disposed of, IPSAS ~~29XX (ED-38)~~ requires the full €24 million gain on the hedging instrument to be recognized in surplus or deficit. Using the step-by-step method, the amount to be recognized in surplus or deficit in respect of the net investment in Entity C would be only €11 million loss. Entity D could adjust the foreign currency translation reserves of both 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.

Example 3—Receipt of a Concessionary Loan

- IE37. 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 loan should be repaid over the 5 year period as follows:

Year 1: no capital repayments

Year 2: 10% of the capital

Year 3: 20% of the capital

Year 4: 30% of the capital

Year 5: 40% of the capital

Interest is paid annually in arrears, at a rate of 5% per annum on the outstanding balance of the loan. A market related rate of interest for a similar transaction is 10%.

- IE38. The entity has received a concessionary loan of CU5 million, which will be repaid at 5% below the current market interest rate. The difference between the proceeds of the loan and the present value of the contractual payments in terms of the loan agreement, discounted using the market related rate of interest, is recognized as non-exchange revenue.

- IE39. The journal entries to account for the concessionary loan are as follows:

- On initial recognition, the entity recognizes the following (assuming that the entity subsequently measures concessionary loan at amortized cost):

Dr Bank	5,000,000	
Cr Loan (refer to Table 2 below)		4,215,450

Cr Liability or non-exchange revenue 784,550

Recognition of the receipt of the loan at fair value

IPSAS 23 is considered in recognizing either a liability or revenue for the off-market portion of the loan. Example 26 of that IPSAS provides journal entries for the recognition and measurement of the off-market portion of the loan deemed to be non-exchange revenue.

2. Year 1: The entity recognizes the following:

Dr Interest (refer to Table 3 below) 421,545

Cr Loan 421,545

Recognition of interest using the effective interest method (CU4,215,450 X 10%)

Dr Loan (refer to Table 1 below) 250,000

Cr Bank 250,000

Recognition of interest paid on outstanding balance (CU5m X 5%)

3. Year 2: The entity recognizes the following:

Dr Interest 438,700

Cr Loan 438,700

Recognition of interest using the effective interest method (CU4,386,995 X 10%)

Dr Loan 750,000

Cr Bank 750,000

Recognition of interest paid on outstanding balance (CU5m X 5% + CU500,000 capital repaid)

4. Year 3: The entity recognizes the following:

Dr Interest 407,569

Cr Loan 407,569

Recognition of interest using the effective interest method (CU4,075,695 X 10%)

Dr Loan 1,225,000

Cr Bank 1,225,000

Recognition of interest paid on outstanding balance (CU4.5m X 5% + CU1m capital repaid)

5. Year 4: The entity recognizes the following:

Dr Interest 325,826

Cr Loan 325,826

Recognition of interest using the effective interest method (CU 3,258,264 X 10%)

Dr Loan 1,675,000

Cr Bank 1,675,000

Recognition of interest paid on outstanding balance (CU3.5m X 5% + CU1.5m capital repaid)

6. Year 5: The entity recognizes the following:

Dr Interest 190,909

Cr Loan 190,909

Recognition of interest using the effective interest method (CU1,909,091 X 10%)

Dr Loan 2,100,000

Cr Bank 2,100,000

Recognition of interest paid on outstanding balance (CU2m X 5% + CU2m capital repaid)

Calculations:

Table 1: Amortization schedule (using contractual repayments at 5% interest):

	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	CU	CU	CU	CU	CU	CU
Capital	5,000,000	5,000,000	5,000,000	4,500,000	3,500,000	2,000,000
Interest	-	250,000	250,000	225,000	175,000	100,000
Payments	-	250,000	750,000	1,225,000	1,675,000	2,100,000
Balance	5,000,000	5,000,000	4,500,000	3,500,000	2,000,000	-

Table 2: Discounting contractual cash flows (based on a market rate of 10%)

	Year 1	Year 2	Year 3	Year 4	Year 5
	CU	CU	CU	CU	CU
Capital balance	5,000,000	4,500,000	3,500,000	2,000,000	-
Interest payable	250,000	250,000	225,000	175,000	100,000
Total payments (capital and interest)	250,000	750,000	1,225,000	1,675,000	2,100,000
Present value of payments	<u>227,272</u>	619,835	920,360	1,144,048	1,303,935

Total present value of payments	<u>4,215,450</u>
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Proceeds received	5,000,000
Less: Present value of outflows (fair value of loan on initial recognition)	<u>4,215,450</u>
Off-market portion of loan to be recognized as non-exchange revenue	<u><u>784,550</u></u>

Table 3: Calculation of loan balance and interest using the effective interest method:

	Year 1	Year 2	Year 3	Year 4	Year 5
	CU	CU	CU	CU	CU
Capital	4,215,450	4,386,995	4,075,695	3,258,264	1,909,091
Interest accrual	421,545	438,700	407,569	325,827	190,909
Interest and capital payments	250,000	750,000	1,225,000	1,675,000	2,100,000
Balance	4,386,995	4,075,695	3,258,264	1,909,091	-

Example 4—Payment of a Concessionary Loan

IE40. The department of education makes low interest loans available to qualifying students on flexible repayment terms as a means of promoting tertiary education.

IE41. The department advanced CU250 million to various students at the beginning of the financial year, with the following terms and conditions:

- Capital is repaid as follows:
 - Year 1 to 3: no capital repayments
 - Year 4: 30% capital to be repaid
 - Year 5: 30% capital to be repaid
 - Year 6: 40% capital to be repaid
- Interest is calculated at 6% interest on the outstanding loan balance, and is paid annually in arrears. Assume the market rate of interest for a similar loan is 11.5%.

IE42. The journal entries to account for the concessionary loan are as follows (assuming the entity subsequently measures the concessionary loan at amortized cost):

1. On initial recognition, the entity recognizes the following:

Dr Loan	199,345,480
Dr Expense	50,654,520
Cr Bank	250,000,000

2. Year 1: The entity recognizes the following:

Dr Loan	22,924,730
Cr Interest revenue	22,924,730
<i>(Interest accrual using the effective interest method CU199,345,480 X 11.5%)</i>	
Dr Bank	15,000,000
Cr Loan	15,000,000
<i>(Interest payment of CU250m X 6%)</i>	
3. Year 2: The entity recognizes the following:

Dr Loan	23,836,074
Cr Interest revenue	23,836,074
<i>(Interest accrual using the effective interest method CU207,270,210 X 11.5%)</i>	
Dr Bank	15,000,000
Cr Loan	15,000,000
<i>(Interest payment of CU250m X 6%)</i>	
4. Year 3: The entity recognizes the following:

Dr Loan	24,852,223
Cr Interest revenue	24,852,223
<i>(Interest accrual using the effective interest method CU216,106,284 X 11.5%)</i>	
Dr Bank	15,000,000
Cr Loan	15,000,000
5. Year 4: The entity recognizes the following:

Dr Loan	25,985,228
Cr Interest revenue	25,985,228
<i>(Interest accrual using the effective interest method CU225,958, 228,507 X 11.5%)</i>	
Dr Bank	90,000,000
Cr Loan	90,000,000
<i>(Interest payment of CU250m X 6% + CU75m capital repaid)</i>	
6. Year 5: The entity recognizes the following:

Dr Loan	18,623,530
Cr Interest revenue	18,623,530
<i>(Interest accrual using the effective interest method CU161,943,735 X 11.5%)</i>	

Dr Bank 85,500,000
Cr Loan 85,500,000

(Interest payment of CUI75m X 6% + CU75m capital repaid)

7. Year 6: The entity recognizes the following:

Dr Loan 10,932,735
Cr Interest revenue 10,932,735

(Interest accrual using the effective interest method CU95,067,265 X 11.5%)

Dr Bank 106,000,000
Cr Loan 106,000 000

(Interest payment of CU100m X 6% + CU100m capital repaid)

Calculations

Table 1: Amortization schedule (using contractual repayments at 6% interest):

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>
	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>
<u>Capital</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>
<u>Interest</u>	<u>=</u>	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>	<u>10,500</u>	<u>6,000</u>
<u>Payments</u>	<u>=</u>	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>	<u>90,000</u>	<u>85,500</u>	<u>106,000</u>
<u>Balance</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>	<u>175,000</u>	<u>100,000</u>	<u>=</u>

Table 2: Discounting contractual cash flows (based on a market rate of 11.5%)

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>
	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>	<u>CU'000</u>
<u>Capital balance</u>	<u>250,000</u>	<u>250,000</u>	<u>250,000</u>	<u>175,000</u>	<u>100,000</u>	<u>=</u>
<u>Interest payable</u>	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>	<u>10,500</u>	<u>6,000</u>
<u>Total payments (capital and interest)</u>	<u>15,000</u>	<u>15,000</u>	<u>15,000</u>	<u>90,000</u>	<u>85,500</u>	<u>106,000</u>
<u>Present value of payments</u>	<u>13,452,915</u>	<u>12,065,394</u>	<u>10,820,981</u>	<u>58,229,497</u>	<u>49,612,576</u>	<u>55,164,117</u>

Total present value of payments	<u>199,345,480</u>
Proceeds paid	<u>250,000,000</u>
Less: Present value of outflows (fair value of loan on initial recognition)	<u>50,654,520</u>
Off-market portion of loan to be recognized as expense	<u>199,345,480</u>

Table 3: Calculation of loan balance and interest using the effective interest method:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>
	<u>CU</u>	<u>CU</u>	<u>CU</u>	<u>CU</u>	<u>CU</u>	<u>CU</u>
Capital	<u>199,345,480</u>	<u>207,270,210</u>	<u>216,106,284</u>	<u>225,958,228</u>	<u>161,943,735</u>	<u>95,067,265</u>
Interest accrual	<u>22,924,730</u>	<u>23,836,074</u>	<u>24,852,223</u>	<u>25,985,228</u>	<u>18,623,530</u>	<u>10,932,735</u>
Interest and capital payments	<u>15,000,000</u>	<u>15,000,000</u>	<u>15,000,000</u>	<u>90,000,000</u>	<u>85,500,000</u>	<u>106,000,000</u>
Balance	<u>207,270,210</u>	<u>216,106,284</u>	<u>225,958,228</u>	<u>161,943,735</u>	<u>95,067,265</u>	<u>-</u>

Example 5—Financial Guarantee Contract Provided at Nominal Consideration

- IE43. Entity C is a major motor vehicle manufacturer in Jurisdiction A. On January 1, 201V 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 30 year loan of 50 million Currency Units (CUs) repayable in two equal instalments of 25 million CUs in 201X and 204Z. Entity C provides nominal consideration of 30,000 CUs to Government A. Prior to entering into negotiation with Government A, Entity C had approached a number of other entities to issue a guarantee, but none of these entities was prepared to issue such a guarantee. There are no recent examples of financial guarantee contracts in the motor manufacturing sector of the economy in Jurisdiction A or in neighboring Jurisdictions D & E. Government A concludes that it cannot use a valuation technique as the use of a valuation technique does not provide a reliable measure of fair value. Government A therefore determines to measure the financial guarantee contract in accordance with IPSAS 19.
- IE44. On December, 31 201V, having reviewed the financial position and performance of Entity C, Government A determines that there is no present obligation to Entity B in respect of the financial guarantee contract. Government A does not recognize a liability in its statement of financial position. Government A makes the disclosures relating to fair value and credit risk in IPSAS ~~30XX (ED-39)~~, “Financial Instruments: Disclosures” in respect of the financial guarantee contract. It also discloses a contingent liability of 50

million CUs in accordance with IPSAS 19. In its statement of financial performance Government A recognizes revenue of 1,000 CUs in respect of the nominal consideration payable by Entity C.

- IE45. In 201Z there has been a further downturn in the motor manufacturing sector affecting Entity C. Entity C is seeking bankruptcy protection and has defaulted on the first repayment of principal, although it has met its obligations for interest payments. Government A determines that Entity C is unlikely to recover, but negotiations are advanced with a potential acquirer (Entity D), which will restructure Entity B. 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 recognizes an expense and liability for 25 million CUs and discloses a contingent liability of 25 million CUs.

Example 6—Interaction Between Measurement Requirements of IPSAS 23 and IPSAS 29

Background

- IE46. An individual donates shares in listed entity X to public sector entity A on January 1, 20X8. At that date, the shares in entity X have a fair value of CU1,000,000. At December 31, 20X8 the fair value of the shares is CU900,000. As part of the arrangement, entity A incurs the transfer duty to have the shares transferred into its name. These costs amount to CU10,000.
- IE47. Listed entity X provides telecommunications infrastructure and related services to the public. During 20X9, new technology was introduced into the telecommunications industry, making the infrastructure and equipment used by entity X almost obsolete. This resulted in a permanent decline in the value of listed entity X. The value of the impairment loss as at December 31, 20X9 is CU700,000. Entity A has a policy of accounting for investments in shares as an available for sale financial asset. Assume that the arrangement is a contractual arrangement, no present obligations arise from the donation and that the entity's reporting period ends on December 31, 20X8.

Analysis

- IE48. As entity A received the shares as a donation, it uses IPSAS 23 to initially recognize the shares acquired and the related non-exchange revenue. However, because entity A has acquired a financial asset, it considers the initial measurement requirements of IPSAS 23 and IPSAS 29.
- IE49. IPSAS 23 prescribes that assets acquired as part of a non-exchange revenue transaction are initially measured at fair value, while IPSAS 29 prescribes that financial assets are initially measured at fair value and, depending on subsequent measurement, transaction costs may or may not be included. As the entity has a policy of accounting for investments in shares as available for sale financial assets, the transaction costs of CU10,000 are added to the value of the shares of CU1,000,000 on initial measurement.
- IE50. The subsequent measurement and derecognition of the shares is addressed in IPSAS 29. The entity classifies investments in shares as available for sale financial assets which means that the shares are measured at a fair value with any subsequent changes in fair

value recognized in net assets/equity. Impairment losses are however recognized in surplus or deficit in the period in which they occur.

The journal entries at initial acquisition and at the reporting dates are as follows:

1. Acquisition of shares through donation

Dr	Available for sale financial asset (investment in entity X)	1,010,000
Cr	Non-exchange revenue	1,000,000
Cr	Bank (Transfer costs paid)	10,000

2. Subsequent measurement at December 31, 20X8

Dr	Net assets/equity (fair value adjustment of investment)	110,000
Cr	Available for sale financial asset (investment in entity X)	110,000

3. Subsequent measurement at December 31, 20X9

Dr	Impairment loss (surplus or deficit)	700,000
Cr	Available for sale financial asset	700,000

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS [29XX \(ED-38\)](#).

Section A—Scope

A.1 Practice of Settling Net: Forward Contract to Purchase a Commodity

Entity XYZ enters into a fixed price forward contract to purchase one million liters 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 IPSAS [29XX \(ED-38\)](#). Instead, it is accounted for as an executory contract.

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. 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 (IPSAS [29XX \(ED-38\)](#).4 and IPSAS [29XX \(ED-38\)](#).AG22).

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 (IPSAS [29XX \(ED-38\)](#).6). 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 IPSAS [29XX \(ED-38\)](#) because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract rather than 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.

Section B—Definitions

B.1 Definition of a Derivative: Examples of Derivatives and Underlyings

What are examples of common derivative contracts and the identified underlying?

IPSAS ~~29XX (ED 38)~~ 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; and**
- (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 instruments 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 instruments of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates

Type of contract	Main pricing-settlement variable (underlying variable)
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 instruments of another entity)

The above list provides examples of contracts that normally qualify as derivatives under IPSAS ~~29XX (ED 38)~~. 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 of IPSAS ~~29XX (ED 38)~~ may apply, for example, if it is a weather derivative (see IPSAS ~~29XX (ED 38)~~.AG5), a contract to buy or sell a non-financial item such as commodity (see IPSAS ~~29XX (ED 38)~~.4 and IPSAS ~~29XX (ED 38)~~.AG22) or a contract settled in an entity's own shares (see IPSAS ~~28XX (ED 37)~~.25–IPSAS ~~28XX (ED 37)~~.29). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.2 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 IPSAS ~~29XX (ED 38)~~, 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.3 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 \times 10 per cent \times 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 IPSAS ~~29XX (ED-38)~~. 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 IPSAS ~~29XX (ED-38)~~.

B.4 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 IPSAS ~~29XX (ED-38)~~. Therefore, the contract is not accounted for as a derivative under IPSAS ~~29XX (ED-38)~~. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.5 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 principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under IPSAS ~~29XX (ED-38)~~?

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
- 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 IPSAS ~~29XX (ED-38)~~.10 does not require net settlement.

B.6 Definition of a Derivative: Option Not Expected to be Exercised

The definition of a derivative in IPSAS ~~29XX (ED-38)~~.10 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.7 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 rand based on its sales volume in Mozambique in exchange for US dollars at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. IPSAS ~~29XX (ED-38)~~ does not exclude from its scope derivatives that are based on sales volume.

B.8 Definition of a Derivative: Prepaid Forward

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is CU50 per share; the one-year forward price of T is CU55 per share. XYZ is required to prepay the forward contract at inception with a CU50 million payment. The initial investment in the forward contract of CU50 million is less than the notional amount applied to the underlying, one million shares at the forward price of CU55 per share, i.e. CU55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T’s shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.9 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.10 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 IPSAS ~~29XX (ED-38)~~, 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 (IPSAS ~~29XX (ED-38)~~.10). 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.11 Definition of Held for Trading: Balancing a Portfolio

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 per cent of total portfolio value. The investment manager of the portfolio is authorized to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments. Is Entity A permitted to classify the instruments as available-for-sale?

It depends on Entity A’s intentions and past practice. If the portfolio manager is authorized to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available-for-sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

B.12 Definition of Held-to-Maturity Financial Assets: Index-Linked Principal

Entity A purchases a five-year equity-index-linked note with an original issue price of CU10 at a market price of CU12 at the time of purchase. The note requires no interest payments before maturity. At maturity, the note requires payment of the original issue price of CU10 plus a supplemental redemption amount that depends on whether a specified share price index exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the share index at maturity and the level of the share index when the note was issued divided by the level of the share index at the time of issue. Entity A has the positive intention and ability to hold the note to maturity. Can Entity A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of CU10 and fixed maturity and Entity A has the positive intention and ability to hold it to maturity (IPSAS ~~29XX (ED-38)~~.10). However, the equity index feature is a call option not closely related to

the debt host, which must be separated as an embedded derivative under IPSAS ~~29XX (ED 38)~~.12. The purchase price of CU12 is allocated between the host debt instrument and the embedded derivative. For example, if the fair value of the embedded option at acquisition is CU4, the host debt instrument is measured at CU8 on initial recognition. In this case, the discount of CU2 that is implicit in the host bond (principal of CU10 minus the original carrying amount of CU8) is amortized to surplus or deficit over the term to maturity of the note using the effective interest method.

B.13 Definition of Held-to-Maturity Financial Assets: Index-Linked Interest

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes. However, the commodity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (IPSAS ~~29XX (ED 38)~~.12). IPSAS ~~29XX (ED 38)~~.14 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

B.14 Definition of Held-to-Maturity Financial Assets: Sale Following Rating Downgrade

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily. A downgrade is likely to indicate a decline in the issuer's creditworthiness. IPSAS ~~29XX (ED 38)~~ specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in IPSAS ~~29XX (ED 38)~~ and therefore not raise a question about the entity's intention to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in IPSAS ~~29XX (ED 38)~~. A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class could often be regarded as reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be regarded as significant.

B.15 Definition of Held-to-Maturity Financial Assets: Permitted Sales

Would sales of held-to-maturity financial assets due to a change in management compromise the classification of other financial assets as held to maturity?

Yes. A change in management is not identified under IPSAS ~~29XX (ED 38)~~.AG35 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held to maturity. Sales in response to such a change in management would, therefore, call into question the entity's intention to hold investments to maturity.

To illustrate: Entity X has a portfolio of financial assets that is classified as held to maturity. In the current period, at the direction of the governing body, the senior management team has been replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in

order to carry out an expansion strategy designated and approved by the governing body. Although the previous management team had been in place since the entity's inception and Entity X had never before undergone a major restructuring, the sale nevertheless calls into question Entity X's intention to hold remaining held-to-maturity financial assets to maturity.

B.16 Definition of Held-to-Maturity Investments: Sales in Response to Entity-Specific Capital Requirements

In some countries, regulators of banks or other industries may set *entity-specific* capital requirements that are based on an assessment of the risk in that particular entity. IPSAS ~~29XX (ED-38)~~.AG35(e) indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the industry's capital requirements may do so under IPSAS ~~29XX (ED-38)~~ without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in *entity-specific* capital requirements imposed by regulators (i.e. capital requirements applicable to a particular entity, but not to the industry) raise such doubt?

Yes, such sales "taint" the entity's intention to hold other financial assets as held to maturity unless it can be demonstrated that the sales fulfill the condition in IPSAS ~~29XX (ED-38)~~.10 in that they result from an increase in capital requirements, which is an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

B.17 Definition of Held-to-Maturity Financial Assets: Pledged Collateral, Repurchase Agreements (repos) and Securities Lending Agreements

An entity cannot have a demonstrated ability to hold to maturity an investment if it is subject to a constraint that could frustrate its intention to hold the financial asset to maturity. Does this mean that a debt instrument that has been pledged as collateral, or transferred to another party under a repo or securities lending transaction, and continues to be recognized cannot be classified as a held-to-maturity investment?

No. An entity's intention and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or securities lending agreement. However, an entity does not have the positive intention and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments.

B.18. Definition of Held-to-Maturity Financial Assets: "Tainting"

In response to unsolicited tender offers, Entity A sells a significant amount of financial assets classified as held to maturity on economically favorable terms. Entity A does not classify any financial assets acquired after the date of the sale as held to maturity. However, it does not reclassify the remaining held-to-maturity investments since it maintains that it still intends to hold them to maturity. Is Entity A in compliance with IPSAS ~~29XX (ED-38)~~?

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held to maturity (HTM) results in the conditions in IPSAS ~~29XX (ED 38)~~.10 and IPSAS ~~29XX (ED 38)~~.AG35 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as available-for-sale financial assets. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under IPSAS ~~29XX (ED 38)~~.60. IPSAS ~~29XX (ED 38)~~.10 makes it clear that at least two full financial years must pass before an entity can again classify financial assets as HTM.

B.19 Definition of Held-to-Maturity Investments: Sub-Categorization for the Purpose of Applying the “Tainting” Rule

Can an entity apply the conditions for held-to-maturity classification in IPSAS ~~29XX (ED 38)~~.10 separately to different categories of held-to-maturity financial assets, such as debt instruments denominated in US dollars and debt instruments denominated in euro?

No. The “tainting rule” in IPSAS ~~29XX (ED 38)~~.10 is clear. If an entity has sold or reclassified more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

B.20 Definition of Held-to-Maturity Investments: Application of the “Tainting” Rule on Consolidation

Can an entity apply the conditions in IPSAS ~~29XX (ED 38)~~.10 separately to held-to-maturity financial assets held by different entities in an economic entity, for example, if separate entities are in different countries with different legal or economic environments?

No. If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in IPSAS ~~29XX (ED 38)~~.10 are met.

B.21 Definition of Loans and Receivables: Equity Instrument

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes. If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met. IPSAS ~~27XX (ED 37)~~.13–IPSAS ~~27XX (ED 37)~~.276 provide guidance about the classification of a financial instrument as a liability or as an equity instrument from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under IPSAS ~~28XX (ED 37)~~, it cannot be classified within loans and receivables by the holder.

B.22 Definition of Loans and Receivables: Banks’ Deposits in Other Banks

Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not

intend to sell it. Would such a deposit fall within loans and receivables under IPSAS ~~29XX (ED-38)~~.10?

Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

B.23 Definition of Amortized Cost: Perpetual Debt Instruments with Fixed or Market-Based Variable Rate

Sometimes entities purchase or issue debt instruments that are required to be measured at amortized cost and in respect of which the issuer has no obligation to repay the principal amount. Interest may be paid either at a fixed rate or at a variable rate. Would the difference between the initial amount paid or received and zero (“the maturity amount”) be amortized immediately on initial recognition for the purpose of determining amortized cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayments of principal, there is no amortization of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortized cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (IPSAS ~~29XX (ED-38)~~.10).

B.24 Definition of Amortized Cost: Perpetual Debt Instruments with Decreasing Interest Rate

If the stated rate of interest on a perpetual debt instrument decreases over time, would amortized cost equal the principal amount in each period?

No. From an economic perspective, some or all of the interest payments are repayments of the principal amount. For example, the interest rate may be stated as 16 per cent for the first ten years and as zero per cent in subsequent periods. In that case, the initial amount is amortized to zero over the first ten years using the effective interest method, since a portion of the interest payments represents repayments of the principal amount. The amortized cost 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 cash payments of either principal or interest in subsequent periods).

B.25 Example of Calculating Amortized Cost: Financial Asset

Financial assets that are excluded from fair valuation and have a fixed maturity should be measured at amortized cost. How is amortized cost calculated?

Under IPSAS ~~29XX (ED-38)~~, amortized cost 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 net 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 amortized cost 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 principal amount of CU1,250 and carries fixed interest of 4.7 per cent that is paid annually ($\text{CU1,250} \times 4.7 \text{ per cent} = \text{CU59}$ per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

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 amortized cost, interest revenue and cash flows of the debt instrument in each reporting period.

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost 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 principal will be prepaid at the end of 20X2 and the remaining 50 per cent at the end of 20X4. In accordance with IPSAS ~~29XX (ED 38)~~.AG20, the opening balance of the debt instrument in 20X2 is adjusted. The adjusted amount is calculated 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 opening balance in 20X2 of CU1,138. The adjustment of CU52 ($\text{CU1,138} - \text{CU1,086}$) is recorded in surplus or deficit in 20X2. The table below provides information about the amortized cost, interest revenue and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost 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	–

If the debt instrument becomes impaired, say, at the end of 20X3, the impairment loss is calculated as the difference between the carrying amount (CU595) and the present value of estimated future cash flows discounted at the original effective interest rate (10 per cent).

B.26 Example of Calculating Amortized Cost: 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 and no embedded derivative is issued at CU1,250 and has a maturity amount of CU1,250, would the amortized cost 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 (IPSAS ~~29XX (ED-38)~~.10).

The following example illustrates how amortized cost 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, 2000, Entity A issues a debt instrument for a price of CU1,250. The principal amount is CU1,250 and the debt instrument is repayable on December 31, 2004. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 per cent in 2000 (CU75), 8.0 per cent in 2001 (CU100), 10.0 per cent in 2002 (CU125), 12.0 per cent in 2003 (CU150), and 16.4 per cent in 2004 (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 amortized cost in each period. In each period, the amortized cost at the beginning of the period is multiplied by the effective interest rate of 10 per cent and added to the amortized cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortized cost in each period is as follows:

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost at the end of the year
2000	1,250	125	75	1,300
2001	1,300	130	100	1,330
2002	1,330	133	125	1,338
2003	1,338	134	150	1,322

2004

1,322

133

1,250 + 205

–

B.27 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. IPSAS ~~29XX (ED 38)~~.10 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in IPSAS ~~29XX (ED 38)~~.10, is not limited to a formal stock exchange or organized over-the-counter market. Rather, 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.28 Regular Way Contracts: Forward Contract

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for CU10 per share. The contract is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.29 Regular Way Contracts: Which Customary Settlement Provisions Apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases one million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.30 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.31 Recognition and Derecognition of Financial Liabilities Using Trade Date or Settlement Date Accounting

IPSAS ~~29XX (ED-38)~~ 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. IPSAS ~~29XX (ED-38)~~ 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 IPSAS ~~29XX (ED-38)~~.18 and IPSAS ~~29XX (ED-38)~~.41 apply. IPSAS ~~29XX (ED-38)~~.16 states that financial liabilities are recognized on the date the entity ‘becomes a party to the contractual provisions of the instrument’. Such contracts generally are not recognized unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IPSAS ~~29XX (ED-38)~~. IPSAS ~~29XX (ED-38)~~.41 specifies that financial liabilities are derecognized only when they are extinguished, i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Section C—Embedded Derivatives

C.1 Embedded Derivatives: Separation of Host Debt Instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the entity makes its own judgment of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, 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 principal 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 instrument.

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 instrument. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid instrument 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 instrument. 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 instrument. 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 instrument. 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 instrument?

No. The economic behavior of a hybrid instrument with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, capton, floortion or swaption feature in a hybrid instrument) should be based on the stated terms of the option feature documented in the hybrid instrument. 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 instrument.

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 instrument being exercised generally is not zero, it would be inconsistent with the likely economic behavior of the hybrid instrument 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 instrument. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behavior of the hybrid instrument, 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 instrument.

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 instrument. 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 instrument, 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 instrument.

C.3 Embedded Derivatives: Accounting for a Convertible Bond

What is the accounting treatment of an investment in a bond (financial asset) that is convertible into shares equity instruments of the issuing entity or another entity before maturity?

An investment in a convertible bond that is convertible before maturity generally cannot be classified as a held-to-maturity investment because that would be inconsistent with paying for the conversion feature—the right to convert into equity instruments before maturity.

An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative.

If the bond is classified as available for sale (i.e. fair value changes recognized in net assets/equity until the bond is sold), the equity conversion option (the embedded derivative) is separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognized in surplus or deficit unless the option is part of a cash flow hedging relationship.

If the convertible bond is measured at fair value with changes in fair value recognized in surplus or deficit, separating the embedded derivative from the host bond is not permitted.

C.4 Embedded Derivatives: Equity Kicker

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an “equity kicker”) in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognized in surplus or deficit (IPSAS [29XX \(ED 38\)](#).12(c)), 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 (IPSAS [29XX \(ED 38\)](#).12(a)). 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 (IPSAS ~~29XX (ED-38)~~.12(b) and IPSAS ~~29XX (ED-38)~~.10(a)). 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. IPSAS ~~29XX (ED-38)~~.AG21 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.5 Embedded Derivatives: Identifying Debt or Equity Instruments as Host Contracts

Entity A purchases a five-year “debt” instrument issued by Entity B with a principal amount of CU1 million that is indexed to the share price of Entity C. At maturity, Entity A will receive from Entity B the principal amount plus or minus the change in the fair value of 10,000 shares of Entity C. The current share price is CU110. No separate interest payments are made by Entity B. The purchase price is CU1 million. Entity A classifies the debt instrument as available-for-sale. Entity A concludes that the instrument is a hybrid instrument with an embedded derivative because of the equity-indexed principal. For the purposes of separating an embedded derivative, is the host contract an equity instrument or a debt instrument?

The host contract is a debt instrument because the hybrid instrument has a stated maturity, i.e. it does not meet the definition of an equity instrument (IPSAS ~~28XX (ED-37)~~.9 and IPSAS ~~28XX (ED-37)~~.14). It is accounted for as a zero coupon debt instrument. Thus, in accounting for the host instrument, Entity A imputes interest on CU1 million over five years using the applicable market interest rate at initial recognition. The embedded non-option derivative is separated so as to have an initial fair value of zero (see Question C.1).

C.6 Embedded Derivatives: Synthetic Instruments

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since IPSAS ~~29XX (ED-38)~~.AG46(a) 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 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 IPSAS ~~29XX (ED-38)~~. 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.5, which had no substance apart from the resulting interest rate swap.

C.7 Embedded Derivatives: Purchases and Sales Contracts in Foreign Currency Instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under IPSAS ~~29XX (ED 38)~~?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contract as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in surplus or deficit unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 Embedded Foreign Currency Derivatives: Unrelated Foreign Currency Provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IPSAS ~~29XX (ED 38)~~ 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 (IPSAS ~~29XX (ED 38)~~.4 and IPSAS ~~29XX (ED 38)~~.AG22). 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 IPSAS ~~29XX (ED 38)~~.12, 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 (IPSAS ~~29XX (ED 38)~~.AG46(d)).

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 IPSAS ~~29XX (ED 38)~~.AG45(d) 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 IPSAS ~~29XX (ED-38)~~.12.

C.9 Embedded Foreign Currency Derivatives: Currency of International Commerce

IPSAS ~~29XX (ED-38)~~.AG46(d) 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.10 Embedded Derivatives: Holder Permitted, But Not Required, to Settle Without Recovering Substantially all of its Recognized Investment

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recognized investment and the issuer does not have such a right (for example, a puttable debt instrument), does the contract satisfy the condition in IPSAS ~~29XX (ED-38)~~.AG46(a) that the holder would not recover substantially all of its recognized investment?

No. The condition that ‘the holder would not recover substantially all of its recognized investment’ is not satisfied if the terms of the combined instrument permit, but do not require, the investor to settle the combined instrument in a manner that causes it not to recover substantially all of its recognized investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that ‘the holder would not recover substantially all of its recognized investment’ applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognized investment.

C.11 Embedded Derivatives: Reliable Determination of Fair Value

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No. In this case, the entire combined contract is treated as a financial instrument held for trading (IPSAS ~~29XX (ED-38)~~.14). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The entity might conclude, however,

that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment.

C.12 Identifying Contracts Containing Embedded Derivatives

The examples below illustrate whether an embedded derivative exists in the following contracts. Assume for purposes of the examples, that the entity's functional currency is US dollars:

Description of contract and related features	Impact of the conditions?	Why is it an embedded derivative or not?
Leases		
An entity is the tenant in a 10 year lease of a property with the rental payments contractually determined for the first year, but thereafter increase in line with:		
(a) Consumer Price Index (CPI)	The rental payments due in terms of the rental agreement will fluctuate in accordance with CPI.	The rental payments escalate in accordance with an inflation index in the same economic environment as the lease. Therefore this feature is closely related to the host contract, and the entity should not account for the embedded derivative separately from the host contract (see AG46(f)). The entire lease contract should be accounted for in accordance with IPSAS 13, "Leases".
(b) Three times CPI	The rental payments due in terms of the rental agreement will fluctuate in accordance with three times the CPI.	Although the rental payments escalate in accordance with an inflation index in the same economic environment as the lease, but the index is leveraged (i.e. it is a multiple of CPI, see AG46(f)). The embedded derivative should be separated from the host lease contract and accounted for as a financial instrument (the lease contract should be accounted for in accordance with IPSAS 13).
(c) US Property Price Index	The rental payments due in terms of the rental agreement will fluctuate in accordance with a property price index.	The rental payments escalate in accordance with an inflation index in the same economic environment as the lease. Therefore this feature is closely related to the host contract,

		and the embedded derivative should not be accounted for separately (see AG46(f)(i)). The entire lease contract should be accounted for in accordance with IPSAS 13.
(d) UK Property Price Index	The rental payments due in terms of the rental agreement will fluctuate in accordance an index which is in a foreign currency.	The rental payments escalate in accordance with an inflation index which is not in the same economic environment as the lease. Therefore this feature is not closely related to the host contract, and an embedded derivative exists (see AG46(f)). The embedded derivative should be separated from the host lease contract and accounted for as a financial instrument (the lease contract should be accounted for in accordance with IPSAS 13).
Contracts for the purchase or supply of goods		
A local authority contracts with a firm to build low cost houses in various sites over the next five years. The contract stipulates that the building price escalates by: 60% of the cost increases in line with a wage index; 20% of the cost increases in line with the price of steel; 20% of the cost increases with the cost of cement.	The effect of this clause in the contract is that the payments for the houses will increase based on the increases in raw materials and other inputs into the construction of the houses, in specific ratios.	If it can be proven reliably that the cost of building houses is comprised 60% of labor, 20% steel and 20% cement, these features are closely linked to the host contract. If not, it can be argued that the price is leveraged (because the ratios may be incorrect and do not reflect the cost structure). The entity will then need to account for the embedded derivative separately from the host contract.
A department of defense the enters into an agreement to supply satellite technology to an overseas country. The contract price is agreed at USD100 000.	The contract will be settled in US dollars, which is the functional currency of the supplier, but not the buyer.	The US dollar is the functional currency of a substantial party to the contract (see AG46(d)(i)). Therefore this embedded derivative is closely related to the host contract and the entity should not account for the embedded derivative separately from the host contract (see AG46).

(Some of the examples in the table above are sourced and adapted from: Manual of Accounting – IFRS for the UK, issued by PricewaterhouseCoopers Inc in 2006)

Section D—Recognition and Derecognition

D.1 Initial Recognition

D.1.1 Recognition: Cash Collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognize the cash collateral it has received as an asset?

Yes. The ultimate realization of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realized by Entity A. Therefore, Entity A recognizes the cash as an asset and a payable to Entity B while Entity B derecognizes the cash and recognizes a receivable from Entity A.

D.2 Regular Way Purchase or Sale of a Financial Asset

D.2.1 Trade Date vs. Settlement Date: Amounts to be Recorded for a Purchase

How are the trade date and settlement date accounting principles in the Standard applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard 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	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X1			
Financial asset	—	—	—
Financial liability	—	—	—
December 31, 20X1			
Receivable	—	2	2
Financial asset	—	—	—
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(2)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(2)
January 4, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,003	1,003
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(3)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(3)

Trade date accounting			
Balances	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
December 31, 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Net assets/equity (fair value adjustment)	–	(2)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(2)
January 4, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Net assets/equity (fair value adjustment)	–	(3)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(3)

D.2.2 Trade date vs. settlement date: amounts to be recorded for a sale

How are the trade date and settlement date accounting principles in the Standard applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard 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 amortized cost 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 interest that might have accrued on the asset is disregarded).

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	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Net assets/equity (fair value adjustment)	–	10	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	10
December 31, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Net assets/equity (fair value adjustment)	–	10	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	10
January 4, 20X3			
Net assets/equity (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	10	10	10

Trade date accounting			
Balances	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Equity (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
December 31, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Net assets/equity (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
January 4, 20X3			
Net assets/equity (fair value adjustment)	–	–	–
Accumulated surplus or deficit (through surplus or deficit)	10	10	10

D.2.3 Settlement Date Accounting: Exchange of Non-Cash Financial Assets

If an entity recognizes sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognized in accordance with IPSAS ~~29XX (ED 38)~~.66?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under IPSAS ~~29XX (ED 38)~~.66 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognized on the trade date as described in IPSAS ~~29XX (ED 38)~~.AG70. In that case, the entity recognizes a

liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on December 29, 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is carried at amortized cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both assets have a fair value of CU1,010 on December, 29, while the amortized cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for loans and receivables and trade date accounting for assets 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 Realization 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, incremental costs that are directly attributable to the acquisition of the asset, for example fees and commissions, are added to the amount originally recognized. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally

recognized. For financial instruments that are measured at fair value through surplus or deficit, transaction costs are not added to the fair value measurement at initial recognition.

For financial instruments that are carried at amortized cost, such as held-to-maturity investments, loans and receivables, and financial liabilities that are not at fair value through surplus or deficit, transaction costs are included in the calculation of amortized cost using the effective interest method and, in effect, amortized through surplus or deficit over the life of the instrument.

For available-for-sale financial assets, transaction costs are recognized in other net assets/equity as part of a change in fair value at the next remeasurement. If an available-for-sale financial asset has fixed or determinable payments and does not have an indefinite life, the transaction costs are amortized to surplus or deficit using the effective interest method. If an available-for-sale financial asset does not have fixed or determinable payments and has an indefinite life, the transaction costs are recognized in surplus or deficit when the asset is derecognized or becomes impaired.

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 Fair Value Measurement Considerations

E.2.1 Fair Value Measurement Considerations for Investment Funds

IPSAS ~~29XX (ED 38)~~.AG1043 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors on the basis of mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets on the basis of mid-market prices?

No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in IPSAS ~~29XX (ED 38)~~.AG1043 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognized in its statement of financial position and the prices used for the net asset value calculation.

E.2.2 Fair Value Measurement: Large Holding

Entity A holds 15 per cent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is CU100. Daily trading volume is 0.1 per cent of outstanding shares. Because Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price, Entity A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A would be able to obtain a price of CU105, i.e. a 5 per cent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

Under IPSAS ~~29XX (ED-38)~~.AG10³², a published price quotation in an active market is the best estimate of fair value. Therefore, Entity A uses the published price quotation (CU100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

E.3 Gains and Losses

E.3.1 Available-For-Sale Financial Assets: Exchange of Shares

Entity A holds a small number of shares in Entity B. The shares are classified as available-for-sale. On December 20, 20X0, the fair value of the shares is CU120 and the cumulative gain recognized in net assets/equity is CU20. On the same day, Entity B is acquired by Entity C. As a result, Entity A receives shares in Entity C in exchange for those it had in Entity B of equal fair value. Under IPSAS ~~29XX (ED-38)~~.64(b), should Entity A reclassify the cumulative gain of CU20 recognized in net assets/equity to surplus or deficit?

Yes. The transaction qualifies for derecognition under IPSAS ~~29XX (ED-38)~~. IPSAS ~~29XX (ED-38)~~.64(b) requires the cumulative gain or loss on an available-for-sale financial asset that has been recognized in net assets/equity to be recognized in surplus or deficit when the asset is derecognized. In the exchange of shares, Entity A disposes of the shares it had in Entity B and receives shares in Entity C.

E.3.2 IPSAS ~~29XX (ED-38)~~ and IPSAS 4 Available-For-Sale Financial Assets: Separation of Currency Component

For an available-for-sale monetary financial asset, the entity recognizes changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit in accordance with IPSAS 4.27(a) and IPSAS 4.32 and other changes in the carrying amount in net assets/equity in accordance with IPSAS ~~29XX (ED-38)~~. How is the cumulative gain or loss that is recognized in net assets/equity determined?

It is the difference between the amortized cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity. For the purpose of applying IPSAS 4.32 the asset is treated as an asset measured at amortized cost in the foreign currency.

To illustrate: on December 31, 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a principal amount of FC1,250, carries fixed interest of 4.7 per cent that is paid annually ($FC1,250 \times 4.7$ per cent = FC59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as available-for-sale, and thus recognizes gains and losses in net assets/equity. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 (= $FC1,000 \times 1.5$).

Dr	Bond	LC1,500
	Cr	Cash
		LC1,500

On December 31, 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 (= $FC1,060$

× 2). The amortized cost is FC1,041 (= LC2,082). In this case, the cumulative gain or loss to be recognized and accumulated in net assets/equity is the difference between the fair value and the amortized cost on December 31, 20X2, i.e. LC38 (= LC2,120 – LC2,082).

Interest received on the bond on December 31, 20X2 is FC59 (= LC118). Interest revenue determined in accordance with the effective interest method is FC100 (= 1,000 × 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 (IPSAS 4.25). 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 recognized in surplus or deficit is LC510 (= LC2,082 – LC1,500 – LC72). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.00 – 1.75]).

Dr	Bond	LC620	
Dr	Cash	LC118	
	Cr	Interest revenue	LC175
	Cr	Exchange gain	LC525
	Cr	Fair value change in net assets/equity	LC38

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 amortized cost is FC1,086 (= LC2,715). The cumulative gain or loss to be accumulated in net assets/equity is the difference between the fair value and the amortized cost on December 31, 20X3, i.e. negative LC40 (= LC2,675 – LC2,715). Thus, the amount recognized in net assets/equity 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 per cent). 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 (IPSAS 4.25). Thus, recognized 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 recognized 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 net assets/equity	LC78	
	Cr	Interest revenue	LC234
	Cr	Exchange gain	LC547

E.3.3 IPSAS ~~29XX (ED-38)~~ and IPSAS 4 Exchange Differences Arising on Translation of Foreign Entities: Net Assets/Equity or, Surplus or Deficit?

IPSAS 4.37 and IPSAS 4.57 states that all exchange differences resulting from translating the financial statements of a foreign operation should be recognized in net assets/equity until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets classified as at fair value through surplus or deficit and financial assets that are available-for-sale.

IPSAS ~~29XX (ED-38)~~.64 requires that changes in fair value of financial assets classified as at fair value through surplus or deficit should be recognized in surplus or deficit and changes in fair value of available-for-sale investments should be recognized in net assets/equity.

If the foreign operation is a controlled entity whose financial statements are consolidated with those of its controlling entity, in the consolidated financial statements how are IPSAS ~~29XX (ED-38)~~.64 and IPSAS 4.44 applied?

IPSAS ~~29XX (ED-38)~~ applies in the accounting for financial instruments in the financial statements of a foreign operation and IPSAS 4 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign controlled entity (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under IPSAS ~~29XX (ED-38)~~.

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 (= LCY100 × 2.00) in the consolidated financial statements.

At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognizes the trading asset at LCY110 in its statement of financial position and recognizes a fair value gain of LCY10 in its surplus or deficit. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 (= LCY110 × 3.00) in the currency of Country X. Therefore, Entity A recognizes the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of changes in net assets/equity of B "at the exchange rates at the dates of the transactions" (IPSAS 4.44(b)). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ($[3.00 + 2.00] / 2 = 2.50$, in accordance with IPSAS 4.25). Therefore, while the fair value of the trading asset has increased by LCX130 (= LCX330 – LCX200), Entity A recognizes only LCX25 (= LCY10 × 2.5) of this increase in consolidated surplus or deficit to comply with IPSAS 4.44(b). The resulting exchange difference, i.e. the remaining increase in the fair value of the debt instrument (LCX130 – LCX25 =

LCX105), is accumulated in net assets/equity until the disposal of the net investment in the foreign operation in accordance with IPSAS 4.57.

E.3.4 IPSAS ~~29XX (ED 38)~~ and IPSAS 4: Interaction between IPSAS ~~29XX (ED 38)~~ and IPSAS 4

IPSAS ~~29XX (ED 38)~~ includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in surplus or deficit. IPSAS 4 includes rules about the reporting of foreign currency items and the recognition of exchange differences in surplus or deficit. In what order are IPSAS 4 and IPSAS ~~XX (ED 38)~~ 29 applied?

Statement of Financial Position

Generally, the measurement of a financial asset or financial liability at fair value, cost or amortized cost is first determined in the foreign currency in which the item is denominated in accordance with IPSAS ~~29XX (ED 38)~~. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IPSAS 4 (IPSAS ~~29XX (ED 38)~~.AG11~~65~~). For example, if a monetary financial asset (such as a debt instrument) is carried at amortized cost under IPSAS ~~29XX (ED 38)~~, amortized cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognized using the closing rate in the entity's financial statements (IPSAS 4.27). That applies regardless of whether a monetary item is measured at cost, amortized cost or fair value in the foreign currency (IPSAS 4.28). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is carried at fair value in the foreign currency (IPSAS 4.27(c)) and at a historical rate if it is not carried at fair value under IPSAS ~~29XX (ED 38)~~ because its fair value cannot be reliably measured (IPSAS 4.27(b) and IPSAS ~~29XX (ED 38)~~.48).

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 IPSAS ~~29XX (ED 38)~~, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognized using a historical rate under IPSAS 4 (IPSAS ~~29XX (ED 38)~~.99), i.e. the foreign currency amount is recognized using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (IPSAS 4.27(b)).

Surplus or Deficit

The recognition of a change in the carrying amount of a financial asset or financial liability in surplus or deficit depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognizing changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognizing a monetary item at a rate different from that at which it was initially recognized during the period, or recognized in previous financial statements, is recognized in surplus or deficit or in net assets/equity in accordance with IPSAS 4 (IPSAS ~~29XX (ED-38)~~.AG1165, IPSAS 4.32 and IPSAS 4.37), 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 in IPSAS ~~29XX (ED-38)~~ apply (IPSAS ~~29XX (ED-38)~~.106). Differences arising from recognizing a monetary item at a foreign currency amount different from that at which it was previously recognized are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognized in surplus or deficit or in net assets/equity in accordance with IPSAS ~~29XX (ED-38)~~. For example, although an entity recognizes gains and losses on available-for-sale monetary financial assets in net assets/equity (IPSAS ~~29XX (ED-38)~~.64(b)), the entity nevertheless recognizes the changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit (IPSAS 4.27(a)).

Any changes in the carrying amount of a *non-monetary item* are recognized in surplus or deficit or in net assets/equity in accordance with IPSAS ~~29XX (ED-38)~~ (IPSAS ~~29XX (ED-38)~~.AG1165). For example, for available-for-sale financial assets the entire change in the carrying amount, including the effect of changes in foreign currency rates, is recognized in net assets/equity. If the non-monetary item is designated as a cash flow hedge of an unrecognized firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in IPSAS ~~29XX (ED-38)~~ apply (IPSAS ~~XX (ED-38)~~29.106).

When some portion of the change in carrying amount is recognized in net assets/equity and some portion is recognized in surplus or deficit, for example, if the amortized cost of a foreign currency bond classified as available-for-sale has increased in foreign currency (resulting in a gain in surplus or deficit) but its fair value has decreased in the functional currency (resulting in a loss recognized in net assets/equity), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognized in surplus or deficit or in net assets/equity.

E.4 Impairment and Uncollectibility of Financial Assets

E.4.1 Objective Evidence of Impairment

Does IPSAS ~~29XX (ED-38)~~ require that an entity be able to identify a single, distinct past causative event to conclude that it is probable that an impairment loss on a financial asset has been incurred?

No. IPSAS ~~29XX (ED-38)~~.68 states “It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment.” Also, IPSAS ~~29XX (ED-38)~~.69 states that “a downgrade of an entity’s credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.” Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors’ or issuers’ liquidity, solvency and business and financial risk

exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

E.4.2 Impairment: Future Losses

Does IPSAS ~~29XX (ED-38)~~ permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Entity A lends CU1,000 to Customer B, can it recognize an immediate impairment loss of CU10 if Entity A, based on historical experience, expects that 1 per cent of the principal amount of loans given will not be collected?

No. IPSAS ~~29XX (ED-38)~~.45 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, IPSAS ~~29XX (ED-38)~~.67 requires that an impairment loss is recognized only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with IPSAS ~~29XX (ED-38)~~.45 and IPSAS ~~29XX (ED-38)~~.67 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

E.4.3 Assessment of Impairment: Principal and Interest

Because of Customer B's financial difficulties, Entity A is concerned that Customer B will not be able to make all principal and interest payments due on a loan in a timely manner. It negotiates a restructuring of the loan. Entity A expects that Customer B will be able to meet its obligations under the restructured terms. Would Entity A recognize an impairment loss if the restructured terms are as reflected in any of the following cases?

- (a) Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.**
- (b) Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.**
- (c) Customer B will pay the full principal amount of the original loan on the original due date with interest only at a lower interest rate than the interest rate inherent in the original loan.**
- (d) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.**
- (e) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.**

IPSAS ~~29XX (ED-38)~~.67 indicates that an impairment loss has been incurred if there is objective evidence of impairment. The amount of the impairment loss for a loan measured at amortized

cost is the difference between the carrying amount of the loan and the present value of future principal and interest payments discounted at the loan's original effective interest rate. In cases (a)–(d) above, the present value of the future principal and interest payments discounted at the loan's original effective interest rate will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognized in those cases.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan's original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss. However, this fact pattern is unlikely given Customer B's financial difficulties.

E.4.4 Assessment of Impairment: Fair Value Hedge

A loan with fixed interest rate payments is hedged against the exposure to interest rate risk by a receive-variable, pay-fixed interest rate swap. The hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. Should an assessment of impairment in the loan take into account the fair value adjustment for interest rate risk?

Yes. The loan's original effective interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, the original effective interest rate and amortized cost of the loan are adjusted to take into account recognized fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan.

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the estimated future cash flows of the loan discounted at the adjusted effective interest rate. When a loan is included in a portfolio hedge of interest rate risk, the entity should allocate the change in the fair value of the hedged portfolio to the loans (or groups of similar loans) being assessed for impairment on a systematic and rational basis.

E.4.5 Impairment: Provision Matrix

An entity calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix that specifies fixed provision rates for the number of days a loan has been classified as non-performing (zero per cent if less than 90 days, 20 per cent if 90–180 days, 50 per cent if 181–365 days and 100 per cent if more than 365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables under IPSAS ~~29XX (ED 38)~~.72?

Not necessarily. IPSAS ~~XX (ED 38)~~29.72 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

E.4.6 Impairment: Excess Losses

Does IPSAS ~~29XX (ED 38)~~ permit an entity to recognize impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in identified individual financial assets or identified groups of similar financial assets?

No. IPSAS ~~29XX (ED 38)~~ does not permit an entity to recognize impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics (IPSAS ~~29XX (ED 38)~~.73) on the basis of objective evidence about the existence of impairment in those assets (IPSAS ~~29XX (ED 38)~~.67). Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognized as impairment or bad debt losses under IPSAS ~~29XX (ED 38)~~. However, if an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics (IPSAS ~~XX (ED 38)~~29.73).

E.4.7 Recognition of Impairment on a Portfolio

IPSAS ~~29XX (ED 38)~~.72 requires that impairment be recognized for financial assets carried at amortized cost. IPSAS ~~29XX (ED 38)~~.73 states that impairment may be measured and recognized individually or on a portfolio basis for a group of similar financial assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortized cost, does IPSAS ~~29XX (ED 38)~~ allow non-recognition of the impairment of the first asset?

No. If an entity knows that an individual financial asset carried at amortized cost is impaired, IPSAS ~~29XX (ED 38)~~.72 requires that the impairment of that asset should be recognized. It states: “the amount of the loss is measured as the difference between *the asset’s* carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate” (emphasis added). Measurement of impairment on a portfolio basis under IPSAS ~~29XX (ED 38)~~.73 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

E.4.8 Impairment: Recognition of Collateral

If an impaired financial asset is secured by collateral that does not meet the recognition criteria for assets in other Standards, is the collateral recognized as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral is not recognized as an asset separate from the impaired financial asset unless it meets the recognition criteria for an asset in another Standard.

E.4.9 Impairment of Non-Monetary Available-For-Sale Financial Asset

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses recognized in net assets/equity becomes impaired, should the cumulative net loss recognized in net assets/equity, including any portion attributable to foreign currency changes, be recognized in?

Yes. IPSAS ~~29XX (ED 38)~~.76 states that when a decline in the fair value of an available-for-sale financial asset has been recognized in net assets/equity and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognized in net assets/equity should be recognized in surplus or deficit even though the asset has not been derecognized. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognized in net assets/equity is also recognized in surplus or deficit. Any subsequent losses, including any portion attributable to foreign currency changes, are also recognized in surplus or deficit until the asset is derecognized.

E.4.10 Impairment: Whether the Available-For-Sale Reserve in Net Assets/Equity can be Negative

IPSAS ~~29XX (ED 38)~~ requires that gains and losses arising from changes in fair value on available-for-sale financial assets are recognized in net assets/equity. If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognized in net assets/equity be recognized in surplus or deficit?

Not necessarily. The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired. An entity assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of assets may be impaired, in accordance with IPSAS ~~29XX (ED 38)~~.68-70 IPSAS ~~29XX (ED 38)~~.69 states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. Additionally, a decline in the fair value of a financial asset below its cost or amortized cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

Section F—Hedging

F.1 Hedging Instruments

F.1.1 Hedging the Fair Value Exposure of a Bond Denominated in a Foreign Currency

Entity J, whose functional currency is the Japanese yen, has issued 5 million five-year US dollar fixed rate debt. Also, it owns a 5 million five-year fixed rate US dollar bond which it has classified as available-for-sale. Can Entity J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No. IPSAS ~~29XX (ED-38)~~.81 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Entity J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

Alternatively, can the US dollar liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

Yes. However, hedge accounting is unnecessary because the amortized cost of the hedging instrument and the hedged item are both remeasured using closing rates. Regardless of whether Entity J designates the relationship as a cash flow hedge or a fair value hedge, the effect on surplus or deficit is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognized in surplus or deficit to correspond with the recognition of the change in spot rate on the hedged item in surplus or deficit as required by IPSAS 4.

F.1.2 Hedging with a Non-Derivative Financial Asset or Liability

Entity J's functional currency is the Japanese yen. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of 5 million US dollars. It has also entered into a fixed price sales commitment for 5 million US dollars that matures in two years and is not accounted for as a derivative because it meets the exemption for normal sales in paragraph 4. Can Entity J designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting?

No. IPSAS ~~29XX (ED-38)~~.81 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk.

Alternatively, can Entity J designate its US dollar liability as a cash flow hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment?

Yes. IPSAS ~~29XX (ED-38)~~ permits the designation of a non-derivative asset or liability as a hedging instrument in either a cash flow hedge or a fair value hedge of the exposure to changes in foreign exchange rates of a firm commitment (IPSAS ~~29XX (ED-38)~~.97). Any gain or loss on the non-derivative hedging instrument that is recognized in net assets/equity during the period preceding the future sale is recognized in surplus or deficit when the sale takes place (IPSAS ~~29XX (ED-38)~~.106).

Alternatively, can Entity J designate the sales commitment as the hedging instrument instead of the hedged item?

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under IPSAS ~~29XX (ED 38)~~.12 and IPSAS ~~29XX (ED 38)~~.AG46, it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

F.1.3 Hedge Accounting: Use of Written Options in Combined Hedging Instruments

Issue (a) – Does IPSAS ~~29XX (ED 38)~~.AG1276 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because IPSAS ~~29XX (ED 38)~~.AG1276 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) – What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

- (a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.
- (b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

F.1.4 Internal Hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different entities within an economic entity or divisions within a single legal entity. Does IPSAS ~~29XX (ED 38)~~.82 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. IPSAS ~~29XX (ED 38)~~ does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial

statements for hedging transactions within an economic entity, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in IPSAS 6.49 requires that ‘Balances, transactions, revenue and expenses within the economic entity shall be eliminated in full’.

On the other hand, hedging transaction within an economic entity may be designated as a hedge in the individual or separate financial statements of an individual entity, if the transaction is an external transaction from the perspective of the economic entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarizes the application of IPSAS ~~29XX (ED-38)~~ to internal hedging transactions.

- IPSAS ~~29XX (ED-38)~~ does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.
- Internal derivative contracts between two separate entities within an economic entity can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the economic entity.
- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.
- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the economic entity can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the economic entity.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by individual entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the treasury division of Entity A enters into an internal interest rate swap with another division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the treasury division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, IPSAS ~~29XX (ED-38)~~ does not allow hedge accounting treatment for the hedging transaction undertaken by the treasury and other divisions. IPSAS ~~29XX (ED-38)~~.82 indicates that only derivatives that involve a party external to the entity can be designated as hedging instruments and, further, that any gains or losses on transactions within an economic entity or within individual entities should be eliminated on consolidation. Therefore, transactions between different divisions within Entity A

do not qualify for hedge accounting treatment in the financial statements of Entity A. Similarly, transactions between different entities within an economic entity do not qualify for hedge accounting treatment in consolidated financial statements.

However, if in addition to the internal swap in the above example the trading division enters into an interest rate swap or other contract with an external party that offsets the exposure hedged in the internal swap, hedge accounting is permitted under IPSAS ~~29XX (ED-38)~~. For the purposes of IPSAS ~~29XX (ED-38)~~, the hedged item is the loan (or group of similar loans) in the treasury division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions of them that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under IPSAS ~~29XX (ED-38)~~, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the treasury division are identified and the other conditions for hedge accounting are met. It should be noted, however, that IPSAS ~~XX (ED-38)~~29.88 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

F.1.5 Offsetting Internal Derivative Contracts Used to Manage Interest Rate Risk

If a central treasury function enters into internal derivative contracts with controlled entities and various divisions within the economic entity to manage interest rate risk on a centralized basis, can those contracts qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts?

No. An internal contract designated at the controlled entity level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in surplus or deficit (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in net assets/equity (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There is also no basis for recognizing the gain or loss on the internal derivative in net assets/equity for one entity and recognizing it in surplus or deficit by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the controlled entity or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the controlled entity or division levels would be used to offset each other on consolidation. Accordingly, since IPSAS ~~29XX (ED-38)~~.81 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the controlled entity or division level that are not laid off with external parties must be reversed on consolidation.

It should be noted, however, that there will be no effect on surplus or deficit and net assets/equity of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at

the controlled entity or division level and, in the case of cash flow hedges, where the hedged items affect surplus or deficit in the same period. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognized in surplus or deficit, and their use as cash flow hedges by two separate entities or divisions within the economic entity will also result in the fair value amounts being offset against each other in net assets/equity. However, there may be an effect on individual line items in both the consolidated statement of changes in net assets/equity and the consolidated statement of financial position, for example when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognized in a different line item in the statement of financial position or statement of changes in net assets/equity. In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, gains and losses recognized would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognized in surplus or deficit and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognized in net assets/equity.

Question F.1.4 describes the application of IPSAS ~~29XX (ED 38)~~ to internal hedging transactions.

F.1.6 Offsetting Internal Derivative Contracts Used to Manage Foreign Currency Risk

If a central treasury function enters into internal derivative contracts with controlled entities and various divisions within the economic entity to manage foreign currency risk on a centralized basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. IPSAS 6, “Consolidated and Separate Financial Statements” requires all internal transactions to be eliminated in consolidated financial statements. As stated in IPSAS ~~29XX (ED 38)~~.82, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the economic entity. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the controlled entity or division level and are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on surplus or deficit or net assets/equity if (a) the internal derivatives are used in the same type of hedge relationship (i.e. fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognized in net assets/equity are recognized in surplus or deficit in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognized in surplus or deficit or in net assets/equity will offset on consolidation resulting in the same surplus or deficit and net assets/equity as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of changes in net

assets/equity and the consolidated statement of financial position, that would need to be eliminated. In addition, there is an effect on surplus or deficit and net assets/equity if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on surplus or deficit and net assets/equity for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognized in net assets/equity are recognized in surplus or deficit in different periods (because the hedged items affect surplus or deficit in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because IPSAS ~~29XX (ED-38)~~.⁸¹ permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognized firm commitments. This is because an unrecognized firm commitment or forecast transaction does not qualify as a hedging instrument under IPSAS ~~29XX (ED-38)~~. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements. As a result, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an asset or liability (basis adjustment) or recognized in net assets/equity would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument.

F.1.7 Internal Derivatives: Examples of Applying Question F.1.6

In each case, FC = foreign currency, LC = local currency (which is the entity's functional currency), and TC = treasury centre.

Case 1 Offset of Fair Value Hedges

Controlled Entity A has trade receivables of FC100, due in 60 days, which it hedges using a forward contract with TC. Controlled Entity B has payables of FC50, also due in 60 days, which it hedges using a forward contract with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive LC in 60 days.

At the end of month 1, FC weakens against LC. A incurs a foreign exchange loss of LC10 on its receivables, offset by a gain of LC10 on its forward contract with TC. B makes a foreign exchange gain of LC5 on its payables offset by a loss of LC5 on its forward contract with TC.

TC makes a loss of LC10 on its internal forward contract with A, a gain of LC5 on its internal forward contract with B, and a gain of LC5 on its external forward contract.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries

Dr	Foreign exchange loss	LC10	
	Cr Receivables		LC10
Dr	<i>Internal contract TC</i>	<i>LC10</i>	
	Cr <i>Internal gain TC</i>		<i>LC10</i>

B's entries

Dr	Payables	LC5	
	Cr Foreign exchange gain		LC5
Dr	<i>Internal loss TC</i>	<i>LC5</i>	
	Cr <i>Internal contract TC</i>		<i>LC5</i>

TC's entries

Dr	<i>Internal loss A</i>	<i>LC10</i>	
	Cr <i>Internal contract A</i>		<i>LC10</i>
Dr	<i>Internal contract B</i>	<i>LC5</i>	
	Cr <i>Internal gain B</i>		<i>LC5</i>
Dr	External forward contract	LC5	
	Cr Foreign exchange gain		LC5

Both A and B could apply hedge accounting in their individual financial statements provided all conditions in IPSAS [29XX \(ED-38\)](#) are met. However, in this case, no hedge accounting is required because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognized immediately in surplus or deficit of A and B without hedge accounting.

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, the payable in B hedges FC50 of the receivables in A. The external forward contract in TC hedges the remaining FC50 of the receivable in A. Hedge accounting is not necessary in the consolidated financial statements because monetary items are measured at spot foreign exchange rates under IPSAS 4 irrespective of whether hedge accounting is applied.

The net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IPSAS [29XX \(ED-38\)](#).

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
External forward contract	LC5	–
Gains and losses	–	–
Internal contracts	–	–

Case 2 Offset of Cash Flow Hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future expenses of FC500 (rental for offices), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a ‘loss’ of LC20 on its anticipated revenues because the LC value of these revenues decreases. This is offset by a ‘gain’ of LC20 on its forward contract with TC.

B incurs a ‘gain’ of LC50 on its anticipated advertising cost because the LC value of the expense decreases. This is offset by a ‘loss’ of LC50 on its transaction with TC.

TC incurs a ‘gain’ of LC50 on its internal transaction with B, a ‘loss’ of LC20 on its internal transaction with A and a loss of LC30 on its external forward contract.

A and B complete the necessary documentation, the hedges are effective, and both A and B qualify for hedge accounting in their individual financial statements. A recognizes the gain of LC20 on its internal derivative transaction in net assets/equity and B recognizes the loss of LC50 in net assets/equity. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A’s entries

<i>Dr Internal contract TC</i>	<i>LC20</i>	
<i>Cr Net assets/equity</i>		<i>LC20</i>

B’s entries

<i>Dr Net assets/equity</i>	<i>LC50</i>	
<i>Cr Internal contract TC</i>		<i>LC50</i>

TC’s entries

<i>Dr Internal loss A</i>	<i>LC20</i>	
<i>Cr Internal contract Cr A</i>		<i>LC20</i>

<i>Dr</i>	<i>Internal contract B</i>	<i>LC50</i>	
	<i>Cr</i>	<i>Internal gain B</i>	<i>LC50</i>
<i>Dr</i>	Foreign exchange loss	LC30	
	<i>Cr</i>	External forward contract	LC30

For the consolidated financial statements, TC's external forward contract on FC300 is designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. IPSAS ~~29XX (ED 38)~~ requires that in the consolidated financial statements at the end of month 1, the accounting effects of the internal derivative transactions must be eliminated.

However, the net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries in order for the requirements of IPSAS ~~29XX (ED 38)~~ to be met.

	<i>Debit</i>	<i>Credit</i>
External forward contract	–	LC30
Net assets/equity	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 3 Offset of Fair Value and Cash Flow Hedges

Assume that the exposures and the internal derivative transactions are the same as in cases 1 and 2. However, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for LC in 90 days.

TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential between FC and LC is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a minimal effect on surplus or deficit in TC.

As in cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A recognizes a gain of LC20 on its internal derivative transaction in net assets/equity and B recognizes a loss of LC50 on its internal derivative transaction in net assets/equity.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries

<i>Dr</i>	Foreign exchange loss	LC10	
	<i>Cr</i>	Receivables	LC10
<i>Dr</i>	<i>Internal contract TC</i>	<i>LC10</i>	

<i>Cr Internal gain TC</i>	<i>LC10</i>
<i>Dr Internal contract TC</i>	<i>LC20</i>
<i>Cr Net assets/equity</i>	<i>LC20</i>

B's entries

<i>Dr Payables</i>	<i>LC5</i>
<i>Cr Foreign exchange gain</i>	<i>LC5</i>
<i>Dr Internal loss TC</i>	<i>LC5</i>
<i>Cr Internal contract TC</i>	<i>LC5</i>
<i>Dr Net assets/equity</i>	<i>LC50</i>
<i>Cr Internal contract TC</i>	<i>LC50</i>

TC's entries

<i>Dr Internal loss A</i>	<i>LC10</i>
<i>Cr Internal contract A</i>	<i>LC10</i>
<i>Dr Internal loss A</i>	<i>LC20</i>
<i>Cr Internal contract A</i>	<i>LC20</i>
<i>Dr Internal contract B</i>	<i>LC5</i>
<i>Cr Internal gain B</i>	<i>LC5</i>
<i>Dr Internal contract B</i>	<i>LC50</i>
<i>Cr Internal gain B</i>	<i>LC50</i>
<i>Dr Foreign exchange loss</i>	<i>LC25</i>
<i>Cr External forward contract</i>	<i>LC25</i>

<i>TOTAL (for the internal derivatives)</i>	<i>A</i>	<i>B</i>	<i>Total</i>
	<i>LC</i>	<i>LC</i>	<i>TC</i>
Surplus or deficit (fair value hedges)	10	(5)	5
Net assets/equity (cash flow hedges)	20	(50)	(30)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e. those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25

Net assets/equity	LC30	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable LC5; Cr Net assets/equity LC5;
- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC10; Cr Receivable LC10; and
- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC25; Cr External forward contract LC25.

In the consolidated financial statements at the end of month 1, IPSAS ~~29XX (ED-38)~~ requires the accounting effects of the internal derivative transactions to be eliminated.

However, the total net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IPSAS ~~29XX (ED-38)~~.

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 4 Offset of Fair Value and Cash Flow Hedges with Adjustment to Carrying Amount of Inventory

Assume similar transactions as in case 3, except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. Assume also that the entity has a policy of basis-adjusting hedged forecast non-financial items. At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of LC50 on B's internal derivative, recognized in net assets/equity in month 1, is adjusted against the carrying amount of inventory in B. The gain of LC20 on A's internal derivative is recognized in net assets/equity as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and a proportion of the receivable (FC50) offset FC300 of the anticipated inventory purchase. There is a natural hedge between the remaining FC200 of anticipated cash outflow in B and the anticipated cash inflow of FC200 in A. This relationship does not qualify for hedge accounting under IPSAS ~~29XX (ED-38)~~ and this time there is only a partial offset between gains and losses on the internal derivatives that hedge these amounts.

At the end of months 1 and 2, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries (all at the end of month 1)

Dr	Foreign exchange loss	LC10	
	Cr Receivables		LC10
Dr	<i>Internal contract TC</i>	<i>LC10</i>	
	Cr <i>Internal gain TC</i>		<i>LC10</i>
Dr	<i>Internal contract TC</i>	<i>LC20</i>	
	Cr <i>Net assets/equity</i>		<i>LC20</i>

B's entries

At the end of month 1:

Dr	Payables	LC5	
	Cr Foreign exchange gain		LC5
Dr	<i>Internal loss TC</i>	<i>LC5</i>	
	Cr <i>Internal contract TC</i>		<i>LC5</i>
Dr	<i>Net assets/equity</i>	<i>LC50</i>	
	Cr <i>Internal contract TC</i>		<i>LC50</i>

At the end of month 2:

Dr	Inventory	LC50	
	Cr <i>Net assets/equity</i>		LC50

TC's entries (all at the end of month 1)

Dr	<i>Internal loss A</i>	<i>LC10</i>	
	Cr <i>Internal contract A</i>		<i>LC10</i>
Dr	<i>Internal loss A</i>	<i>LC20</i>	
	Cr <i>Internal contract A</i>		<i>LC20</i>
Dr	<i>Internal contract B</i>	<i>LC5</i>	
	Cr <i>Internal gain B</i>		<i>LC5</i>

<i>Dr Internal contract B</i>	<i>LC50</i>	
<i>Cr Internal gain B</i>		<i>LC50</i>
Dr Foreign exchange loss	LC25	
Cr Forward		LC25

<i>TOTAL (for the internal derivatives)</i>	<i>A</i>	<i>B</i>	<i>Total</i>
	<i>LC</i>	<i>LC</i>	<i>TC</i>
Surplus or deficit (fair value hedges)	10	(5)	5
Net assets/equity (cash flow hedges)	20	–	20
Basis adjustment (inventory)	–	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e. those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	–	LC20
Basis adjustment (inventory)	LC50	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Payables LC5; Cr Net assets/equity LC5.
- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC10; Cr Receivable LC10; and at the end of month 2, Dr Inventory LC10; Cr Net assets/equity LC10.
- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Net assets/equity LC25; Cr External forward contract LC25; and at the end of month 2, Dr Inventory LC25; Cr Net assets/equity LC25.

The total net balances after elimination of the accounting entries relating to the internal derivatives are as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	–	LC5
Basis adjustment (inventory)	LC35	–
Gains and losses	–	–
Internal contracts	–	–

These total net balances are different from those that would be recognized if the internal derivatives were not eliminated, and it is these net balances that IPSAS ~~29XX (ED-38)~~ requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances before elimination of the internal derivatives are as follows:

- (a) To reclassify LC15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not hedged by an external instrument (neither the external forward contract of FC250 in TC nor the external payable of FC100 in A); and
- (b) To reclassify the gain of LC15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

Dr	Net assets/equity	LC15	
	Cr	Inventory	LC15

F.1.8 Combination of Written and Purchased Options

In most cases, IPSAS ~~29XX (ED-38)~~.AG1276 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with one counterparty, can an entity split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No. IPSAS ~~29XX (ED-38)~~.83 specifies that a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question F.1.3 addresses the issue of whether and when a combination of options is considered as a written option.

F.1.9 Delta-Neutral Hedging Strategy

Does IPSAS ~~29XX (ED-38)~~ permit an entity to apply hedge accounting for a 'delta-neutral' hedging strategy and other dynamic hedging strategies under which the quantity of the hedging instrument is constantly adjusted in order to maintain a desired hedge ratio, for

example, to achieve a delta-neutral position insensitive to changes in the fair value of the hedged item?

Yes. IPSAS ~~29XX (ED-38)~~.83 states that ‘a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting’. For example, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in IPSAS ~~29XX (ED-38)~~.98 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

F.1.10 Hedging Instrument: Out of the Money Put Option

Entity A has an investment in one share of Entity B, which it has classified as available-for-sale. To give itself partial protection against decreases in the share price of Entity B, Entity A acquires a put option on one share of Entity B and designates the change in the intrinsic value of the put as a hedging instrument in a fair value hedge of changes in the fair value of its share in Entity B. The put gives Entity A the right to sell one share of Entity B at a strike price of CU90. At the inception of the hedging relationship, the share has a quoted price of CU100. Since the put option gives Entity A the right to dispose of the share at a price of CU90, the put should normally be fully effective in offsetting price declines below CU90 on an intrinsic value basis. Price changes above CU90 are not hedged. In this case, are changes in the fair value of the share of Entity B for prices above CU90 regarded as hedge ineffectiveness under IPSAS ~~29XX (ED-38)~~.98 and recognized in surplus or deficit under IPSAS ~~29XX (ED-38)~~.99?

No. IPSAS ~~29XX (ED-38)~~.83 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument. The changes in the intrinsic value of the option provide protection against the risk of variability in the fair value of one share of Entity B below or equal to the strike price of the put of CU90. For prices above CU90, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on one share of Entity B for prices above CU90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognizing gains and losses on the hedged item.

Therefore, Entity A recognizes changes in the fair value of the share in net assets/equity if it is associated with variation in its price above CU90 (IPSAS ~~29XX (ED-38)~~.64 and IPSAS ~~29XX (ED-38)~~.101). Changes in the fair value of the share associated with price declines below CU90 form part of the designated fair value hedge and are recognized in surplus or deficit under IPSAS ~~XX (ED-38)29~~.99(b). Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognized in surplus or deficit (IPSAS ~~29XX (ED-38)~~.99(a)). Changes in the time value of the put are excluded from the designated hedging relationship and recognized in surplus or deficit under IPSAS ~~29XX (ED-38)~~.65(a).

F.1.11 Hedging Instrument: Proportion of the Cash Flows of a Cash Instrument

In the case of foreign exchange risk, a non-derivative financial asset or non-derivative financial liability can potentially qualify as a hedging instrument. Can an entity treat the cash flows for specified periods during which a financial asset or financial liability that is designated as a hedging instrument remains outstanding as a proportion of the hedging instrument under IPSAS ~~29XX (ED-38)~~.84, and exclude the other cash flows from the designated hedging relationship?

No. IPSAS ~~29XX (ED-38)~~.84 indicates that a hedging relationship may not be designated for only a portion of the time period in which the hedging instrument is outstanding. For example, the cash flows during the first three years of a ten-year borrowing denominated in a foreign currency cannot qualify as a hedging instrument in a cash flow hedge of the first three years of revenue in the same foreign currency. On the other hand, a non-derivative financial asset or financial liability denominated in a foreign currency may potentially qualify as a hedging instrument in a hedge of the foreign currency risk associated with a hedged item that has a remaining time period until maturity that is equal to or longer than the remaining maturity of the hedging instrument (see Question F.2.17).

F.1.12 Hedges of More Than One Type of Risk

Issue (a) – Normally a hedging relationship is designated between an entire hedging instrument and a hedged item so that there is a single measure of fair value for the hedging instrument. Does this preclude designating a single financial instrument simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge?

No. For example, entities commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. IPSAS ~~29XX (ED-38)~~.85 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in IPSAS ~~XX (ED-38)29~~.85 are met.

Issue (b) – If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

IPSAS ~~30XX (ED-39)~~.25 requires disclosures separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. The instrument in question would be reported in the IPSAS ~~30XX (ED-39)~~.25 disclosures separately for each type of hedge.

F.1.13 Hedging Instrument: Dual Foreign Currency Forward Exchange Contract

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a ten-year fixed rate pound sterling-denominated note receivable. The principal amounts of the asset and liability when converted into the Japanese yen are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pounds sterling at the end of five years. If Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency

exposure on the principal repayments of both instruments, can it qualify for hedge accounting?

Yes. IPSAS ~~29XX (ED 38)~~.85 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows.

- (a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and yen, and yen and pounds, respectively.
- (b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward protects it for only the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question F.2.17.
- (c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

F.1.14 Concurrent Offsetting Swaps and Use of One as a Hedging Instrument

Entity A enters into an interest rate swap and designates it as a hedge of the fair value exposure associated with fixed rate debt. The fair value hedge meets the hedge accounting criteria of IPSAS ~~29XX (ED 38)~~. Entity A simultaneously enters into a second interest rate swap with the same swap counterparty that has terms that fully offset the first interest rate swap. Is Entity A required to view the two swaps as one unit and therefore precluded from applying fair value hedge accounting to the first swap?

It depends. IPSAS ~~29XX (ED 38)~~ is transaction-based. If the second swap was not entered into in contemplation of the first swap or there is a substantive business purpose for structuring the transactions separately, then the swaps are not viewed as one unit.

For example, some entities have a policy that requires a centralized treasury (which is a controlled entity in an economic entity) enter into third-party derivative contracts on behalf of other controlled entities within the organization to hedge the controlled entities' interest rate risk exposures. The treasury also enters into internal derivative transactions with those controlled entities in order to track those hedges operationally within the organization. Because the treasury also enters into derivative contracts as part of its trading operations, or because it may wish to rebalance the risk of its overall portfolio, it may enter into a derivative contract with the same third party during the same business day that has substantially the same terms as a contract entered into as a hedging instrument on behalf of another controlled entity. In this case, there is a valid business purpose for entering into each contract.

Judgment is applied to determine whether there is a substantive business purpose for structuring the transactions separately. For example, if the sole purpose is to obtain fair value accounting treatment for the debt, there is no substantive business purpose.

F.2 Hedged items

F.2.1 Whether a Derivative can be Designated as a Hedged Item

Does IPSAS ~~29XX (ED 38)~~ permit designating a derivative instrument (whether a stand-alone or separately recognized embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognized in surplus or deficit unless they are designated and effective hedging instruments (IPSAS ~~29XX (ED 38)~~.10). As an exception, IPSAS ~~29XX (ED 38)~~.AG1276 permits the designation of a purchased option as the hedged item in a fair value hedge.

F.2.2 Cash Flow Hedge: Anticipated Issue of Fixed Rate Debt

Is hedge accounting allowed for a hedge of an anticipated issue of fixed rate debt?

Yes. This would be a cash flow hedge of a highly probable forecast transaction that will affect surplus or deficit (IPSAS ~~29XX (ED 38)~~.96) provided that the conditions in IPSAS ~~29XX (ED 38)~~.98 are met.

To illustrate: Entity R periodically issues new bonds to refinance maturing bonds, provide working capital and for various other purposes. When Entity R decides it will be issuing bonds, it may hedge the risk of changes in the long-term interest rate from the date it decides to issue the bonds to the date the bonds are issued. If long-term interest rates go up, the bond will be issued either at a higher rate or with a higher discount or smaller premium than was originally expected. The higher rate being paid or decrease in proceeds is normally offset by the gain on the hedge. If long-term interest rates go down, the bond will be issued either at a lower rate or with a higher premium or a smaller discount than was originally expected. The lower rate being paid or increase in proceeds is normally offset by the loss on the hedge.

For example, in August 2000 Entity R decided it would issue CU200 million seven-year bonds in January 2001. Entity R performed historical correlation studies and determined that a seven-year treasury bond adequately correlates to the bonds Entity R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Entity R hedged the anticipated issue of the bonds by selling (shorting) CU186 million worth of futures on seven-year treasury bonds. From August 2000 to January 2001 interest rates increased. The short futures positions were closed in January 2001, the date the bonds were issued, and resulted in a CU1.2 million gain that will offset the increased interest payments on the bonds and, therefore, will affect surplus or deficit over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecast issue of debt.

F.2.3 Hedge Accounting: Core Deposit Intangibles

Is hedge accounting treatment permitted for a hedge of the fair value exposure of core deposit intangibles?

It depends on whether the core deposit intangible is generated internally or acquired (e.g. as part of an entity combination).

Internally generated core deposit intangibles are not recognized as intangible assets under IPSAS ~~31XX (ED 40)~~, “Intangible Assets”. Because they are not recognized, they cannot be designated as a hedged item.

If a core deposit intangible is acquired together with a related portfolio of deposits, the core deposit intangible is required to be recognized separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in IPSAS ~~31XX (ED 40)~~. A recognized core deposit intangible asset could be designated as a hedged item, but only if it meets the conditions in paragraph 98, including the requirement in paragraph 98 that the effectiveness of the hedge can be measured reliably. Because it is often difficult to measure reliably the fair value of a core deposit intangible asset other than on initial recognition, it is unlikely that the requirement in paragraph 98(d) will be met.

F.2.4 Hedge Accounting: Hedging of Future Foreign Currency Revenue Streams

Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable. Under IPSAS ~~29XX (ED 38)~~.96(b)) a hedge of an anticipated sale may qualify as a cash flow hedge. For example, an entity which owns and operates a cross-border toll road may use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are “highly probable,” as required by IPSAS ~~29XX (ED 38)~~.98, it may designate a currency borrowing as a cash flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognized in net assets/equity until the revenues occur.

It is unlikely that an entity can reliably predict 100 per cent of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the “highly probable” criterion.

F.2.5 Cash Flow Hedges: “All in One” Hedge

If a derivative instrument is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price, can the derivative instrument be designated as the hedging instrument in a cash flow hedge of that gross settlement assuming the other cash flow hedge accounting criteria are met?

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative.

This applies to all fixed price contracts that are accounted for as derivatives under IPSAS ~~29XX (ED-38)~~.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under IPSAS ~~29XX (ED-38)~~ (for example, because the entity has a practice of settling such contracts net in cash or 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), the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, if an entity enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a derivative because its term exceeds the regular way delivery period in the marketplace, the entity may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired.

F.2.6 Hedge Relationships: Entity-Wide Risk

An entity has a fixed rate asset and a fixed rate liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset and designates the interest rate swap as a fair value hedge of the fixed rate asset. Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Yes. IPSAS ~~29XX (ED-38)~~ does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure to interest rate increases that is offset by the interest rate swap.

F.2.7 Cash Flow Hedge: Forecast Transaction Related to an Entity's Net Assets/Equity

Can a forecast transaction in the entity's own equity instruments or forecast dividend or similar payments to owners be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecast transaction must expose the entity to a particular risk that can affect surplus or deficit (IPSAS ~~29XX (ED-38)~~.96). The classification of financial instruments as liabilities or net assets/equity generally provides the basis for determining whether transactions or other payments relating to such instruments are recognized in surplus or deficit IPSAS ~~28XX (ED-37)~~. For example, distributions to holders of an equity instrument are debited by the issuer directly to net assets/equity (IPSAS ~~28XX (ED-37)~~.40). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend or similar

distribution that has not yet been paid and is recognized as a financial liability may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.

F.2.8 Hedge Accounting: Risk of a Transaction Not Occurring

Does IPSAS ~~29XX (ED 38)~~ permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall operational risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognized assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (IPSAS ~~29XX (ED 38)~~.96).

F.2.9 Held-to-Maturity Investments: Hedging Variable Interest Rate Payments

Can an entity designate a pay-variable, receive-fixed interest rate swap as a cash flow hedge of a variable rate, held-to-maturity investment?

No. It is inconsistent with the designation of a debt investment as being held to maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. IPSAS ~~29XX (ED 38)~~.88 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk "because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates."

F.2.10 Hedged Items: Purchase of Held-to-Maturity Investment

An entity forecasts the purchase of a financial asset that it intends to classify as held to maturity when the forecast transaction occurs. It enters into a derivative contract with the intent to lock in the current interest rate and designates the derivative as a hedge of the forecast purchase of the financial asset. Can the hedging relationship qualify for cash flow hedge accounting even though the asset will be classified as a held-to-maturity investment?

Yes. With respect to interest rate risk, IPSAS ~~29XX (ED 38)~~ prohibits hedge accounting for financial assets that are classified as held-to-maturity (IPSAS ~~29XX (ED 38)~~.88). However, even though the entity intends to classify the asset as held to maturity, the instrument is not classified as such until the transaction occurs.

F.2.11 Cash Flow Hedges: Reinvestment of Funds Obtained from Held-to-Maturity Investments

An entity owns a variable rate asset that it has classified as held to maturity. It enters into a derivative contract with the intention to lock in the current interest rate on the reinvestment of variable rate cash flows, and designates the derivative as a cash flow hedge of the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on the held-to-maturity asset. Assuming that the other hedge accounting criteria are met, can the hedging relationship qualify for cash flow hedge accounting even

though the interest payments that are being reinvested come from an asset that is classified as held to maturity?

Yes. IPSAS ~~29XX (ED-38)~~.88 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question F.2.8 specifies that this applies not only to fair value hedges, i.e. hedges of the exposure to fair value interest rate risk associated with held-to-maturity investments that pay fixed interest, but also to cash flow hedges, i.e. hedges of the exposure to cash flow interest rate risk associated with held-to-maturity investments that pay variable interest at current market rates. However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecast future interest receipts on debt instruments resulting from the forecast reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecast to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

F.2.12 Hedge Accounting: Prepayable Financial Asset

If the issuer has the right to prepay a financial asset, can the investor designate the cash flows after the prepayment date as part of the hedged item?

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are 'highly probable' (IPSAS ~~29XX (ED-38)~~.98). For example, cash flows after the prepayment date may qualify as highly probable if they result from a group or pool of similar assets (for example, mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

F.2.13 Fair Value Hedge: Risk That Could Affect Surplus or Deficit

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are classified as loans and receivables?

Yes. Under IPSAS ~~29XX (ED-38)~~, loans and receivables are carried at amortized cost. Many entities hold the bulk of their loans and receivables until maturity. Thus, changes in the fair value of such loans and receivables that are due to changes in market interest rates will not affect surplus or deficit. IPSAS ~~29XX (ED-38)~~.96 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect surplus or deficit. Therefore, IPSAS ~~29XX (ED-38)~~.96 may appear to preclude fair value hedge accounting for loans and receivables. However, it follows from IPSAS ~~29XX (ED-38)~~.88 that loans and receivables can be hedged items with respect to interest rate risk since they are not designated as held-to-maturity investments. The entity could sell them and the change in fair values would affect surplus or deficit. Thus, fair value hedge accounting is permitted for loans and receivables.

F.2.14 Intragroup and intra-entity Hedging transactions

An Australian entity, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by a Swiss entity, which prepares consolidated financial statements (which include the Australian subsidiary) in Swiss francs. The Swiss controlling entity enters into a forward contract to hedge the change in yen relative to the Australian dollar. Can that hedge qualify for hedge accounting in the consolidated financial statements, or must the Australian controlled that has the foreign currency exposure be a party to the hedging transaction?

The hedge can qualify for hedge accounting provided the other hedge accounting criteria in IPSAS ~~29XX (ED-38)~~ are met. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's surplus or deficit and, therefore, would also affect consolidated surplus or deficit. IPSAS ~~29XX (ED-38)~~ does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

F.2.15 Internal Contracts: Single Offsetting External Derivative

An entity uses what it describes as internal derivative contracts to document the transfer of responsibility for interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For example, if the central treasury function has entered into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division, it would enter into an interest rate swap with an external counterparty that exactly offsets the four internal swaps. Assuming that the hedge accounting criteria are met, in the entity's financial statements would the single offsetting external derivative qualify as a hedging instrument in a hedge of a part of the underlying items on a gross basis?

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. IPSAS ~~29XX (ED-38)~~.94 indicates that a hedge of an overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis. Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An entity follows the approach outlined in IPSAS ~~29XX (ED-38)~~.94 and IPSAS ~~29XX (ED-38)~~.AG14¹⁰ to designate part of the underlying cash flows as the hedged position.

F.2.16 Internal Contracts: External Derivative Contracts that are Settled Net

Issue (a) – An entity uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. For each internal derivative contract, the central treasury function enters into a derivative contract with a single external counterparty that offsets the internal derivative contract. For example, if the central treasury function has entered into a receive-5 per cent-fixed, pay-LIBOR interest rate swap with another division that has entered into the internal contract with central treasury to hedge the exposure to variability in interest cash flows on a pay-LIBOR borrowing, central treasury would enter into a pay-5 per cent-fixed, receive-LIBOR interest rate swap on the same principal terms with the external counterparty. Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled since there is a netting agreement with the external counterparty. Assuming that the other hedge accounting criteria are met, can the individual external derivative contracts, such as the pay-5 per cent-fixed, receive-LIBOR interest rate swap above, be designated as hedging instruments of underlying gross exposures, such as the exposure to changes in variable interest payments on the pay-LIBOR borrowing above, even though the external derivatives are settled on a net basis?

Generally, yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty, provided the hedge accounting criteria in IPSAS ~~29XX (ED-38)~~ are met. See also Question F.1.13.

Issue (b) – Treasury observes that by entering into the external offsetting contracts and including them in the centralized portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the entity. Therefore, it enters into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally, yes. The purpose of structuring the external derivative contracts in this manner is consistent with the entity's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid purpose qualify as hedging instruments. Moreover, the answer to Question F.1.13 specifies that hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the same counterparty if there is a substantive purpose for structuring the transactions separately.

F.2.17 Partial Term Hedging

IPSAS ~~29XX (ED-38)~~.84 indicates that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.

Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as available-for-sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

F.2.18 Hedging Instrument: Cross-Currency Interest Rate Swap

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a 10-year fixed rate pound sterling-denominated note receivable. Entity A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Entity A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Entity A?

Yes. IPSAS ~~29XX (ED 38)~~.90 permits hedge accounting for components of risk, if effectiveness can be measured. Also, IPSAS ~~29XX (ED 38)~~.85 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be identified clearly, effectiveness can be demonstrated, and specific designation of the hedging instrument and different risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and US dollars. The swap is measured at fair value with changes in fair value recognized in surplus or deficit. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five-year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under IPSAS 4 and the changes to their carrying amounts recognized in surplus or deficit.

F.2.19 Hedged Items: Hedge of Foreign Currency Risk of Publicly Traded Shares

Entity A acquires shares in Entity B on a foreign stock exchange for their fair value of 1,000 in foreign currency (FC). It classifies the shares as available-for-sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell FC750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge

accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to FC750 in foreign currency?

Yes. IPSAS ~~29XX (ED-38)~~ permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (IPSAS ~~29XX (ED-38)~~.90). Therefore, Entity A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of FC750 associated with the shares or as a cash flow hedge of a forecast sale of the shares, provided the timing of the sale is identified. Any variability in the fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below FC750.

F.2.20 Hedge accounting: stock index

An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does IPSAS ~~29XX (ED-38)~~ permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, IPSAS ~~29XX (ED-38)~~.93 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

F.2.21 Hedge Accounting: Netting of Assets and Liabilities

May an entity group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An entity's hedging strategy and risk management practices may assess cash flow risk on a net basis but IPSAS ~~29XX (ED-38)~~.94 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. IPSAS ~~29XX (ED-38)~~.AG14~~10~~ provides an

example of how an entity might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

F.3 Hedge Accounting

F.3.1 Cash Flow Hedge: Fixed Interest Rate Cash Flows

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt instrument. Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

No. IPSAS ~~29XX~~ (ED 38).96(b) states that a cash flow hedge is “a hedge of the exposure to variability in cash flows.” In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

F.3.2 Cash Flow Hedge: Reinvestment of Fixed Interest Rate Cash Flows

An entity manages interest rate risk on a net basis. On January 1, 2001, it forecasts aggregate cash inflows of CU100 on fixed rate assets and aggregate cash outflows of CU90 on fixed rate liabilities in the first quarter of 2002. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecast net cash inflow of CU10. The entity designates as the hedged item the first CU10 of cash inflows on fixed rate assets in the first quarter of 2002. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 2002 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the entity could also hedge the interest rate exposure associated with the forecast reinvestment of the interest and principal it receives on fixed rate assets (see Question F.6.2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (for example, if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the reinvestment of interest cash inflows on fixed rate assets). However, potentially it could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

F.3.3 Foreign Currency Hedge

Entity A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

- (a) **A fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognized in surplus or deficit; or**
- (b) **A cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognized net assets/equity?**

IPSAS ~~29XX (ED 38)~~ does not preclude either of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk are recognized immediately in surplus or deficit. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognized in net assets/equity, that amount is recognized in surplus or deficit in the same period or periods during which the hedged item (the liability) affects surplus or deficit, i.e. when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to surplus or deficit in the same periods during which the liability is remeasured, not when the payment occurs. See Question F.3.4.

F.3.4 Foreign Currency Cash Flow Hedge

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to surplus or deficit (IPSAS 4.27 and IPSAS 4.32).

If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognized immediately in surplus or deficit and the gain or loss on remeasuring the receivable is also recognized in surplus or deficit.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognized in net assets/equity, and the ineffective portion in surplus or deficit (IPSAS ~~29XX (ED 38)~~.106). The amount recognized in net assets/equity is recognized in surplus or deficit in the same period or periods during which changes in the measurement of the receivable affect surplus or deficit (IPSAS ~~29XX (ED 38)~~.111).

F.3.5 Fair Value Hedge: Variable Rate Debt Instrument

Does IPSAS ~~29XX (ED-38)~~ permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

F.3.6 Fair Value Hedge: Inventory

IPSAS ~~29XX (ED-38)~~.96(a) states that a fair value hedge is “a hedge of the exposure to changes in fair value of a recognized asset or liability ... that is attributable to a particular risk and could affect surplus or deficit.” Can an entity designate inventories, such as oil inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the oil price, although inventories are measured at the lower of cost and net realizable value or cost and current replacement cost under IPSAS 12, “Inventories” ?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect surplus or deficit when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realizable value test under IPSAS 12. The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

F.3.7 Hedge Accounting: Forecast Transaction

For cash flow hedges, a forecast transaction that is subject to a hedge must be “highly probable.” How should the term “highly probable” be interpreted?

The term “highly probable” indicates a much greater likelihood of happening than the term “more likely than not.” An assessment of the likelihood that a forecast transaction will take place is not based solely on management’s intentions because intentions are not verifiable. A transaction’s probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

- (a) The frequency of similar past transactions;
- (b) The financial and operational ability of the entity to carry out the transaction;
- (c) Substantial commitments of resources to a particular activity (for example, the undertaking of specific infrastructure projects);
- (d) The extent of loss or disruption of operations that could result if the transaction does not occur;

- (e) The likelihood that transactions with substantially different characteristics might be used to achieve the same purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of debt instruments); and
- (f) The entity's operational plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

F.3.8 Retrospective Designation of Hedges

Does IPSAS ~~29XX~~ (~~ED-38~~) permit an entity to designate hedge relationships retrospectively?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in IPSAS ~~XX~~ (~~ED-38~~)^{29.98} are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

F.3.9 Hedge Accounting: Designation at the Inception of the Hedge

Does IPSAS ~~29XX~~ (~~ED-38~~) permit an entity to designate and formally document a derivative contract as a hedging instrument after entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, IPSAS ~~29XX~~ (~~ED-38~~) requires a hedging instrument to be designated and formally documented as such from the inception of the hedge relationship (IPSAS ~~29XX~~ (~~ED-38~~).⁹⁸); in other words, a hedge relationship cannot be designated

retrospectively. Also, it precludes designating a hedging relationship for only a portion of the time period during which the hedging instrument remains outstanding (IPSAS ~~29XX (ED-38)~~.84). However, it does not require the hedging instrument to be acquired at the inception of the hedge relationship.

F.3.10 Hedge Accounting: Identification of Hedged Forecast Transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

F.3.11 Cash Flow Hedge: Documentation of Timing of Forecast Transaction

For a hedge of a forecast transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date on, or time period in which, the forecast transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (IPSAS ~~29XX (ED-38)~~.AG15¹⁰) and it must be possible to measure its effectiveness reliably (IPSAS ~~XX (ED-38)~~29.98(d)). Also, the hedged forecast transaction must be highly probable (IPSAS ~~XX (ED-38)~~29.98(c)). To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance with IPSAS ~~29XX (ED-38)~~.98(d), it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecast transaction is no longer expected to occur, hedge accounting is discontinued in accordance with IPSAS ~~29XX (ED-38)~~.112(c).

F.4 Hedge Effectiveness

F.4.1 Hedging on an After-Tax Basis

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

IPSAS ~~29XX (ED-38)~~ permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

F.4.2 Hedge Effectiveness: Assessment on Cumulative Basis

IPSAS ~~29XX (ED 38)~~.98(b) requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognized in surplus or deficit as it occurs.

To illustrate: an entity designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25–50 basis points, while LIBOR changes daily. Over a period of 1–2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.

F.4.3 Hedge Effectiveness: Counterparty Credit Risk

Must an entity consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An entity cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument. When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the entity considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the entity. For a cash flow hedge, if it becomes probable that a counterparty will default, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change, which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

F.4.4 Hedge Effectiveness: Effectiveness Tests

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

IPSAS ~~29XX (ED 38)~~ does not provide specific guidance about how effectiveness tests are performed. IPSAS ~~29XX (ED 38)~~ specifies that a hedge is normally regarded as highly effective only if (a) at inception and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results are within a range of 80–125 per cent. IPSAS ~~29XX (ED 38)~~.AG14~~54~~ also states that the expectation in (a) can be demonstrated in various ways.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An entity is required to document at the inception of the hedge how effectiveness will be assessed and then to apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, i.e. a comparison of hedging gains and losses with the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

F.4.5 Hedge Effectiveness: Less than 100 Per Cent Offset

If a cash flow hedge is regarded as highly effective because the actual risk offset is within the allowed 80–125 per cent range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge recognized in net assets/equity?

No. IPSAS ~~29XX (ED 38)~~.106(a) indicates that only the effective portion is recognized in net assets/equity. IPSAS ~~29XX (ED 38)~~.106(b) requires the ineffective portion to be recognized in surplus or deficit.

F.4.6 Assuming Perfect Hedge Effectiveness

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No. IPSAS ~~29XX (ED 38)~~.98(e) requires an entity to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (IPSAS ~~29XX (ED 38)~~.AG15049). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

F.5 Cash Flow Hedges

F.5.1 Hedge Accounting: Non-Derivative Monetary Asset or Non-Derivative Monetary Liability Used as a Hedging Instrument

If an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognized in surplus or deficit (IPSAS 4.32)

and the exchange differences on the hedging instrument be recognized in net assets/equity until the repayment of the liability (IPSAS ~~29XX (ED-38)~~.106)?

No. Exchange differences on the monetary asset and the monetary liability are both recognized in surplus or deficit in the period in which they arise (IPSAS 4.32). IPSAS ~~29XX (ED-38)~~.AG11~~65~~ specifies that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are recognized in surplus or deficit.

F.5.2 Cash Flow Hedges: Performance of Hedging Instrument (1)

Entity A has a floating rate liability of CU1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of CU49 in the fair value of the swap. This increase consists of a change of CU50 resulting from an increase in market interest rates and a change of minus CU1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by CU50. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognized in surplus or deficit?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk (IPSAS ~~29XX (ED-38)~~.AG1~~5049~~). However, because Entity A determines that the hedge relationship is still highly effective, it recognizes the effective portion of the change in fair value of the swap, i.e. the net change in fair value of CU49, in net assets/equity. There is no debit to surplus or deficit for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, i.e. CU50, exceeds the cumulative change in value of the hedging instrument, i.e. CU49.

Dr Swap

CU49

Cr Net assets/equity

CU49

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with IPSAS ~~29XX (ED-38)~~.112.

Would the answer change if the fair value of the swap instead increases to CU51 of which CU50 results from the increase in market interest rates and CU1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to surplus or deficit of CU1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, i.e. CU51, exceeds the

cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, i.e. CU50. The difference of CU1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognized in surplus or deficit.

Dr	Swap	CU51	
	Cr	Net assets/equity	CU50
		Surplus or deficit	CU1

F.5.3 Cash Flow Hedges: Performance of Hedging Instrument (2)

On September 30, 20X1, Entity A hedges the anticipated sale of 24 barrels of oil on March 1, 20X2 by entering into a short forward contract on 24 barrels of oil. The contract requires net settlement in cash determined as the difference between the future spot price of oil on a specified commodity exchange and CU1,000. Entity A expects to sell the oil in a different, local market. Entity A determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On December 31, the spot price of oil has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is CU1,100. The fair value of Entity A's forward contract is negative CU80. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognized in surplus or deficit?

No. In a cash flow hedge, ineffectiveness is not recognized in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is CU80, while the fair value of the cumulative change in expected future cash flows on the hedged item is CU100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognized in surplus or deficit (IPSAS ~~29XX (ED 38)~~.106(b)). Because Entity A determines that the hedge relationship is still highly effective, it recognizes the entire change in fair value of the forward contract (CU80) in net assets/equity.

Dr	Net assets/equity	CU80	
	Cr	Forward	CU80

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with IPSAS ~~29XX (ED 38)~~.112.

F.5.4 Cash Flow Hedges: Forecast Transaction Occurs Before the Specified Period

An entity designates a derivative as a hedging instrument in a cash flow hedge of a forecast transaction, such as a forecast sale of a commodity. The hedging relationship meets all the

hedge accounting conditions, including the requirement to identify and document the period in which the transaction is expected to occur within a reasonably specific and narrow range of time (see Question F.2.17). If, in a subsequent period, the forecast transaction is expected to occur in an earlier period than originally anticipated, can the entity conclude that this transaction is the same as the one that was designated as being hedged?

Yes. The change in timing of the forecast transaction does not affect the validity of the designation. However, it may affect the assessment of the effectiveness of the hedging relationship. Also, the hedging instrument would need to be designated as a hedging instrument for the whole remaining period of its existence in order for it to continue to qualify as a hedging instrument (see IPSAS ~~XX (ED-38)29~~.84 and Question F.2.17).

F.5.5 Cash Flow Hedges: Measuring Effectiveness for a Hedge of a Forecast Transaction in a Debt Instrument

A forecast investment in an interest-earning asset or forecast issue of an interest-bearing liability creates a cash flow exposure to interest rate changes because the related interest payments will be based on the market rate that exists when the forecast transaction occurs. The objective of a cash flow hedge of the exposure to interest rate changes is to offset the effects of future changes in interest rates so as to obtain a single fixed rate, usually the rate that existed at the inception of the hedge that corresponds with the term and timing of the forecast transaction. During the period of the hedge, it is not possible to determine what the market interest rate for the forecast transaction will be at the time the hedge is terminated or when the forecast transaction occurs. In this case, how is the effectiveness of the hedge assessed and measured?

During this period, effectiveness can be measured on the basis of changes in interest rates between the designation date and the interim effectiveness measurement date. The interest rates used to make this measurement are the interest rates that correspond with the term and occurrence of the forecast transaction that existed at the inception of the hedge and that exist at the measurement date as evidenced by the term structure of interest rates.

Generally it will not be sufficient simply to compare cash flows of the hedged item with cash flows generated by the derivative hedging instrument as they are paid or received, since such an approach ignores the entity's expectations of whether the cash flows will offset in subsequent periods and whether there will be any resulting ineffectiveness.

The discussion that follows illustrates the mechanics of establishing a cash flow hedge and measuring its effectiveness. For the purpose of the illustrations, assume that an entity expects to issue a CU100,000 one-year debt instrument in three months. The instrument will pay interest quarterly with principal due at maturity. The entity is exposed to interest rate increases and establishes a hedge of the interest cash flows of the debt by entering into a forward starting interest rate swap. The swap has a term of one year and will start in three months to correspond with the terms of the forecast debt issue. The entity will pay a fixed rate and receive a variable rate, and the entity designates the risk being hedged as the LIBOR-based interest component in the forecast issue of the debt.

Yield curve

The yield curve provides the foundation for computing future cash flows and the fair value of such cash flows both at the inception of, and during, the hedging relationship. It is based on current market yields on applicable reference bonds that are traded in the marketplace. Market yields are converted to spot interest rates (“spot rates” or “zero coupon rates”) by eliminating the effect of coupon payments on the market yield. Spot rates are used to discount future cash flows, such as principal and interest rate payments, to arrive at their fair value. Spot rates also are used to compute forward interest rates that are used to compute variable and estimated future cash flows. The relationship between spot rates and one-period forward rates is shown by the following formula:

Spot-forward relationship

$$F = \frac{(1 + SR_t)^t}{(1 + SR_{t-1})^{t-1}} - 1$$

where

F = forward rate (%)

SR = spot rate (%)

t = period in time (e.g. 1, 2, 3, 4, 5)

Also, for the purpose of this illustration, assume that the following quarterly-period term structure of interest rates using quarterly compounding exists at the inception of the hedge.

Yield curve at inception – (beginning of period 1)					
Forward periods	1	2	3	4	5
Spot rates	3.75%	4.50%	5.50%	6.00%	6.25%
Forward rates	3.75%	5.25%	7.51%	7.50%	7.25%

The one-period forward rates are computed on the basis of spot rates for the applicable maturities. For example, the current forward rate for Period 2 calculated using the formula above is equal to $[1.0450^2/1.0375] - 1 = 5.25$ per cent. The current one-period forward rate for Period 2 is different from the current spot rate for Period 2, since the spot rate is an interest rate from the beginning of Period 1 (spot) to the end of Period 2, while the forward rate is an interest rate from the beginning of Period 2 to the end of Period 2.

Hedged item

In this example, the entity expects to issue a CU100,000 one-year debt instrument in three months with quarterly interest payments. The entity is exposed to interest rate increases and would like to eliminate the effect on cash flows of interest rate changes that may happen before the forecast transaction takes place. If that risk is eliminated, the entity would obtain an interest rate on its debt issue that is equal to the one-year forward coupon rate currently available in the marketplace in three months. That forward coupon rate, which is different from the forward (spot) rate, is 6.86 per cent, computed from the term structure of interest rates shown above. It is the market rate of interest that exists at the inception of the hedge, given the terms of the forecast debt instrument. It results in the fair value of the debt being equal to par at its issue.

At the inception of the hedging relationship, the expected cash flows of the debt instrument can be calculated on the basis of the existing term structure of interest rates. For this purpose, it is

assumed that interest rates do not change and that the debt would be issued at 6.86 per cent at the beginning of Period 2. In this case, the cash flows and fair value of the debt instrument would be as follows at the beginning of Period 2.

Issue of fixed rate debt					
Beginning of period 2 - No rate changes (spot based on forward rates)					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	
Spot rates		5.25%	6.38%	6.75%	6.88%
Forward rates		5.25%	7.51%	7.50%	7.25%
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Principal					100,000
<i>Fair value:</i>					
Interest	6,592	1,694	1,663	1,632	1,603
Principal	93,408				93,408 ^(a)
Total	100,000				
(a) $CU100,000/(1 + [0.0688/4])^4$					

Since it is assumed that interest rates do not change, the fair value of the interest and principal amounts equals the par amount of the forecast transaction. The fair value amounts are computed on the basis of the spot rates that exist at the inception of the hedge for the applicable periods in which the cash flows would occur had the debt been issued at the date of the forecast transaction. They reflect the effect of discounting those cash flows on the basis of the periods that will remain after the debt instrument is issued. For example, the spot rate of 6.38 per cent is used to discount the interest cash flow that is expected to be paid in Period 3, but it is discounted for only two periods because it will occur two periods after the forecast transaction.

The forward interest rates are the same as shown previously, since it is assumed that interest rates do not change. The spot rates are different but they have not actually changed. They represent the spot rates one period forward and are based on the applicable forward rates.

Hedging instrument

The objective of the hedge is to obtain an overall interest rate on the forecast transaction and the hedging instrument that is equal to 6.86 per cent, which is the market rate at the inception of the hedge for the period from Period 2 to Period 5. This objective is accomplished by entering into a forward starting interest rate swap that has a fixed rate of 6.86 per cent. Based on the term structure of interest rates that exist at the inception of the hedge, the interest rate swap will have such a rate. At the inception of the hedge, the fair value of the fixed rate payments on the interest rate swap will

equal the fair value of the variable rate payments, resulting in the interest rate swap having a fair value of zero. The expected cash flows of the interest rate swap and the related fair value amounts are shown as follows.

Interest rate swap					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Forecast variable interest		1,313	1,877	1,876	1,813
<i>Forecast based on forward rate</i>		<i>5.25%</i>	<i>7.51%</i>	<i>7.50%</i>	<i>7.25%</i>
Net interest		(403)	161	160	97
<i>Fair value:</i>					
<i>Discount rate (spot)</i>		<i>5.25%</i>	<i>6.38%</i>	<i>6.75%</i>	<i>6.88%</i>
Fixed interest	6,592	1,694	1,663	1,632	1,603
Forecast variable interest	6,592	1,296	1,819	1,784	1,693
Fair value of interest rate swap	0	(398)	156	152	90

At the inception of the hedge, the fixed rate on the forward swap is equal to the fixed rate the entity would receive if it could issue the debt in three months under terms that exist today.

Measuring hedge effectiveness

If interest rates change during the period the hedge is outstanding, the effectiveness of the hedge can be measured in various ways.

Assume that interest rates change as follows immediately before the debt is issued at the beginning of Period 2.

Yield curve - Rates increase 200 basis points					
<i>Forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	
Spot rates	5.75%	6.50%	7.50%		8.00%
Forward rates	5.75%	7.25%	9.51%		9.50%

Under the new interest rate environment, the fair value of the pay-fixed at 6.86 per cent, receive-variable interest rate swap that was designated as the hedging instrument would be as follows.

Fair value of interest rate swap						
Total						
Original forward periods	1	2	3	4	5	
Remaining periods		1	2	3	4	
	CU	CU	CU	CU	CU	CU
<i>Cash flows:</i>						
Fixed interest @6.86%		1,716	1,716	1,716	1,716	
Forecast variable interest		1,438	1,813	2,377	2,376	
Forecast based on new forward rate		5.25%	7.25%	9.51%	9.50%	
Net interest		(279)	97	661	660	
<i>Fair value:</i>						
New discount rate (spot)		5.75%	6.50%	7.50%	8.00%	
Fixed interest	6,562	1,692	1,662	1,623	1,585	
Forecast variable interest	7,615	1,417	1,755	2,248	2,195	
Fair value of net interest	1,053	(275)	93	625	610	

In order to compute the effectiveness of the hedge, it is necessary to measure the change in the present value of the cash flows or the value of the hedged forecast transaction. There are at least two methods of accomplishing this measurement.

Method A Compute change in fair value of debt					
Total					
Original forward periods	1	2	3	4	5
Remaining periods		1	2	3	4
	CU	CU	CU	CU	CU
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Principal					100,000
<i>Fair value:</i>					
New discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Interest	6,562	1,692	1,662	1,623	1,585
Principal	92,385				92,385 ^(a)
Total	98,947				
Fair value at inception	100,000				
Fair value difference	(1,053)				
(a) $CU100,000 / (1 + [0.08/4])^4$					

Under Method A, a computation is made of the fair value in the new interest rate environment of debt that carries interest that is equal to the coupon interest rate that existed at the inception of

the hedging relationship (6.86 per cent). This fair value is compared with the expected fair value as of the beginning of Period 2 that was calculated on the basis of the term structure of interest rates that existed at the inception of the hedging relationship, as illustrated above, to determine the change in the fair value. Note that the difference between the change in the fair value of the swap and the change in the expected fair value of the debt exactly offset in this example, since the terms of the swap and the forecast transaction match each other.

Method B Compute change in fair value of cash flows					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	
Market rate at inception		6.86%	6.86%	6.86%	6.86%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		1.11%	(0.39%)	(2.64%)	(2.64%)
Cash flow difference (principal × rate)		CU279	(CU97)	(CU661)	(CU660)
Discount rate (<i>spot</i>)		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,053)	CU275	(CU93)	(CU625)	(CU610)

Under Method B, the present value of the change in cash flows is computed on the basis of the difference between the forward interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. The market rate that existed at the inception of the hedge is the one-year forward coupon rate in three months. The present value of the change in cash flows is computed on the basis of the current spot rates that exist at the effectiveness measurement date for the applicable periods in which the cash flows are expected to occur. This method also could be referred to as the “theoretical swap” method (or “hypothetical derivative” method) because the comparison is between the hedged fixed rate on the debt and the current variable rate, which is the same as comparing cash flows on the fixed and variable rate legs of an interest rate swap.

As before, the difference between the change in the fair value of the swap and the change in the present value of the cash flows exactly offset in this example, since the terms match.

Other considerations

There is an additional computation that should be performed to compute ineffectiveness before the expected date of the forecast transaction that has not been considered for the purpose of this illustration. The fair value difference has been determined in each of the illustrations as of the expected date of the forecast transaction immediately before the forecast transaction, i.e. at the beginning of Period 2. If the assessment of hedge effectiveness is done before the forecast transaction occurs, the difference should be discounted to the current date to arrive at the actual amount of ineffectiveness. For example, if the measurement date were one month after the hedging relationship was established and the forecast transaction is now expected to occur in two

months, the amount would have to be discounted for the remaining two months before the forecast transaction is expected to occur to arrive at the actual fair value. This step would not be necessary in the examples provided above because there was no ineffectiveness. Therefore, additional discounting of the amounts, which net to zero, would not have changed the result.

Under Method B, ineffectiveness is computed on the basis of the difference between the forward coupon interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. Computing the change in cash flows based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date is inappropriate if the objective of the hedge is to establish a single fixed rate for a series of forecast interest payments. This objective is met by hedging the exposures with an interest rate swap as illustrated in the above example. The fixed interest rate on the swap is a blended interest rate composed of the forward rates over the life of the swap. Unless the yield curve is flat, the comparison between the forward interest rate exposures over the life of the swap and the fixed rate on the swap will produce different cash flows whose fair values are equal only at the inception of the hedging relationship. This difference is shown in the table below.

<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	
Forward rate at inception		5.25%	7.51%	7.50%	7.25%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		(0.50%)	0.26%	(2.00%)	(2.25%)
Cash flow difference (principal × rate)		(CU125)	CU64	(CU501)	(CU563)
Discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,055)	(CU123)	CU62	(CU474)	(CU520)
Fair value of interest rate swap	CU1,053				
Ineffectiveness	(CU2)				

If the objective of the hedge is to obtain the forward rates that existed at the inception of the hedge, the interest rate swap is ineffective because the swap has a single blended fixed coupon rate that does not offset a series of different forward interest rates. However, if the objective of the hedge is to obtain the forward coupon rate that existed at the inception of the hedge, the swap is effective, and the comparison based on differences in forward interest rates suggests ineffectiveness when none may exist. Computing ineffectiveness based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date would be an appropriate measurement of ineffectiveness if the hedging objective is to lock in those forward interest rates. In that case, the

appropriate hedging instrument would be a series of forward contracts each of which matures on a repricing date that corresponds with the date of the forecast transactions.

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and IPSAS ~~29XX (ED 38)~~ does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (IPSAS ~~29XX (ED 38)~~.83). It is recognized, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

F.5.6 Cash Flow Hedges: Firm Commitment to Purchase Property, Plant and Equipment~~Inventory~~ in a Foreign Currency

Entity A has the Local Currency (LC) as its functional currency and presentation currency. On June 30, 20X1, it enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver LC109,600 on June 30, 20X2 at an initial cost and fair value of zero. It designates the forward exchange contract as a hedging instrument in a cash flow hedge of a firm commitment to purchase spare parts for its electricity distribution network on March 31, 20X2 and the resulting payable of FC100,000, which is to be paid on June 30, 20X2. All hedge accounting conditions in IPSAS ~~29XX (ED 38)~~ are met.

As indicated in the table below, on June 30, 20X1, the spot exchange rate is LC1.072 to FC1, while the twelve-month forward exchange rate is LC1.096 to FC1. On December 31, 20X1, the spot exchange rate is LC1.080 to FC1, while the six-month forward exchange rate is LC1.092 to FC1. On March 31, 20X2, the spot exchange rate is LC1.074 to FC1, while the three-month forward rate is LC1.076 to FC1. On June 30, 20X2, the spot exchange rate is LC1.072 to FC1. The applicable yield curve in the local currency is flat at 6 per cent per year throughout the period. The fair value of the forward exchange contract is negative LC388 on December 31, 20X1 $\{([1.092 \times 100,000] - 109,600)/1.06(6/12)\}$, negative LC1.971 on March 31, 20X2 $\{([1.076 \times 100,000] - 109,600)/1.06((3/12))\}$, and negative LC2,400 on June 30, 20X2 $\{1.072 \times 100,000 - 109,600\}$.

Date	Spot rate	Forward rate to June 30, 20X2	Fair value of forward contract
June 30, 20X1	1.072	1.096	–
December 31, 20X1	1.080	1.092	(388)
March 31, 20X2	1.074	1.076	(1,971)
June 30, 20X2	1.072	–	(2,400)

Issue (a) – What is the accounting for these transactions if the hedging relationship is designated as being for changes in the fair value of the forward exchange contract and the entity's accounting policy is to apply basis adjustment to non-financial assets that result from hedged forecast transactions?

The accounting entries are as follows.

June 30, 20X1

Dr	Forward	LC0	
	Cr	Cash	LC0

To record the forward exchange contract at its initial amount of zero (IPSAS ~~29XX (ED 38)~~.45). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract and the assessment of hedge effectiveness are based on the forward price (IPSAS ~~29XX (ED 38)~~.AG14~~98~~).

December 31, 20X1

Dr	Net assets/equity	LC388	
	Cr	Forward liability	LC388

To record the change in the fair value of the forward exchange contract between June 30, 20X1 and December 31, 20X1, i.e. $LC388 - 0 = LC388$, in net assets/equity (IPSAS ~~29XX (ED 38)~~.106). The hedge is fully effective because the loss on the forward exchange contract (LC388) exactly offsets the change in cash flows associated with the purchase contract based on the forward price $[(LC388) = \{([1.092 \times 100,000] - 109,600)/1.06(6/12)\} - \{([1.096 \times 100,000] - 109,600)/1.06\}]$.

March 31, 20X2

Dr	Net assets/equity	LC1,583	
	Cr	Forward liability	LC1,583

To record the change in the fair value of the forward exchange contract between January 1, 20X2 and March 31, 20X2 (i.e. $LC1,971 - LC388 = LC1,583$) in net assets/equity (IPSAS ~~29XX (ED 38)~~.106). The hedge is fully effective because the loss on the forward exchange contract (LC1,583) exactly offsets the change in cash flows associated with the purchase contract based on the forward price $[(LC1,583) = \{([1.076 \times 100,000] - 109,600)/1.06(3/12)\} - \{([1.092 \times 100,000] - 109,600)/1.06(6/12)\}]$.

Dr	Property, plant and equipment (purchase price)	LC107,400	
Dr	Property, plant and equipment (hedging loss)	LC1,971	
	Cr	Net assets/equity	LC1,971
	Cr	Payable	LC107,400

To recognize the purchase of the spare parts at the spot rate ($1.074 \times FC100,000$) and remove the cumulative loss on the forward exchange contract that has been recognized in net assets/equity (LC1,971) and include it in the initial measurement of the spare parts purchased. Accordingly, the initial measurement of the is LC109,371 consisting of a purchase consideration of LC107,400 and a hedging loss of LC1,971.

June 30, 20X2

Dr	Payable	LC107,400
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Cr	Cash	LC107,200
Cr	Surplus or deficit	LC200

To record the settlement of the payable at the spot rate ($FC100,000 \times 1.072 = 107,200$) and the associated exchange gain of LC200 ($LC107,400 - LC107,200$).

Dr	Surplus or deficit	LC429
Cr	Forward liability	LC429

To record the loss on the forward exchange contract between April 1, 20X2 and June 30, 20X2 (i.e. $LC2,400 - LC1,971 = LC429$) in surplus or deficit. The hedge is regarded as fully effective because the loss on the forward exchange contract (LC429) exactly offsets the change in the fair value of the payable based on the forward price ($LC429 = ([1.072 \times 100,000] - 109,600 - \{([1.076 \times 100,000] - 109,600)/1.06(3/12)\})$).

Dr	Forward liability	LC2,400
Cr	Cash	LC2,400

To record the net settlement of the forward exchange contract.

Issue (b) – What is the accounting for these transactions if the hedging relationship instead is designated as being for changes in the spot element of the forward exchange contract and the interest element is excluded from the designated hedging relationship (IPSAS ~~29XX (ED 38).83~~)?

The accounting entries are as follows.

June 30, 20X1		
Dr	Forward	LC0
Cr	Cash	LC0

To record the forward exchange contract at its initial amount of zero (IPSAS ~~29XX (ED 38).45~~). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the premium or discount on the forward contract is excluded from the assessment of effectiveness (IPSAS ~~29XX (ED 38).AG1498~~).

December 31, 20X1		
Dr	Surplus or deficit (interest element)	LC1,165
Cr	Net assets/equity (spot element)	LC777
Cr	Forward liability	LC388

To record the change in the fair value of the forward exchange contract between June 30, 20X1 and December 31, 20X1, i.e. $LC388 - 0 = LC388$. The change in the present value of spot settlement of the forward exchange contract is a gain of LC777 ($\{([1.080 \times 100,000] - 107,200)/1.06(6/12)\} - \{([1.072 \times 100,000] - 107,200)/1.06\}$), which is recognized in net assets/equity (IPSAS ~~29XX (ED 38).106~~). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,165 ($388 + 777$), which is

recognized in surplus or deficit (IPSAS ~~29XX (ED 38)~~.83 and IPSAS ~~29XX (ED 38)~~.64(a)). The hedge is fully effective because the gain in the spot element of the forward contract (LC777) exactly offsets the change in the purchase price at spot rates ($LC777 = \{([1.080 \times 100,000] - 107,200)/1.06(6/12)\} - \{([1.072 \times 100,000] - 107,200)/1.06\}$).

March 31, 20X2

Dr Net assets/equity (spot element)	LC580	
Dr Surplus or deficit (interest element)	LC1,003	
Cr Forward liability		LC1,583

To record the change in the fair value of the forward exchange contract between January 1, 20X2 and March 31, 20X2, i.e. $LC1,971 - LC388 = LC1,583$. The change in the present value of the spot settlement of the forward exchange contract is a loss of LC580 ($\{([1.074 \times 100,000] - 107,200)/1.06(3/12)\} - \{([1.080 \times 100,000] - 107,200)/1.06(6/12)\}$), which is recognized in net assets/equity (IPSAS ~~29XX (ED 38)~~.106(a)). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,003 ($LC1,583 - LC580$), which is recognized in surplus or deficit (IPSAS ~~29XX (ED 38)~~.83 and IPSAS ~~29XX (ED 38)~~.64(a)). The hedge is fully effective because the loss in the spot element of the forward contract (LC580) exactly offsets the change in the purchase price at spot rates [$(580) = \{([1.074 \times 100,000] - 107,200)/1.06(3/12)\} - \{([1.080 \times 100,000] - 107,200)/1.06(6/12)\}$].

Dr Property, plant and equipment (purchase price)	LC107,400	
Dr Net assets/equity	LC197	
Cr Property, plant and equipment (hedging gain)		LC197
Cr Payable		LC107,400

To recognize the purchase of the paper at the spot rate ($= 1.074 \times FC100,000$) and remove the cumulative gain on the spot element of the forward exchange contract that has been recognized in net assets/equity ($LC777 - LC580 = LC197$) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is LC107,203, consisting of a purchase consideration of LC107,400 and a hedging gain of LC197.

June 30, 20X2

Dr Payable	LC107,400	
Cr Cash		LC107,200
Cr Surplus or deficit		LC200

To record the settlement of the payable at the spot rate ($FC100,000 \times 1.072 = LC107,200$) and the associated exchange gain of LC200 ($- [1.072 - 1.074] \times FC100,000$).

Dr Surplus or deficit (spot element)	LC197	
Dr Surplus or deficit (interest element)	LC232	
Cr Forward liability		LC429

To record the change in the fair value of the forward exchange contract between April 1, 20X2 and June 30, 20X2 (i.e. $LC2,400 - LC1,971 = LC429$). The change in the present value of the

spot settlement of the forward exchange contract is a loss of LC197 ($[1.072 \times 100,000] - 107,200 - \{([1.074 \times 100,000] - 107,200)/1.06(3/12)\}$), which is recognized in surplus or deficit. The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC232 (LC429 – LC197), which is recognized in surplus or deficit. The hedge is fully effective because the loss in the spot element of the forward contract (LC197) exactly offsets the change in the present value of the spot settlement of the payable $[(LC197) = \{[1.072 \times 100,000] - 107,200 - \{([1.074 \times 100,000] - 107,200)/1.06(3/12)\}]$.

Dr	Forward liability	LC2,400	
	Cr	Cash	LC2,400

To record the net settlement of the forward exchange contract.

The following table provides an overview of the components of the change in fair value of the hedging instrument over the term of the hedging relationship. It illustrates that the way in which a hedging relationship is designated affects the subsequent accounting for that hedging relationship, including the assessment of hedge effectiveness and the recognition of gains and losses.

<i>Period ending</i>	<i>Change in spot settlement</i>	<i>Fair value of change in spot settlement</i>	<i>Change in forward settlement</i>	<i>Fair value of change in forward settlement</i>	<i>Fair value of change in interest element</i>
<i>LC</i>	<i>LC</i>	<i>LC</i>	<i>LC</i>	<i>LC</i>	<i>LC</i>
June 20X1	–	–	–	–	–
December 20X1	800	777	(400)	(388)	(1,165)
March 20X2	(600)	(580)	(1,600)	(1,583)	(1,003)
June 20X2	(200)	(197)	(400)	(429)	(232)
Total	–	–	(2,400)	(2,400)	(2,400)

F.6 Hedges: Other Issues

F.6.1 Hedge Accounting: Management of Interest Rate Risk in Entities Such as Departments of Finance

Entities, such as departments of finance, often manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have systems to accumulate critical information throughout the entity about their financial assets, financial liabilities and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many entities use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If an entity manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under IPSAS [29XX \(ED 38\)](#)?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to the net exposure (IPSAS ~~29XX (ED-38)~~.94, IPSAS ~~29XX (ED-38)~~.AG14¹⁰ and IPSAS ~~29XX (ED-38)~~.AG15⁴³). It is not possible to designate a net position as a hedged item under IPSAS ~~29XX (ED-38)~~ because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognized in surplus or deficit.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting in IPSAS ~~29XX (ED-38)~~.98 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately affects the entity's surplus or deficit (IPSAS ~~29XX (ED-38)~~.AG15³²) and the entity designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their objective.

The factors an entity must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question F.6.2.

F.6.2 Hedge Accounting Considerations when Interest Rate Risk is Managed on a Net Basis

If an entity manages its exposure to interest rate risk on a net basis, what are the issues the entity should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues (a)–(l) below deal with the main issues. First, Issues (a) and (b) discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues (c)–(l) expand on various aspects of the accounting for cash flow hedges. Issues (c)–(f) consider the application of the hedge accounting criteria for cash flow hedges in IPSAS ~~29XX (ED-38)~~, and Issues (g) and (h) discuss the required accounting treatment. Finally, Issues (i)–(l) elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue (a) – Can a derivative that is used to manage interest rate risk on a net basis be designated under IPSAS ~~29XX (ED-38)~~ as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Both types of designation are possible under IPSAS ~~29XX (ED-38)~~. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets, liabilities and firm commitments or as a cash flow hedge of forecast transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

In economic terms, it does not matter whether the derivative instrument is regarded as a fair value hedge or as a cash flow hedge. Under either perspective of the exposure, the derivative has

the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offset the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue (b).

To illustrate: a department of finance has the following assets and liabilities with a maturity of two years.

	Variable interest	Fixed interest
	CU	CU
Assets	60	100
Liabilities	(100)	(60)
Net	(40)	40

The entity takes out a two-year swap with a notional principal of CU40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be regarded and designated either as a fair value hedge of CU40 of the fixed rate assets or as a cash flow hedge of CU40 of the variable rate liabilities.

Issue (b) – What are the critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of a derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses for these categories are different. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the highly probable test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (IPSAS [29XX \(ED-38\)](#).98(b)). This test may be difficult to meet if, for example, the derivative

hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. If an entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. However, for that period, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. Furthermore, the fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecast cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (IPSAS ~~29XX (ED-38)~~.98(c) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument (IPSAS ~~29XX (ED-38)~~.98(b)). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecast transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecast transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems considerations

The accounting for fair value hedges differs from that for cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective interest rate of the hedged item (IPSAS ~~29XX (ED-38)~~.99). As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the assets or liabilities being hedged in order for the entity to be able to recompute their effective interest rate, determine the subsequent amortization of the fair value adjustment to surplus or deficit, and determine the amount that should be recognized in surplus or deficit when assets are sold or liabilities extinguished (IPSAS

~~29XX (ED-38)~~.99 and IPSAS ~~29XX (ED-38)~~.103). To comply with the requirements for fair value hedge accounting, it will generally be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective interest rate of the hedged items, and amortize the changes to surplus or deficit over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecast transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognized in net assets/equity (IPSAS ~~29XX (ED-38)~~.105). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the cumulative gains and losses recognized in net assets/equity from changes in the fair value of a hedging instrument should be recognized in surplus or deficit (IPSAS ~~29XX (ED-38)~~.111 and IPSAS ~~29XX (ED-38)~~.112). For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling the changes in the cash flows of the derivative and the recognition of such changes in surplus or deficit.

The timing of the recognition in surplus or deficit can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecast transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced, each of which creates a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rates are matched with the derivative hedging instrument. IPSAS ~~29XX (ED-38)~~.111 specifies that the amounts recognized in net assets/equity should be recognized in surplus or deficit in the same period or periods during which the hedged item affects surplus or deficit.

Issue (c) – If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by IPSAS ~~29XX (ED-38)~~.98(a)?

The following would be included in the documentation.

The hedging relationship—The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.

The entity's risk management objective and strategy for undertaking the hedge—The entity's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.

The type of hedge—The hedge is documented as a cash flow hedge.

The hedged item—The hedged item is documented as a group of forecast transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for example, scheduled on a monthly basis. The hedged item may include interest cash

flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue (e), the forecast transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The hedged risk—The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based on the same yield curve as the derivative hedging instrument.

The hedging instrument—Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecast transactions occurring in the specified future time periods designated as being hedged.

The method of assessing effectiveness—The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecast transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

Issue (d) – If the hedging relationship is designated as a cash flow hedge, how does an entity satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in IPSAS ~~29XX (ED 38)~~.98(b)?

An entity may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue (e) – If the hedging relationship is designated as a cash flow hedge, how does an entity demonstrate a high probability of the forecast transactions occurring as required by IPSAS ~~29XX (ED 38)~~.98(c)?

An entity may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecast transactions that are designated as being hedged are highly probable to occur. Such a schedule should be supported by management's stated intentions and past practice of reinvesting cash inflows and refinancing cash outflows.

For example, an entity may forecast aggregate gross cash inflows of CU100 and aggregate gross cash outflows of CU90 in a particular time period in the near future. In this case, it may wish to designate the forecast reinvestment of gross cash inflows of CU10 as the hedged item in the future time period. If more than CU10 of the forecast cash inflows are contractually specified and have low credit risk, the entity has strong evidence to support an assertion that gross cash

inflows of CU10 are highly probable to occur and to support the designation of the forecast reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecast transactions occurring may also be demonstrated under other circumstances.

Issue (f) – If the hedging relationship is designated as a cash flow hedge, how does an entity assess and measure effectiveness under IPSAS ~~29XX (ED 38)~~.98(d) and IPSAS ~~29XX (ED 38)~~.98(e)?

Effectiveness is required to be measured at a minimum at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the recognition in surplus or deficit of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecast transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognized initially in net assets/equity are recognized in surplus or deficit.

Issue (g) – If the hedging relationship is designated as a cash flow hedge, how does an entity account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions in IPSAS ~~29XX (ED 38)~~.106 - IPSAS ~~29XX (ED 38)~~.111, as follows:

- (i) The portion of gains and losses on hedging derivatives determined to result from effective hedges is recognized in net assets/equity whenever effectiveness is measured; and
- (ii) The ineffective portion of gains and losses resulting from hedging derivatives is recognized in surplus or deficit.

IPSAS ~~29XX (ED 38)~~.111 specifies that the amounts recognized in net assets/equity should be recognized in surplus or deficit in the same period or periods during which the hedged item affects surplus or deficit. Accordingly, when the forecast transactions occur, the amounts previously recognized in net assets/equity are recognized in surplus or deficit. For example, if an interest rate swap is designated as a hedging instrument of a series of forecast cash flows, the changes in the cash flows of the swap are removed from net assets/equity and recognized in surplus or deficit in the periods when the forecast cash flows and the cash flows of the swap offset each other.

Issue (h) – If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognized in net assets/equity if the

hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecast transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for example, the forecast transactions are no longer highly probable, the net cumulative gain or loss recognized in net assets/equity remains in net assets/equity until the forecast transaction occurs (IPSAS ~~29XX (ED 38)~~.112(a) and IPSAS ~~29XX (ED 38)~~.112(b)). If the hedged forecast transactions are no longer expected to occur, the net cumulative gain or loss is recognized in surplus or deficit (IPSAS ~~29XX (ED 38)~~.112(c)).

Issue (i) –IPSAS ~~29XX (ED 38)~~.84 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, does IPSAS ~~29XX (ED 38)~~.84 preclude redesignating the hedging instrument?

No. IPSAS ~~29XX (ED 38)~~.84 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity. IPSAS ~~29XX (ED 38)~~.84 does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the ineffective portion of the gain or loss on the derivative instrument is recognized immediately in surplus or deficit (IPSAS ~~29XX (ED 38)~~.106) and hedge accounting based on the previous designation of the hedge relationship cannot be continued (IPSAS ~~29XX (ED 38)~~.112). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognized in net assets/equity remaining in net assets/equity?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognized in surplus or deficit in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognized in net assets/equity are recognized in surplus or deficit in the same period or periods during which the hedged forecast transaction affects surplus or deficit (such as in the periods that interest expenses are recognized). However, if an entity expects at any time that all or a portion of a net loss recognized net assets/equity will not be recovered in one or more future periods, it shall reclassify immediately into surplus or deficit the amount that is not expected to be recovered.

Issue (k) – In the answer to Issue (c) above it was indicated that the designated hedged item is a portion of a cash flow exposure. Does IPSAS ~~29XX (ED-38)~~ permit a portion of a cash flow exposure to be designated as a hedged item?

Yes. IPSAS ~~29XX (ED-38)~~ does not specifically address a hedge of a portion of a cash flow exposure for a forecast transaction. However, IPSAS ~~29XX (ED-38)~~.90 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecast reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by IPSAS ~~29XX (ED-38)~~.92, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecast transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue (l) – In the answer to Issue (c) above it was indicated that the hedged item is documented as a group of forecast transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities and option features, how can an entity satisfy the tests in IPSAS ~~29XX (ED-38)~~.87 and IPSAS ~~29XX (ED-38)~~.93 requiring the hedged group to have similar risk characteristics?

IPSAS ~~29XX (ED-38)~~.87 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics. IPSAS ~~29XX (ED-38)~~.93 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated, and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecast transactions. For hedges of cash flow exposures relating to a group of forecast transactions, the overall exposure of the forecast transactions and the assets or liabilities that are repriced may have very different risks. The exposure from forecast transactions may differ depending on the terms that are expected as they relate to credit exposures, maturities, options and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, provided they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free or benchmark interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (i.e. the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be

hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (IPSAS ~~29XX (ED-38)~~.83). For example, if a portfolio of assets consists of assets rated A, BB and B, and the current market interest rates for these assets are LIBOR+20 basis points, LIBOR+40 basis points and LIBOR+60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments based on LIBOR are made to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

F.6.3 Illustrative Example of Applying the Approach in Question F.6.2

The purpose of this example is to illustrate the process of establishing, monitoring and adjusting hedge positions and of qualifying for cash flow hedge accounting in applying the approach to hedge accounting described in Question F.6.2 when an entity manages its interest rate risk on an entity-wide basis. To this end, this example identifies a methodology that allows for the use of hedge accounting and takes advantage of existing risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

The approach illustrated here reflects only one of a number of risk management processes that could be employed and could qualify for hedge accounting. Its use is not intended to suggest that other alternatives could not or should not be used. The approach being illustrated could also be applied in other circumstances (such as for cash flow hedges), for example, hedging the rollover of commercial paper financing.

Identifying, assessing and reducing cash flow exposures

The discussion and illustrations that follow focus on the risk management activities of an entity, such as a department of finance, that manages its interest rate risk by analyzing expected cash flows in a particular currency on an entity-wide basis. The cash flow analysis forms the basis for identifying the interest rate risk of the entity, entering into hedging transactions to manage the risk, assessing the effectiveness of risk management activities, and qualifying for and applying cash flow hedge accounting.

The illustrations that follow assume that an entity had the following expected future net cash flows and hedging positions outstanding in a specific currency, consisting of interest rate swaps, at the beginning of Period X0. The cash flows shown are expected to occur at the end of the period and, therefore, create a cash flow interest exposure in the following period as a result of the reinvestment or repricing of the cash inflows or the refinancing or repricing of the cash outflows.

The illustrations assume that the entity has an ongoing interest rate risk management programme. Schedule I shows the expected cash flows and hedging positions that existed at the beginning of Period X0. It is included here to provide a starting point in the analysis. It provides a basis for considering existing hedges in connection with the evaluation that occurs at the beginning of Period X1.

Schedule I End of period: expected cash flows and hedging positions

<i>Quarterly period</i>	<i>X0</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Expected net cash flows		1,100	1,500	1,200	1,400	1,500	x,xxx
<i>Outstanding interest rate swaps:</i>							
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after outstanding swaps		100	500	500	700	800	x,xxx

The schedule depicts five quarterly periods. The actual analysis would extend over a period of many years, represented by the notation "...n." An entity that manages its interest rate risk on an entity-wide basis re-evaluates its cash flow exposures periodically. The frequency of the evaluation depends on the entity's risk management policy.

For the purposes of this illustration, the entity is re-evaluating its cash flow exposures at the end of Period X0. The first step in the process is the generation of forecast net cash flow exposures from existing interest-earning assets and interest-bearing liabilities, including the rollover of short-term assets and short-term liabilities. Schedule II below illustrates the forecast of net cash flow exposures. A common technique for assessing exposure to interest rates for risk management purposes is an interest rate sensitivity gap analysis showing the gap between interest rate-sensitive assets and interest rate-sensitive liabilities over different time intervals. Such an analysis could be used as a starting point for identifying cash flow exposures to interest rate risk for hedge accounting purposes.

Schedule II Forecast net cash flow and repricing exposures

<i>Quarterly period</i>	<i>Notes</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>		<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
CASH INFLOW AND REPRICING EXPOSURES - from assets							
<i>Principal and interest payments:</i>							
Long-term fixed rate	(1)	2,400	3,000	3,000	1,000	1,200	x,xxx
Short-term (roll over)	(1)(2)	1,575	1,579	1,582	1,586	1,591	x,xxx

Schedule II Forecast net cash flow and repricing exposures									
Variable	rate	–	(1)	2,000	1,000	–	500	500	x,xxx
principal payments									
Variable	rate	–	(2)	125	110	105	114	118	x,xxx
estimated interest									
<i>Total</i>	<i>expected</i>	<i>cash</i>		<i>6,100</i>	<i>5,689</i>	<i>4,687</i>	<i>3,200</i>	<i>3,409</i>	<i>x,xxx</i>
<i>inflows</i>									
Variable	rate	asset	(3)	8,000	7,000	7,000	6,500	6,000	x,xxx
balances									
Cash	inflows	and	(4)	14,100	12,689	11,687	9,700	9,409	x,xxx
repricings									
CASH OUTFLOW AND REPRICING EXPOSURES - from liabilities									
<i>Principal and interest payments:</i>									
Long-term fixed rate			(1)	2,100	400	500	500	301	x,xxx
Short-term (roll over)			(1)(2)	735	737	738	740	742	x,xxx
Variable	rate	–	(1)	–	–	2,000	–	1,000	x,xxx
principal payments									
Variable	rate	–	(2)	100	110	120	98	109	x,xxx
estimated interest									
<i>Total</i>	<i>expected</i>	<i>cash</i>		<i>2,935</i>	<i>1,247</i>	<i>3,358</i>	<i>1,338</i>	<i>2,152</i>	<i>x,xxx</i>
<i>outflows</i>									
Variable	rate	liability	(3)	8,000	8,000	6,000	6,000	5,000	x,xxx
balances									
Cash	outflows	and	(4)	10,935	9,247	9,358	7,338	7,152	x,xxx
repricings									
NET EXPOSURES			(5)	3,165	3,442	2,329	2,362	2,257	x,xxx

- (1) The cash flows are estimated using contractual terms and assumptions based on management's intentions and market factors. It is assumed that short-term assets and liabilities will continue to be rolled over in succeeding periods. Assumptions about prepayments and defaults and the withdrawal of deposits are based on market and historical data. It is assumed that principal and interest inflows and outflows will be reinvested and refinanced, respectively, at the end of each period at the then current market interest rates and share the benchmark interest rate risk to which they are exposed.
- (2) Forward interest rates obtained from Schedule VI are used to forecast interest payments on variable rate financial instruments and expected rollovers of short-term assets and liabilities. All forecast cash flows are associated with the specific time periods (3 months, 6 months, 9 months and 12 months) in which they are expected to occur. For completeness, the interest cash flows resulting from reinvestments, refinancings and repricings are included in the schedule and shown gross even though only the net margin may actually be

reinvested. Some entities may choose to disregard the forecast interest cash flows for risk management purposes because they may be used to absorb operating costs and any remaining amounts would not be significant enough to affect risk management decisions.

- (3) The cash flow forecast is adjusted to include the variable rate asset and liability balances in each period in which such variable rate asset and liability balances are repriced. The principal amounts of these assets and liabilities are not actually being paid and, therefore, do not generate a cash flow. However, since interest is computed on the principal amounts for each period based on the then current market interest rate, such principal amounts expose the entity to the same interest rate risk as if they were cash flows being reinvested or refinanced.
- (4) The forecast cash flow and repricing exposures that are identified in each period represent the principal amounts of cash inflows that will be reinvested or repriced and cash outflows that will be refinanced or repriced at the market interest rates that are in effect when those forecast transactions occur.
- (5) The net cash flow and repricing exposure is the difference between the cash inflow and repricing exposures from assets and the cash outflow and repricing exposures from liabilities. In the illustration, the entity is exposed to interest rate declines because the exposure from assets exceeds the exposure from liabilities and the excess (i.e. the net amount) will be reinvested or repriced at the current market rate and there is no offsetting refinancing or repricing of outflows.

Note that some entities may regard some portion of their non-interest bearing demand deposits as economically equivalent to long-term debt. However, these deposits do not create a cash flow exposure to interest rates and would therefore be excluded from this analysis for accounting purposes.

Schedule II *Forecast net cash flow and repricing exposures* provides no more than a starting point for assessing cash flow exposure to interest rates and for adjusting hedging positions. The complete analysis includes outstanding hedging positions and is shown in Schedule III *Analysis of expected net exposures and hedging positions*. It compares the forecast net cash flow exposures for each period (developed in Schedule II) with existing hedging positions (obtained from Schedule I), and provides a basis for considering whether adjustment of the hedging relationship should be made.

Schedule III Analysis of expected net exposures and hedging positions						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Net cash flow and repricing exposures (Schedule II)	3,165	3,442	2,329	2,362	2,257	x,xxx
<i>Pre-existing swaps outstanding:</i>						
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx

Schedule III Analysis of expected net exposures and hedging positions						
(notional amounts)						
<i>Net exposure after pre-existing swaps</i>	2,165	2,442	1,629	1,662	1,557	x,xxx
Transactions to adjust outstanding hedging positions:						
Receive-fixed, pay variable swap 1 (notional amount, 10-years)	2,000	2,000	2,000	2,000	2,000	x,xxx
Pay-fixed, receive-variable swap 2 (notional amount, 3-years)			(1,000)	(1,000)	(1,000)	x,xxx
Swaps ...X						x,xxx
<i>Unhedged cash flow and repricing exposure</i>	165	442	629	662	557	x,xxx

The notional amounts of the interest rate swaps that are outstanding at the analysis date are included in each of the periods in which the interest rate swaps are outstanding to illustrate the impact of the outstanding interest rate swaps on the identified cash flow exposures. The notional amounts of the outstanding interest rate swaps are included in each period because interest is computed on the notional amounts each period, and the variable rate components of the outstanding swaps are repriced to the current market rate quarterly. The notional amounts create an exposure to interest rates that in part is similar to the principal balances of variable rate assets and variable rate liabilities.

The exposure that remains after considering the existing positions is then evaluated to determine the extent to which adjustments of existing hedging positions are necessary. The bottom portion of Schedule III shows the beginning of Period X1 using interest rate swap transactions to reduce the net exposures further to within the tolerance levels established under the entity's risk management policy.

Note that in the illustration, the cash flow exposure is not entirely eliminated. Many entities do not fully eliminate risk but rather reduce it to within some tolerable limit.

Various types of derivative instruments could be used to manage the cash flow exposure to interest rate risk identified in the schedule of forecast net cash flows (Schedule II). However, for the purpose of the illustration, it is assumed that interest rate swaps are used for all hedging activities. It is also assumed that in periods in which interest rate swaps should be reduced, rather than terminating some of the outstanding interest rate swap positions, a new swap with the opposite return characteristics is added to the portfolio.

In the illustration in Schedule III above, swap 1, a receive-fixed, pay-variable swap, is used to reduce the net exposure in Periods X1 and X2. Since it is a 10-year swap, it also reduces exposures identified in other future periods not shown. However, it has the effect of creating an over-hedged position in Periods X3–X5. Swap 2, a forward starting pay-fixed, receive-variable interest rate swap, is used to reduce the notional amount of the outstanding receive-fixed, pay-variable interest rate swaps in Periods X3–X5 and thereby reduce the over-hedged positions.

It also is noted that in many situations, no adjustment or only a single adjustment of the outstanding hedging position is necessary to bring the exposure to within an acceptable limit. However, when the entity's risk management policy specifies a very low tolerance of risk a greater number of adjustments to the hedging positions over the forecast period would be needed to further reduce any remaining risk.

To the extent that some of the interest rate swaps fully offset other interest rate swaps that have been entered into for hedging purposes, it is not necessary to include them in a designated hedging relationship for hedge accounting purposes. These offsetting positions can be combined, de-designated as hedging instruments, if necessary, and reclassified for accounting purposes from the hedging portfolio to the trading portfolio. This procedure limits the extent to which the gross swaps must continue to be designated and tracked in a hedging relationship for accounting purposes. For the purposes of this illustration it is assumed that CU500 of the pay-fixed, receive-variable interest rate swaps fully offset CU500 of the receive-fixed, pay-variable interest rate swaps at the beginning of Period X1 and for Periods X1–X5, and are de-designated as hedging instruments and reclassified to the trading account.

After reflecting these offsetting positions, the remaining gross interest rate swap positions from Schedule III are shown in Schedule IV as follows.

Schedule IV Interest rate swaps designated as hedges						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Receive-fixed, pay-variable (notional amounts)	3,500	3,500	2,700	2,700	2,700	x,xxx
Pay-fixed, receive-variable (notional amounts)	(500)	(500)	(1,000)	(1,000)	(1,000)	x,xxx
<i>Net outstanding swaps positions</i>	<i>3,000</i>	<i>3,000</i>	<i>1,700</i>	<i>1,700</i>	<i>1,700</i>	<i>x,xxx</i>

For the purposes of the illustrations, it is assumed that swap 2, entered into at the beginning of Period X1, only partially offsets another swap being accounted for as a hedge and therefore continues to be designated as a hedging instrument.

Hedge accounting considerations

Illustrating the designation of the hedging relationship

The discussion and illustrations thus far have focused primarily on economic and risk management considerations relating to the identification of risk in future periods and the adjustment of that risk using interest rate swaps. These activities form the basis for designating a hedging relationship for accounting purposes.

The examples in IPSAS ~~29XX (ED-38)~~ focus primarily on hedging relationships involving a single hedged item and a single hedging instrument, but there is little discussion and guidance on portfolio hedging relationships for cash flow hedges when risk is being managed centrally. In this illustration, the general principles are applied to hedging relationships involving a component of risk in a portfolio having multiple risks from multiple transactions or positions.

Although designation is necessary to achieve hedge accounting, the way in which the designation is described also affects the extent to which the hedging relationship is judged to be effective for accounting purposes and the extent to which the entity's existing system for managing risk will be required to be modified to track hedging activities for accounting purposes. Accordingly, an entity may wish to designate the hedging relationship in a manner that avoids unnecessary systems changes by taking advantage of the information already generated by the risk management system and avoids unnecessary bookkeeping and tracking. In designating hedging relationships, the entity may also consider the extent to which ineffectiveness is expected to be recognized for accounting purposes under alternative designations.

The designation of the hedging relationship needs to specify various matters. These are illustrated and discussed here from the perspective of the hedge of the interest rate risk associated with the cash inflows, but the guidance can also be applied to the hedge of the risk associated with the cash outflows. It is fairly obvious that only a portion of the gross exposures relating to the cash inflows is being hedged by the interest rate swaps. Schedule V *The general hedging relationship* illustrates the designation of the portion of the gross reinvestment risk exposures identified in Schedule II as being hedged by the interest rate swaps.

Schedule V The general hedging relationship						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Cash inflow repricing exposure (Schedule II)	14,100	12,689	11,687	9,700	9,409	x,xxx
Receive-fixed, pay-variable swaps (Schedule IV)	3,500	3,500	2,700	2,700	2,700	x,xxx
<i>Hedged exposure percentage</i>	<i>24.8%</i>	<i>27.6%</i>	<i>23.1%</i>	<i>27.8%</i>	<i>28.7%</i>	<i>xx.x%</i>

The hedged exposure percentage is computed as the ratio of the notional amount of the receive-fixed, pay-variable swaps that are outstanding divided by the gross exposure. Note that in Schedule V there are sufficient levels of forecast reinvestments in each period to offset more than the notional amount of the receive-fixed, pay-variable swaps and satisfy the accounting requirement that the forecast transaction is highly probable.

It is not as obvious, however, how the interest rate swaps are specifically related to the cash flow interest risks designated as being hedged and how the interest rate swaps are effective in reducing that risk. The more specific designation is illustrated in Schedule VI *The specific hedging relationship* below. It provides a meaningful way of depicting the more complicated narrative designation of the hedge by focusing on the hedging objective to eliminate the cash flow variability associated with future changes in interest rates and to obtain an interest rate equal to the fixed rate inherent in the term structure of interest rates that exists at the commencement of the hedge.

The expected interest from the reinvestment of the cash inflows and repricings of the assets is computed by multiplying the gross amounts exposed by the forward rate for the period. For example, the gross exposure for Period X2 of CU14,100 is multiplied by the forward rate for Periods X2–X5 of 5.50 per cent, 6.00 per cent, 6.50 per cent and 7.25 per cent, respectively, to compute the expected interest for those quarterly periods based on the current term structure of interest rates. The hedged expected interest is computed by multiplying the expected interest for the applicable three-month period by the hedged exposure percentage.

Schedule VI The specific hedging relationship						
<i>Term structure of interest rates</i>						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
Spot rates	5.00%	5.25%	5.50%	5.75%	6.05%	x.xx%
Forward rates ^(a)	5.00%	5.50%	6.00%	6.50%	7.25%	x.xx%
<i>Cash flow exposures and expected interest amounts</i>						
Repricing period	Time to forecast transaction	Gross amounts exposed	Expected interest			
			CU	CU	CU	CU
2	3 months	14,100	°	194	212	229
3	6 months	12,689			190	206
4	9 months	11,687				190
5	12 months	9,700				176
6	15 months	9,409				
Hedged percentage (Schedule V) in the previous period			24.8%	27.6%	23.1%	27.8%
Hedged expected interest				48	52	44
					49	
						xx

(a) The forward interest rates are computed from the spot interest rates and rounded for the purposes of the presentation. Computations that are based on the forward interest rates are made based on the actual computed forward rate and then rounded for the purposes of the presentation.

It does not matter whether the gross amount exposed is reinvested in long-term fixed rate debt or variable rate debt, or in short-term debt that is rolled over in each subsequent period. The

exposure to changes in the forward interest rate is the same. For example, if the CU14,100 is reinvested at a fixed rate at the beginning of Period X2 for six months, it will be reinvested at 5.75 per cent. The expected interest is based on the forward interest rates for Period X2 of 5.50 per cent and for Period X3 of 6.00 per cent, equal to a blended rate of 5.75 per cent (1.055×1.060)^{0.5}, which is the Period X2 spot rate for the next six months.

However, only the expected interest from the reinvestment of the cash inflows or repricing of the gross amount for the first three-month period after the forecast transaction occurs is designated as being hedged. The expected interest being hedged is represented by the shaded cells. The exposure for the subsequent periods is not hedged. In the example, the portion of the interest rate exposure being hedged is the forward rate of 5.50 per cent for Period X2. In order to assess hedge effectiveness and compute actual hedge ineffectiveness on an ongoing basis, the entity may use the information on hedged interest cash inflows in Schedule VI and compare it with updated estimates of expected interest cash inflows (for example, in a table that looks like Schedule II). As long as expected interest cash inflows exceed hedged interest cash inflows, the entity may compare the cumulative change in the fair value of the hedged cash inflows with the cumulative change in the fair value of the hedging instrument to compute actual hedge effectiveness. If there are insufficient expected interest cash inflows, there will be ineffectiveness. It is measured by comparing the cumulative change in the fair value of the expected interest cash flows to the extent they are less than the hedged cash flows with the cumulative change in the fair value of the hedging instrument.

Describing the designation of the hedging relationship

As mentioned previously, there are various matters that should be specified in the designation of the hedging relationship that complicate the description of the designation but are necessary to limit ineffectiveness to be recognized for accounting purposes and to avoid unnecessary systems changes and bookkeeping. The example that follows describes the designation more fully and identifies additional aspects of the designation not apparent from the previous illustrations.

Example designation
<p><i>Hedging objective</i></p> <p>The hedging objective is to eliminate the risk of interest rate fluctuations over the hedging period, which is the life of the interest rate swap, and in effect obtain a fixed interest rate during this period that is equal to the fixed interest rate on the interest rate swap.</p> <p><i>Type of hedge</i></p> <p>Cash flow hedge.</p> <p><i>Hedging instrument</i></p> <p>The receive-fixed, pay-variable swaps are designated as the hedging instrument. They hedge the cash flow exposure to interest rate risk.</p> <p>Each repricing of the swap hedges a three-month portion of the interest cash inflows that results from:</p> <ul style="list-style-type: none"> • The forecast reinvestment or repricing of the principal amounts shown in Schedule V. • Unrelated investments or repricings that occur after the repricing dates on the swap over its

Example designation

life and involve different borrowers or lenders.

The hedged item—General

The hedged item is a portion of the gross interest cash inflows that will result from the reinvestment or repricing of the cash flows identified in Schedule V and are expected to occur within the periods shown on such schedule. The portion of the interest cash inflow that is being hedged has three components:

- The principal component giving rise to the interest cash inflow and the period in which it occurs,
- The interest rate component, and
- The time component or period covered by the hedge.

The hedged item—The principal component

The portion of the interest cash inflows being hedged is the amount that results from the first portion of the principal amounts being invested or repriced in each period:

- That is equal to the sum of the notional amounts of the received-fixed, pay-variable interest rate swaps that are designated as hedging instruments and outstanding in the period of the reinvestment or repricing, and
- That corresponds to the first principal amounts of cash flow exposures that are invested or repriced at or after the repricing dates of the interest rate swaps.

The hedged item—The interest rate component

The portion of the interest rate change that is being hedged is the change in both of the following:

- The credit component of the interest rate being paid on the principal amount invested or repriced that is equal to the credit risk inherent in the interest rate swap. It is that portion of the interest rate on the investment that is equal to the interest index of the interest rate swap, such as LIBOR, and
- The yield curve component of the interest rate that is equal to the repricing period on the interest rate swap designated as the hedging instrument.

The hedged item—The hedged period

The period of the exposure to interest rate changes on the portion of the cash flow exposures being hedged is:

- The period from the designation date to the repricing date of the interest rate swap that occurs within the quarterly period in which, but not before, the forecast transactions occur, and
- Its effects for the period after the forecast transactions occur equal to the repricing interval of the interest rate swap.

It is important to recognize that the swaps are not hedging the cash flow risk for a single investment over its entire life. The swaps are designated as hedging the cash flow risk from different principal investments and repricings that are made in each repricing period of the swaps

over their entire term. The swaps hedge only the interest accruals that occur in the first period following the reinvestment. They are hedging the cash flow impact resulting from a change in interest rates that occurs up to the repricing of the swap. The exposure to changes in rates for the period from the repricing of the swap to the date of the hedged reinvestment of cash inflows or repricing of variable rate assets is not hedged. When the swap is repriced, the interest rate on the swap is fixed until the next repricing date and the accrual of the net swap settlements is determined. Any changes in interest rates after that date that affect the amount of the interest cash inflow are no longer hedged for accounting purposes.

Designation objectives

Systems considerations

Many of the tracking and bookkeeping requirements are eliminated by designating each repricing of an interest rate swap as hedging the cash flow risk from forecast reinvestments of cash inflows and repricings of variable rate assets for only a portion of the lives of the related assets. Much tracking and bookkeeping would be necessary if the swaps were instead designated as hedging the cash flow risk from forecast principal investments and repricings of variable rate assets over the entire lives of these assets.

This type of designation avoids keeping track of gains and losses recognized in net assets/equity after the forecast transactions occur (IPSAS [29XX \(ED-38\)](#).108 and IPSAS [29XX \(ED-38\)](#).109) because the portion of the cash flow risk being hedged is that portion that will be recognized in surplus or deficit in the period immediately following the forecast transactions that corresponds with the periodic net cash settlements on the swap. If the hedge were to cover the entire life of the assets being acquired, it would be necessary to associate a specific interest rate swap with the asset being acquired. If a forecast transaction is the acquisition of a fixed rate instrument, the fair value of the swap that hedged that transaction would be recognized in surplus or deficit to adjust the interest revenue on the asset when the interest revenue is recognized. The swap would then have to be terminated or redesignated in another hedging relationship. If a forecast transaction is the acquisition of a variable rate asset, the swap would continue in the hedging relationship but it would have to be tracked back to the asset acquired so that any fair value amounts on the swap recognized in net assets/equity could be recognized in surplus or deficit upon the subsequent sale of the asset.

It also avoids the necessity of associating with variable rate assets any portion of the fair value of the swaps that is recognized in net assets/equity. Accordingly, there is no portion of the fair value of the swap that is recognized in net assets/equity that should be recognized in surplus or deficit when a forecast transaction occurs or upon the sale of a variable rate asset.

This type of designation also permits flexibility in deciding how to reinvest cash flows when they occur. Since the hedged risk relates only to a single period that corresponds with the repricing period of the interest rate swap designated as the hedging instrument, it is not necessary to determine at the designation date whether the cash flows will be reinvested in fixed rate or variable rate assets or to specify at the date of designation the life of the asset to be acquired.

Effectiveness considerations

Ineffectiveness is greatly reduced by designating a specific portion of the cash flow exposure as being hedged.

- Ineffectiveness due to credit differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the cash flow risk being hedged as the risk attributable to changes in the interest rates that correspond with the rates inherent in the swap, such as the AA rate curve. This type of designation prevents changes resulting from changes in credit spreads from being considered as ineffectiveness.
- Ineffectiveness due to duration differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the interest rate risk being hedged as the risk relating to changes in the portion of the yield curve that corresponds with the period in which the variable rate leg of the interest rate swap is repriced.
- Ineffectiveness due to interest rate changes that occur between the repricing date of the interest rate swap and the date of the forecast transactions is eliminated by simply not hedging that period of time. The period from the repricing of the swap and the occurrence of the forecast transactions in the period immediately following the repricing of the swap is left unhedged. Therefore, the difference in dates does not result in ineffectiveness.

Accounting considerations

The ability to qualify for hedge accounting using the methodology described here is founded on provisions in IPSAS [29XX \(ED-38\)](#) and on interpretations of its requirements. Some of those are described in the answer to Question F.6.2 *Hedge Accounting Considerations when Interest Rate Risk is Managed on a Net Basis*. Some additional and supporting provisions and interpretations are identified below.

Hedging a portion of the risk exposure

The ability to identify and hedge only a portion of the cash flow risk exposure resulting from the reinvestment of cash flows or repricing of variable rate instruments is found in IPSAS [29XX \(ED-38\)](#).90 as interpreted in the answers to Questions F.6.2 Issue (k) and F.2.17 *Partial Term Hedging*.

Hedging multiple risks with a single instrument

The ability to designate a single interest rate swap as a hedge of the cash flow exposure to interest rates resulting from various reinvestments of cash inflows or repricings of variable rate assets that occur over the life of the swap is founded on IPSAS [29XX \(ED-38\)](#).85 as interpreted in the answer to Question F.1.12 *Hedges of More Than One Type of Risk*.

Hedging similar risks in a portfolio

The ability to specify the forecast transaction being hedged as a portion of the cash flow exposure to interest rates for a portion of the duration of the investment that gives rise to the interest payment without specifying at the designation date the expected life of the instrument and whether

it pays a fixed or variable rate is founded on the answer to Question F.6.2 Issue (I), which specifies that the items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged.

Hedge terminations

The ability to de-designate the forecast transaction (the cash flow exposure on an investment or repricing that will occur after the repricing date of the swap) as being hedged is provided for in IPSAS ~~29XX (ED-38)~~.112 dealing with hedge terminations. While a portion of the forecast transaction is no longer being hedged, the interest rate swap is not de-designated, and it continues to be a hedging instrument for the remaining transactions in the series that have not occurred. For example, assume that an interest rate swap having a remaining life of one year has been designated as hedging a series of three quarterly reinvestments of cash flows. The next forecast cash flow reinvestment occurs in three months. When the interest rate swap is repriced in three months at the then current variable rate, the fixed rate and the variable rate on the interest rate swap become known and no longer provide hedge protection for the next three months. If the next forecast transaction does not occur until three months and ten days, the ten-day period that remains after the repricing of the interest rate swap is not hedged.

F.6.4 Hedge Accounting: Premium or Discount on Forward Exchange Contract

A forward exchange contract is designated as a hedging instrument, for example, in a hedge of a net investment in a foreign operation. Is it permitted to amortize the discount or premium on the forward exchange contract to surplus or deficit over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortized to surplus or deficit under IPSAS ~~XX (ED-38)~~29. Derivatives are always measured at fair value in the statement of financial position. The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognized in surplus or deficit unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a foreign operation, in which case the effective portion of the gain or loss is recognized in net assets/equity. In that case, the amounts recognized in net assets/equity are recognized in surplus or deficit when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under IPSAS ~~29XX (ED-38)~~.84(b), the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are recognized in surplus or deficit.

F.6.5 IPSAS ~~29XX (ED-38)~~ and IPSAS 4 Fair Value Hedge of Asset Measured at Cost

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does IPSAS ~~29XX (ED-38)~~ require the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions in IPSAS ~~29XX (ED-38)~~.98 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

Section G – Other

G.1 Disclosure of Changes in Fair Value

IPSAS ~~29XX (ED-38)~~ requires financial assets classified as available-for-sale (AFS) and financial assets and financial liabilities at fair value through surplus or deficit to be remeasured to fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through surplus or deficit are recognized in surplus or deficit, and fair value changes for AFS assets are recognized in net assets/equity. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

IPSAS ~~30XX (ED-39)~~.23 requires items of revenue, expense and gains and losses to be disclosed. This disclosure requirement encompasses items of revenue, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of fair value changes, distinguishing between changes that are recognized in surplus or deficit and changes that are recognized in net assets/equity. Further breakdown is provided of changes that relate to:

- (a) AFS assets, showing separately the amount of gain or loss recognized in net assets/equity during the period and the amount that was recognized in surplus or deficit for the period;
- (b) Financial assets or financial liabilities at fair value through surplus or deficit, showing separately those fair value changes on financial assets or financial liabilities (i) designated as such upon initial recognition and (ii) classified as held for trading in accordance with IPSAS ~~29XX (ED-38)~~; and
- (c) Hedging instruments.

IPSAS ~~30XX (ED-39)~~ neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that in accordance with IPSAS ~~XX (ED-38)~~.29 it categorizes as held for trading, but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, IPSAS ~~30XX (ED-39)~~.10 requires disclosure of the carrying amounts of financial assets or financial liabilities at fair value through surplus or deficit, showing separately: (i) those designated as such upon initial recognition and (ii) those held for trading in accordance with IPSAS ~~XX (ED-38)~~.29.

G.2 IPSAS ~~29XX (ED-38)~~ and IPSAS 2 Hedge Accounting: Statements of Cash Flows

How should cash flows arising from hedging instruments be classified in statements of cash flows?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in IPSAS 2 has not been updated to reflect IPSAS ~~29XX (ED 38)~~, the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments under IPSAS ~~29XX (ED 38)~~.

Comparison with IAS 39

IPSAS ~~29XX (ED-38)~~, “Financial Instruments: Recognition and Measurement” is drawn primarily from International Accounting Standard 39, “Financial Instruments: Recognition and Measurement” (including amendments up to December 31, 2008 as well amendments made by the IASB to IAS 39 as part of its “Improvements to IFRSs” in April 2009). The main differences between IPSAS ~~29XX (ED-38)~~ and IAS 39 are as follows:

- IPSAS ~~29XX (ED-38)~~ contains additional application guidance to deal with concessionary loans and financial guarantee contracts entered into at nil or nominal consideration. IAS 39 does not deal with these areas.
- In certain instances, IPSAS ~~29XX (ED-38)~~ uses different terminology from IAS 39. The most significant examples are the use of the terms “statement of financial performance” and “net assets/equity.” The equivalent terms in IAS 39 are “statement of comprehensive income or separate income statement (if presented)” and “equity.”
- IPSAS ~~29XX (ED-38)~~ does not distinguish between “revenue” and “income.” IAS 39 distinguishes between “revenue and “income,” with “income” having a broader meaning than the term “revenue.”
- Principles from IFRIC 9, “Reassessment of Embedded Derivatives” and IFRIC 16 “Hedges of a Net Investment in a Foreign Operation” have been included as an appendix to IPSAS ~~29XX (ED-38)~~.



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*International Public Sector Accounting Standard
(IPSAS) 30*

Financial Instruments: Disclosures



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IPSAS 30—FINANCIAL INSTRUMENTS: DISCLOSURES

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IPSAS 30—FINANCIAL INSTRUMENTS: DISCLOSURES

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International Public Sector Accounting Standard (IPSAS) 30, “Financial Instruments: Disclosures” is set out in paragraphs 1–53 and Appendices A and B. All the paragraphs have equal authority except as noted otherwise. IPSAS 30 should be read in the context of its objective, the Basis for Conclusions, and the “Preface to International Public Sector Accounting Standards”. 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.

Introduction

Reasons for issuing the IPSAS

- IN1. The Standard prescribes disclosure requirements for financial instruments and is drawn from IFRS 7, “Financial Instruments: Disclosures” (as at December, 31 2008, including amendments published in April 2009).
- IN2. In recent years, the techniques used by entities for measuring and managing exposure to risks arising from financial instruments have evolved and new risk management concepts and approaches have gained acceptance. In addition, many public and private sector initiatives have made improvements to the disclosure framework for risks arising from financial instruments.
- IN3. The International Public Sector Accounting Standards Board (IPSASB) believes that users of financial statements need information about an entity’s exposure to risks and how those risks are managed. Such information can influence a user’s assessment of the financial position and financial performance of an entity or of the amount, timing and uncertainty of its future cash flows. Greater transparency regarding those risks allows users to make more informed judgments about risk and return.

Main features of the IPSAS

- IN4. IPSAS 30 applies to all risks arising from all financial instruments, except those instruments listed in paragraph 3. IPSAS 30 applies to all entities, including entities that have few financial instruments (e.g. a government department whose only financial instruments are accounts receivable and accounts payable) and those that have many financial instruments (e.g. a financial institution most of whose assets and liabilities are financial instruments). However, the extent of disclosure required depends on the extent of the entity’s use of financial instruments and of its exposure to risk.
- IN5. IPSAS 30 requires disclosure of:
 - (a) The significance of financial instruments for an entity’s financial position, financial performance and cash flows. These disclosures incorporate many of the requirements previously in IPSAS 15.
 - (b) Qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk and market risk. The qualitative disclosures describe management’s objectives, policies and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel. Together, these disclosures provide an overview of the entity’s use of financial instruments and the exposures to risks they create.
- IN6. IPSAS 30 includes in Appendix B mandatory application guidance that explains how to apply the requirements in IPSAS 30. IPSAS 30 is accompanied by non-mandatory

Implementation Guidance that describes how an entity might provide the disclosures required by IPSAS 30.

- IN7. IPSAS 30 supersedes the disclosure requirements of IPSAS 15.
- IN8. IPSAS 30 is effective for annual periods beginning on or after April 1, 2013. Earlier application is encouraged.

Objective

1. The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:
 - (a) The significance of financial instruments for the entity's financial position and performance; and
 - (b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.
2. The principles in this Standard complement the principles for recognizing, measuring and presenting financial assets and financial liabilities in IPSAS 28, "Financial Instruments: Presentation" and IPSAS 29, "Financial Instruments: Recognition and Measurement."

Scope

3. This Standard shall be applied by all entities to all types of financial instruments, except:
 - (a) Those interests in controlled entities, associates or joint ventures that are accounted for in accordance with IPSAS 6, "Consolidated and Separate Financial Statements", IPSAS 7, "Investments in Associates" or IPSAS 8, "Interests in Joint Ventures". However, in some cases, IPSAS 6, IPSAS 7 or IPSAS 8 permits an entity to account for an interest in a controlled entity, associate or joint venture using IPSAS 29; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in controlled entities, associates or joint ventures unless the derivative meets the definition of an equity instrument in IPSAS 28.
 - (b) Employers' rights and obligations arising from employee benefit plans, to which IPSAS 25, "Employee Benefits" applies.
 - (c) Rights and obligations arising under insurance contracts. However, this Standard applies to:
 - (i) Derivatives that are embedded in insurance contracts if IPSAS 29 requires the entity to account for them separately.
 - (ii) An issuer of financial guarantee contracts if the issuer applies IPSAS 29 in recognizing and measuring the contracts, but shall apply the international or national standard dealing with insurance contracts if the issuer elects to apply those standards in recognizing and measuring them.

Notwithstanding (i) and (ii) above, an entity may apply this Standard to other contracts that take the form of insurance contracts which involve the transfer of financial risk.

- (d) Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard

dealing with share based payment applies, except for contracts within the scope of paragraphs 4–6 of IPSAS 29, to which that Standard applies.

- (e) Instruments that are required to be classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS 28.
- 4. This Standard applies to recognized and unrecognized financial instruments. Recognized financial instruments include financial assets and financial liabilities that are within the scope of IPSAS 29. Unrecognized financial instruments include some financial instruments that, although outside the scope of IPSAS 29, are within the scope of this Standard (such as some loan commitments).
- 5. This Standard applies to contracts to buy or sell a non-financial item that are within the scope of IPSAS 29 (see paragraphs 4–6 of IPSAS 29).
- 6. **This Standard applies to all public sector entities other than Government Business Enterprises ~~(GBEs)~~.**
- 7. The “Preface to International Public Sector Accounting Standards” issued by the ~~International Public Sector Accounting Standards Board (IPSASB)~~ explains that ~~Government Business Enterprises (GBEs)~~ apply ~~International Financial Reporting Standards (IFRSs)~~, which are issued by the ~~International Accounting Standards Board (IASB)~~. GBEs are defined in IPSAS 1, “Presentation of Financial Statements.”

Definitions

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

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused

by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

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

Terms defined in other International Public Sector Accounting Standards are used in this Standard with the same meaning as in those other Standards, and are reproduced in the Glossary of Defined Terms published separately.

Classes of Financial Instruments and Level of Disclosure

- 98.** When this Standard requires disclosures by class of financial instrument, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Significance of Financial Instruments for Financial Position and Financial Performance

- 109.** An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Statement of Financial Position

Categories of Financial Assets and Financial Liabilities

- 1140.** The carrying amounts of each of the following categories, as defined in IPSAS 29, shall be disclosed either in the statement of financial position or in the notes:

- (a) Financial assets at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with IPSAS 29;
- (b) Held-to-maturity investments;
- (c) Loans and receivables;
- (d) Available-for-sale financial assets;
- (e) Financial liabilities at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with IPSAS 29; and
- (f) Financial liabilities measured at amortized cost.

Financial Assets or Financial Liabilities at Fair Value through Surplus or Deficit

- 1244.** If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through surplus or deficit, it shall disclose:

- (a) The maximum exposure to credit risk (see paragraph [4342\(a\)](#)) of the loan or receivable (or group of loans or receivables) at the end of the reporting period.
- (b) The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
- (c) The amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
 - (i) As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to *market risk*; or
 - (ii) Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

- (d) The amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

[1342](#). If the entity has designated a financial liability as at fair value through surplus or deficit in accordance with paragraph 10 of IPSAS 29, it shall disclose:

- (a) The amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:
 - (i) As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see Appendix B, paragraph AG4); or
 - (ii) Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

- (b) The difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

[1443](#). The entity shall disclose:

- (a) The methods used to comply with the requirements in paragraphs [1244\(c\)](#) and [1342\(a\)](#).
- (b) If the entity believes that the disclosure it has given to comply with the requirements in paragraph [1244\(c\)](#) or [1342\(a\)](#) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

Reclassification

[1544](#). If the entity has reclassified a financial asset (in accordance with paragraphs 60–63 of IPSAS 29) as one measured:

- (a) At cost or amortized cost, rather than at fair value; or
- (b) At fair value, rather than at cost or amortized cost,

it shall disclose the amount reclassified into and out of each category and the reason for that reclassification.

[1645](#). If the entity has reclassified a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 55 or 57 of IPSAS 29 or out of the available-for-sale category in accordance with paragraph 58 of IPSAS 29, it shall disclose:

- (a) The amount reclassified into and out of each category;
- (b) For each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods;
- (c) If a financial asset was reclassified in accordance with paragraph 55, the rare situation, and the facts and circumstances indicating that the situation was rare;
- (d) For the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognized in surplus or deficit or in net assets/equity in that reporting period and in the previous reporting period;
- (e) For each reporting period following the reclassification (including the reporting period in which the financial asset was reclassified) until derecognition of the financial asset, the fair value gain or loss that would have been recognized in surplus or deficit or in net assets/equity if the financial asset had not been reclassified, and the gain, loss, revenue and expense recognized in surplus or deficit; and
- (f) The effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.

Derecognition

[1746](#). An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 17–39 of IPSAS 29). The entity shall disclose for each class of such financial assets:

- (a) The nature of the assets;
- (b) The nature of the risks and rewards of ownership to which the entity remains exposed;
- (c) When the entity continues to recognize all of the assets, the carrying amounts of the assets and of the associated liabilities; and
- (d) When the entity continues to recognize the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognize, and the carrying amount of the associated liabilities.

Collateral

[1817](#). An entity shall disclose:

- (a) The carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph 39(a) of IPSAS 29; and
- (b) The terms and conditions relating to its pledge.

[1918](#). When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:

- (a) The fair value of the collateral held;
- (b) The fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and
- (c) The terms and conditions associated with its use of the collateral.

Allowance Account for Credit Losses

[2019](#). When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.

Compound Financial Instruments with Multiple Embedded Derivatives

[2120](#). If an entity has issued an instrument that contains both a liability and an equity component (see paragraph 33 of IPSAS 28) and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

Defaults and Breaches

[2221](#). For *loans payable* recognized at the end of the reporting period, an entity shall disclose:

- (a) Details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
- (b) The carrying amount of the loans payable in default at the end of the reporting period; and
- (c) Whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorized for issue.

2322. If, during the period, there were breaches of loan agreement terms other than those described in paragraph 2224, an entity shall disclose the same information as required by paragraph 2224 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the end of the reporting period).

Statement of Financial Performance

Items of Revenue, Expense, Gains or Losses

2423. An entity shall disclose the following items of revenue, expense, gains or losses either in the statement of financial performance or in the notes:

- (a) Net gains or net losses on:
 - (i) Financial assets or financial liabilities at fair value through surplus or deficit, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with IPSAS 29;
 - (ii) Available-for-sale financial assets, showing separately the amount of gain or loss recognized in net assets/equity during the period and the amount reclassified from net assets/equity and recognized directly in surplus or deficit for the period;
 - (iii) Held-to-maturity investments;
 - (iv) Loans and receivables; and
 - (v) Financial liabilities measured at amortized cost;
- (b) Total interest revenue and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through surplus or deficit;
- (c) Fee revenue and expense (other than amounts included in determining the effective interest rate) arising from:
 - (i) Financial assets or financial liabilities that are not at fair value through surplus or deficit; and
 - (ii) Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;

- (d) Interest revenue on impaired financial assets accrued in accordance with paragraph AG131 of IPSAS 29; and
- (e) The amount of any impairment loss for each class of financial asset.

Other Disclosures

Accounting Policies

[2524](#). In accordance with paragraph 132 of IPSAS 1 “Presentation of Financial Statements”, an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge Accounting

[2625](#). An entity shall disclose the following separately for each type of hedge described in [3029](#) (i.e. fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):

- (a) A description of each type of hedge;
- (b) A description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period; and
- (c) The nature of the risks being hedged.

[2726](#). For cash flow hedges, an entity shall disclose:

- (a) The periods when the cash flows are expected to occur and when they are expected to affect surplus or deficit;
- (b) A description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;
- (c) The amount that was recognized in net assets/equity during the period;
- (d) The amount that was reclassified from net assets/equity and included in surplus or deficit for the period, showing the amount included in each line item in the statement of financial performance; and
- (e) The amount that was removed from net assets/equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.

[2827](#). An entity shall disclose separately:

- (a) In fair value hedges, gains or losses:
 - (i) On the hedging instrument; and
 - (ii) On the hedged item attributable to the hedged risk.

- (b) The ineffectiveness recognized in surplus or deficit that arises from cash flow hedges; and
- (c) The ineffectiveness recognized in surplus or deficit that arises from hedges of net investments in foreign operations.

Fair Value

[2928](#). Except as set out in paragraph [3534](#) for each class of financial assets and financial liabilities (see paragraph [98](#)), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

[3029](#). In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.

[3130](#). An entity shall disclose for each class of financial instruments the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. If there has been a change in valuation technique, the entity shall disclose that change and the reasons for making it.

[3234](#). To make the disclosures required by paragraph [3332](#) an entity shall classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy shall have the following levels:

- (a) Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);
- (b) Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as price) or indirectly (i.e. derived from prices) (Level 2); and
- (c) Inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

The level in the fair value hierarchy within which the fair value measurement is categorized in its entirety shall be determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. For this purpose, the significance of an input is assessed against the fair value measurement in its entirety. If a fair value measurement uses observable inputs that require significant adjustment based on unobservable inputs, that measurement is a Level 3 measurement. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

[3332](#). For fair value measurements recognized in the statement of financial position an entity shall disclose for each class of financial instruments:

- (a) The level in the fair value hierarchy into which the fair value measurements are categorized in their entirety, segregating fair value measurements in accordance with the levels defined in paragraph [3234](#).
- (b) Any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level shall be disclosed and discussed separately from transfers out of each level. For this purpose, significance shall be judged with respect to surplus or deficit, and total assets or total liabilities.
- (c) For fair value measurements in Level 3, a reconciliation from the beginning balances to the ending balances, disclosing separately changes during the period attributable to the following:
 - (i) Total gains or losses for the period recognized in surplus or deficit, and a description of where they are presented in the statement of financial performance;
 - (ii) Total gains or losses recognized in net assets/equity;
 - (iii) Purchases, sales, issues and settlements (each type of movement disclosed separately); and
 - (iv) Transfers into or out of Level 3 (e.g. transfers attributable to changes in the observability of market data) and the reasons for those transfers. For significant transfers, transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.
- (d) The amount of total gains or losses for the period in (c)(i) above included in surplus or deficit that are attributable to gains or losses relating to those assets and liabilities held at the end of the reporting period and a description of where those gains or losses are presented in the statement of financial performance.
- (e) For fair value measurements in Level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, the entity shall state that fact and disclose the effect of those changes. The entity shall disclose how the effect of a change to a reasonably possible alternative assumption was calculated. For this purpose, significance shall be judged with respect to surplus or deficit, and total assets or total liabilities, or, when changes in fair value are recognized in net assets/equity, total equity.

An entity shall present the quantitative disclosures required by this paragraph in tabular format unless another format is more appropriate.

[3433](#). If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG106–AG112 of IPSAS 29). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e. the fair value of the consideration given or received), unless conditions described in paragraph AG108 of IPSAS 29 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the

valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:

- (a) Its accounting policy for recognizing that difference in surplus or deficit to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph AG109 of IPSAS 29); and
- (b) The aggregate difference yet to be recognized in surplus or deficit at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

[3534](#). Disclosures of fair value are not required:

- (a) When the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;
- (b) For an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost in accordance with IPSAS 29 because its fair value cannot be measured reliably;
- (c) For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.

[3635](#). In the cases described in paragraph [3534](#)(b) and (c), an entity shall disclose information to help users of the financial statements make their own judgments about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:

- (a) The fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
- (b) A description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
- (c) Information about the market for the instruments;
- (d) Information about whether and how the entity intends to dispose of the financial instruments; and
- (e) If financial instruments whose fair value previously could not be reliably measured are derecognized, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognized.

Concessionary Loans

[3736](#). Concessionary loans are granted by entities on below market terms. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education, and housing loans granted to low income families. For concessionary loans granted an entity shall disclose:

- (a) A reconciliation between the opening and closing carrying amounts of the loans, including:

- (i) Nominal value of new loans granted during the period;
 - (ii) The fair value adjustment on initial recognition;
 - (iii) Loans repaid during the period;
 - (iv) Impairment losses recognized;
 - (v) Any increase during the period in the discounted amount arising from the passage of time; and
 - (vi) Other changes.
- (b) Nominal value of the loans at the end of the period;
 - (c) The purpose and terms of the various types of loans; and
 - (d) Valuation assumptions.

Nature and Extent of Risks Arising from Financial Instruments

3837. An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

3938. The disclosures required by paragraphs 40–49~~39–48~~ focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, *liquidity risk* and market risk.

Qualitative Disclosures

4039. For each type of risk arising from financial instruments, an entity shall disclose:

- (a) The exposures to risk and how they arise;
- (b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
- (c) Any changes in (a) or (b) from the previous period.

Quantitative Disclosures

4140. For each type of risk arising from financial instruments, an entity shall disclose:

- (a) Summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in IPSAS 20, “Related Party Disclosures”), for example the entity’s governing body or chief executive officer.
- (b) The disclosures required by paragraphs 43–49~~42–48~~, to the extent not provided in (a), unless the risk is not material (see paragraphs 45–47 of IPSAS 1 for a discussion of materiality).
- (c) Concentrations of risk if not apparent from (a) and (b).

[4241](#). If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

Credit Risk

[4342](#). An entity shall disclose by class of financial instrument:

- (a) The amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with IPSAS 28);
- (b) In respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;
- (c) Information about the credit quality of financial assets that are neither past due nor impaired; and
- (d) The carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Financial Assets that are either Past Due or Impaired

[4443](#). An entity shall disclose by class of financial asset:

- (a) An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired;
- (b) An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired; and
- (c) For the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

Collateral and Other Credit Enhancements Obtained

[4544](#). When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g. guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose:

- (a) The nature and carrying amount of the assets obtained; and
- (b) When the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Liquidity Risk

[4645](#). An entity shall disclose:

- (a) A maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.
- (b) A maturity analysis for derivative financial liabilities. The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows (see paragraph AG14).
- (c) A description of how it manages the liquidity risk inherent in (a) and (b).

Market Risk

Sensitivity Analysis

[4746](#). Unless an entity complies with paragraph [4847](#), it shall disclose:

- (a) A sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how surplus or deficit and net assets/equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
- (b) The methods and assumptions used in preparing the sensitivity analysis; and
- (c) Changes from the previous period in the methods and assumptions used, and the reasons for such changes.

[4847](#). If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph [4746](#). The entity shall also disclose:

- (a) An explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
- (b) An explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Other Market Risk Disclosures

[4948](#). When the sensitivity analyses disclosed in accordance with paragraph [4746](#) or [4847](#) are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

Effective Date and Transition

[5049](#). **An entity shall apply this Standard for annual financial statements covering periods beginning on or after April 1, 2013. Earlier application is encouraged. If an entity applies this Standard for a period beginning before April 1, 2013, it shall disclose that fact.**

5150. An entity shall not apply this Standard before April 1, 2013, unless it also applies IPSAS 28 and IPSAS 29.

5251. When an entity adopts the accrual basis of accounting, as defined by IPSASs, for financial reporting purposes, subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

5352. If an entity applies this Standard for annual periods beginning before April 1, 2013, it need not present comparative information for the disclosures required by paragraphs 38–49~~37–48~~ about the nature and extent of risks arising from financial instruments.

Appendix A

Defined Terms

This appendix is an integral part of the IPSAS.

credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk , interest rate risk and other price risk .
other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
past due	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

The following terms are defined in paragraph 9 of IPSAS 28 or paragraph 10 of IPSAS 29 and are used in the IPSAS with the meaning specified in IPSAS 28 and IPSAS 29.

- Amortized cost of a financial asset or financial liability
- Available-for-sale financial assets
- Derecognition
- Derivative
- Effective interest method

- ~~Equity instrument~~
- ~~Fair value~~
- ~~Financial asset~~
- ~~Financial asset or financial liability at fair value through surplus or deficit~~
- ~~Financial asset or financial liability held for trading~~
- ~~Financial guarantee contract~~
- ~~Financial instrument~~
- ~~Financial liability~~
- ~~Forecast transaction~~
- ~~Hedging instrument~~
- ~~Held-to-maturity investments~~
- ~~Loans and receivables~~
- ~~Regular way purchase or sale~~

Appendix [AB](#)

Application Guidance

This appendix is an integral part of ~~the~~ IPSAS [30](#).

Classes of Financial Instruments and Level of Disclosure (paragraph [98](#))

- AG1. Paragraph [98](#) requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph [98](#) are determined by the entity and are, thus, distinct from the categories of financial instruments specified in IPSAS 29 (which determine how financial instruments are measured and where changes in fair value are recognized).
- AG2. In determining classes of financial instrument, an entity shall, at a minimum:
- (a) Distinguish instruments measured at amortized cost from those measured at fair value.
 - (b) Treat as a separate class or classes those financial instruments outside the scope of this Standard.
- AG3. An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this Standard, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Significance of Financial Instruments for Financial Position and Financial Performance

Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs [1342](#) and [1413](#))

- AG4. If an entity designates a financial liability as at fair value through surplus or deficit, paragraph [1342\(a\)](#) requires it to disclose the amount of change in the fair value of the financial liability that is attributable to changes in the liability's credit risk. Paragraph [1342\(a\)\(i\)](#) permits an entity to determine this amount as the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk. If the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, this amount can be estimated as follows:

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

This example assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in interest rates are not significant. If the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be disclosed in accordance with paragraph [1312\(a\)](#).

Other Disclosure—Accounting Policies (paragraph [2524](#))

AG5. Paragraph [2524](#) requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

- (a) For financial assets or financial liabilities designated as at fair value through surplus or deficit:
 - (i) The nature of the financial assets or financial liabilities the entity has designated as at fair value through surplus or deficit;
 - (ii) The criteria for so designating such financial assets or financial liabilities on initial recognition; and
 - (iii) How the entity has satisfied the conditions in paragraph 10, 13 or 14 of IPSAS 29 for such designation. For instruments designated in accordance with paragraph (b)(i) of the definition of a financial asset or financial liability at fair value through surplus or deficit in IPSAS 29, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph (b)(ii) of the definition of a financial asset or financial liability at fair value through surplus or deficit in IPSAS 29, that disclosure includes a narrative description of how designation at fair

value through surplus or deficit is consistent with the entity's documented risk management or investment strategy.

- (b) The criteria for designating financial assets as available for sale.
- (c) Whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 40 of IPSAS 29).
- (d) When an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:
 - (i) The criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and
 - (ii) The criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph [2019](#)).
- (e) How net gains or net losses on each category of financial instrument are determined (see paragraph [2423](#)(a)), for example, whether the net gains or net losses on items at fair value through surplus or deficit include interest or revenue from dividends or similar distributions.
- (f) The criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph [24723](#)(e)).
- (g) When the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph [4342](#)(d)).
- (h) For financial guarantee contracts issued through a non-exchange transaction, where no fair value can be determined and a provision is recognized in accordance with IPSAS 19, disclosure of the circumstances that result in a provision being recognized.

Paragraph 137 of IPSAS 1 also requires entities to disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements.

Nature and Extent of Risks Arising from Financial Instruments (paragraphs [38–4937–48](#))

- AG6. The disclosures required by paragraphs [38–4937–48](#) shall be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Quantitative Disclosures (paragraph [4140](#))

- AG7. Paragraph [4140](#)(a) requires disclosures of summary quantitative data about an entity's exposure to risks based on the information provided internally to key management personnel of the entity. When an entity uses several methods to manage a risk exposure, the entity shall disclose information using the method or methods that provide the most relevant and reliable information. IPSAS 3, "Accounting Policies, Changes in Accounting Estimates and Errors" discusses relevance and reliability.
- AG8. Paragraph [4140](#)(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgment taking into account the circumstances of the entity. Disclosure of concentrations of risk shall include:
- (a) A description of how management determines concentrations;
 - (b) A description of the shared characteristic that identifies each concentration (e.g. counterparty, geographical area, currency or market); and
 - (c) The amount of the risk exposure associated with all financial instruments sharing that characteristic.

Maximum Credit Risk Exposure (paragraph [4342](#)(a))

- AG9. Paragraph [4342](#)(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:
- (a) Any amounts offset in accordance with IPSAS 28; and
 - (b) Any impairment losses recognized in accordance with IPSAS 29.
- AG10. Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:
- (a) Granting loans and receivables to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.
 - (b) Entering into derivative contracts, e.g. foreign exchange contracts, interest rate swaps and credit derivatives. When the resulting asset is measured at fair value, the maximum exposure to credit risk at the end of the reporting period will equal the carrying amount.
 - (c) Granting financial guarantees. In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognized as a liability.
 - (d) Making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum

credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognized as a liability.

Quantitative Liquidity Risk Disclosures (paragraphs [4140\(a\)](#) and [4645\(a\)](#) and (b))

AG11. In accordance with paragraph [4140\(a\)](#) an entity discloses summary quantitative data about its exposure to liquidity risk on the basis of the information provided internally to key management personnel. An entity shall explain how those data are determined. If the outflows of cash (or another financial asset) included in those data could either:

- (a) Occur significantly earlier than indicated in the data; or
- (b) Be for significantly different amounts from those indicated in the data (e.g. for a derivative that is included in the data on a net settlement basis but for which the counterparty has the option to require gross settlement);

the entity shall state that fact and provide quantitative information that enables users of its financial statements to evaluate the extent of this risk unless that information is included in the contractual maturity analyses required by paragraph [4645\(a\)](#) or (b).

AG12. In preparing the maturity analyses required by paragraph [4645\(a\)](#) and (b), an entity uses its judgment to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

- (a) Not later than one month;
- (b) Later than one month and not later than three months;
- (c) Later than three months and not later than one year; and
- (d) Later than one year and not later than five years.

AG13. In complying with paragraph [4645\(a\)](#) and (b), an entity shall not separate an embedded derivative from a hybrid (combined) instrument. For such an instrument, an entity shall apply paragraph [4645\(a\)](#).

AG14. Paragraph [4645\(b\)](#) requires an entity to disclose a quantitative maturity analysis for derivative financial liabilities that shows remaining contractual maturities if the contractual maturities are essential for an understanding of the timing of the cash flows. For example, this would be the case for:

- (a) An interest rate swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability.
- (b) All loan commitments.

AG15. Paragraph [4645\(a\)](#) and (b) requires an entity to disclose maturity analyses for financial liabilities that show the remaining contractual maturities for some financial liabilities. In this disclosure:

- (a) When a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which the entity can be required to pay. For

example, financial liabilities that an entity can be required to repay on demand (e.g. demand deposits) are included in the earliest time band.

- (b) When an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.
- (c) For issued financial guarantee contracts the maximum amount of the guarantee is allocated to the earliest period in which the guarantee could be called.

AG16. The contractual amounts disclosed in the maturity analyses as required by paragraph [4645](#)(a) and (b) are the contractual undiscounted cash flows, for example:

- (a) Gross finance lease obligations (before deducting finance charges);
- (b) Prices specified in forward agreements to purchase financial assets for cash;
- (c) Net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged;
- (d) Contractual amounts to be exchanged in a derivative financial instrument (e.g. a currency swap) for which gross cash flows are exchanged; and
- (e) Gross loan commitments.

Such undiscounted cash flows differ from the amount included in the statement of financial position because the amount in that statement is based on discounted cash flows. When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the end of the reporting period. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the end of the period.

AG17. Paragraph [4645](#)(c) requires an entity to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative disclosures required in paragraph [4039](#)(a) and (b). An entity shall disclose a maturity analysis of financial assets it holds for managing liquidity risk (e.g. financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities), if that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk.

AG18. Other factors that an entity might consider in providing the disclosure required in paragraph [4039](#)(c) include, but are not limited to, whether the entity:

- (a) Has committed borrowing facilities (e.g. commercial paper facilities) or other lines of credit (e.g. stand-by credit facilities) that it can access to meet liquidity needs;
- (b) Holds deposits at central banks to meet liquidity needs;
- (c) Has very diverse funding sources;
- (d) Has significant concentrations of liquidity risk in either its assets or its funding sources;

- (e) Has internal control processes and contingency plans for managing liquidity risk;
- (f) Has instruments that include accelerated repayment terms (e.g. on the downgrade of the entity's credit rating);
- (g) Has instruments that could require the posting of collateral (e.g. margin calls for derivatives);
- (h) Has instruments that allows the entity to choose whether it settles its financial liabilities by delivering cash (or another financial asset) or by delivering its own shares; or
- (i) Has instruments that are subject to master netting agreements.

Market Risk—Sensitivity Analysis (paragraphs [4746](#) and [4847](#))

AG19. Paragraph [4746](#)(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. In accordance with paragraph AG3, an entity decides how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. For example:

- (a) An entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading.
- (b) An entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

If an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information.

AG20. Paragraph [4746](#)(a) requires the sensitivity analysis to show the effect on surplus or deficit and net assets/equity of reasonably possible changes in the relevant risk variable (e.g. prevailing market interest rates, currency rates, equity prices or commodity prices). For this purpose:

- (a) Entities are not required to determine what the surplus or deficit for the period would have been if relevant risk variables had been different. Instead, entities disclose the effect on surplus or deficit and net assets/equity at the end of the reporting period assuming that a reasonably possible change in the relevant risk variable had occurred at the end of the reporting period and had been applied to the risk exposures in existence at that date. For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on surplus or deficit (i.e. interest expense) for the current year if interest rates had varied by reasonably possible amounts.
- (b) Entities are not required to disclose the effect on surplus or deficit and net assets/equity for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

AG21. In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:

- (a) The economic environments in which it operates. A reasonably possible change should not include remote or 'worst case' scenarios or 'stress tests'. Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable. For example, assume that interest rates are 5 per cent and an entity determines that a fluctuation in interest rates of ± 50 basis points is reasonably possible. It would disclose the effect on surplus or deficit and net assets/equity if interest rates were to change to 4.5 per cent or 5.5 per cent. In the next period, interest rates have increased to 5.5 per cent. The entity continues to believe that interest rates may fluctuate by ± 50 basis points (i.e. that the rate of change in interest rates is stable). The entity would disclose the effect on surplus or deficit and net assets/equity if interest rates were to change to 5 per cent or 6 per cent. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ± 50 basis points, unless there is evidence that interest rates have become significantly more volatile.
- (b) The time frame over which it is making the assessment. The sensitivity analysis shall show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

AG22. Paragraph [4847](#) permits an entity to use a sensitivity analysis that reflects interdependencies between risk variables, such as a value-at-risk methodology, if it uses this analysis to manage its exposure to financial risks. This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain. Such an entity might comply with paragraph [4847\(a\)](#) by disclosing the type of value-at-risk model used (e.g. whether the model relies on Monte Carlo simulations), an explanation about how the model works and the main assumptions (e.g. the holding period and confidence level). Entities might also disclose the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations, and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

AG23. An entity shall provide sensitivity analyses for the whole of its operations, but may provide different types of sensitivity analysis for different classes of financial instruments.

Interest Rate Risk

AG24. *Interest rate risk* arises on interest-bearing financial instruments recognized in the statement of financial position (e.g. loans and receivables and debt instruments issued) and on some financial instruments not recognized in the statement of financial position (e.g. some loan commitments).

Currency Risk

- AG25. *Currency risk* (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency in which they are measured. For the purpose of this Standard, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.
- AG26. A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

Other Price Risk

- AG27. *Other price risk* arises on financial instruments because of changes in, for example, commodity prices or equity prices. To comply with paragraph 4746, an entity might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.
- AG28. Two examples of financial instruments that give rise to equity price risk are (a) a holding of equities in another entity and (b) an investment in a trust that in turn holds investments in equity instruments. Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.
- AG29. In accordance with paragraph 4746(a), the sensitivity of surplus or deficit (that arises, for example, from instruments classified as at fair value through surplus or deficit and impairments of available-for-sale financial assets) is disclosed separately from the sensitivity of net assets/equity (that arises, for example, from instruments classified as available for sale).
- AG30. Financial instruments that an entity classifies as equity instruments are not remeasured. Neither surplus or deficit nor net assets/equity will be affected by the equity price risk of those instruments. Accordingly, no sensitivity analysis is required.

Appendix C

Amendments to other IPSASs

IPSAS 1, “Presentation of Financial Statements”

Paragraph 75 is amended as follows:

75. Information about expected dates of realization of assets and liabilities is useful in assessing the liquidity and solvency of an entity. ~~IPSAS 15, “Financial Instruments: Disclosure and Presentation”~~ IPSAS 30, “Financial Instruments: Disclosures” requires disclosure of the maturity dates of financial assets and financial liabilities. Financial assets include trade and other receivables and financial liabilities include trade and other payables. Information on the expected date of recovery and settlement of non-monetary assets and liabilities such as inventories and provisions is also useful, whether or not assets and liabilities are classified as current or non-current.

Paragraph 129(d)(ii) is amended as follows:

129. (d) (ii) Non-financial disclosures, e.g. the entity’s financial risk management objectives and policies (see ~~IPSAS 15~~ IPSAS 30).

Paragraph 148 is amended as follows:

148. The disclosure of some of the key assumptions that would otherwise be required in accordance with paragraph 140 is required by other Standards. For example, IPSAS 19 requires disclosure, in specified circumstances, of major assumptions concerning future events affecting classes of provisions. ~~IPSAS 15~~ IPSAS 30 requires disclosure of significant assumptions applied in estimating fair values of financial assets and financial liabilities that are carried at fair value. IPSAS 17 requires disclosure of significant assumptions applied in estimating fair values of revalued items of property, plant and equipment.

A new heading and paragraphs are inserted after paragraph 148 as follows:

Capital

148A. An entity shall disclose information that enables users of its financial statements to evaluate the entity’s objectives, policies and processes for managing capital.

148B. To comply with paragraph 148A, the entity discloses the following:

- (a) Qualitative information about its objectives, policies and processes for managing capital, including (but not limited to):
 - (i) A description of what it manages as capital;

- (ii) When an entity is subject to externally imposed capital requirements, the nature of those requirements and how those requirements are incorporated into the management of capital; and
- (iii) How it is meeting its objectives for managing capital.
- (b) Summary quantitative data about what it manages as capital. Some entities regard some financial liabilities (e.g. some forms of subordinated debt) as part of capital. Other entities regard capital as excluding some components of equity (e.g. components arising from cash flow hedges).
- (c) Any changes in (a) and (b) from the previous period.
- (d) Whether during the period it complied with any externally imposed capital requirements to which it is subject.
- (e) When the entity has not complied with such externally imposed capital requirements, the consequences of such non-compliance.

These disclosures shall be based on the information provided internally to the entity's key management personnel.

148C. An entity may manage capital in a number of ways and be subject to a number of different capital requirements. For example, a conglomerate may include entities that undertake insurance activities and banking activities, and those entities may also operate in several jurisdictions. When an aggregate disclosure of capital requirements and how capital is managed would provide useful information or distorts a financial statement user's understanding of an entity's capital resources, the entity shall disclose separate information for each capital requirement to which the entity is subject.

A new paragraph is inserted after paragraph 154A as follows:

154B IPSAS 30, "Financial Instruments: Disclosures" amended paragraphs 75, 129 and 148 and inserted paragraphs 148A–148C. An entity shall apply the amendments for annual financial statements covering periods beginning on or after April 1, 2013. If an entity applies IPSAS 30 for a period beginning before April 1, 2013, the amendments shall also be applied for that earlier period.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, ~~the International Public Sector Accounting Standards~~ IPSAS 30.

Introduction

- BC1. This Basis for Conclusions summarizes the International Public Sector Accounting Standards Board's (IPSASB) considerations in reaching the conclusions in IPSAS 30, "Financial Instruments: Disclosures". As this IPSAS is based on IFRS 7, "Financial Instruments: Disclosures" issued by the International Accounting Standards Board (IASB), the Basis for Conclusions outlines only those areas where IPSAS 30 deviates from the main requirements of IFRS 7.
- BC2. This project on financial instruments is noted as a key part of the IPSASB's convergence program which aims to converge IPSASs with International Financial Reporting Standards (IFRSs).
- BC3. In developing this IPSAS, the IPSASB agreed to retain the existing text of IFRS 7 wherever consistent with existing IPSASs, except to deal with any public sector specific issues which result in adding or deleting disclosures.
- BC4. In September 2007 the IASB issued amendments to IAS 1, "Presentation of Financial Statements" which introduced a new component into the presentation of financial statements called "comprehensive income". As the IPSASB has not yet considered this, along with some of the other amendments proposed in IAS 1, those amendments have not been included in IPSAS 30.

Concessionary Loans

- BC5. Concessionary loans are granted to or received by an entity on below market terms. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education and housing loans granted to low income families. Such loans are a feature of the public sector and are often made to implement a government's or other public sector entity's social policies. The intention of a concessionary loan at the outset is to provide or receive resources on below market terms. For this reason the IPSASB concluded that more comprehensive disclosures are required by public sector entities for concessionary loans and have included additional disclosure requirements for such loans.

IMPLEMENTATION GUIDANCE

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Appendix

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 30.

Introduction

- IG1. This guidance suggests possible ways to apply some of the disclosure requirements in IPSAS 30. The guidance does not create additional requirements.
- IG2. For convenience, each disclosure requirement in the Standard is discussed separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures might satisfy more than one requirement. For example, information about concentrations of risk might also convey information about exposure to credit or other risk.

Materiality

- IG3. IPSAS 1, “Presentation of Financial Statements” notes that a specific disclosure requirement in an IPSAS need not be satisfied if the information is not material. IPSAS 1 defines materiality as follows:

Omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments made on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The nature or size of the item, or a combination of both, could be the determining factor.

- IG4. IPSAS 1 also explains that definition as follows:

Assessing whether an omission or misstatement could influence decisions of users, and so be material, requires consideration of the characteristics of those users. ‘Users are assumed to have a reasonable knowledge of the public sector and economic activities and accounting and a willingness to study the information with reasonable diligence. Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making and evaluating decisions.

Classes of Financial Instruments and Level of Disclosure (Paragraphs 98 and AG1–AG3)

- IG5. Paragraph AG3 states that ‘an entity decides in the light of its circumstances how much detail it provides to satisfy the requirements of this Standard, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics.’ To satisfy the requirements, an entity may not need to disclose all the information suggested in this guidance.
- IG6. Paragraph 29(c) of IPSAS 1 requires an entity to ‘provide additional disclosures when compliance with the specific requirements in IPSASs is insufficient to enable users to

understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.'

Significance of Financial Instruments for Financial Position and Financial Performance (Paragraphs [10-369-35](#), AG4 and AG5)

Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs [1312\(a\)\(i\)](#) and AG4)

- IG7. The following example illustrates the calculation that an entity might perform in accordance with paragraph AG4 of Appendix [AB](#) of the Standard.
- IG8. On January 1, 20X1, an entity issues a 10-year bond with a par value of CU150,000 and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.
- IG9. 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.*
- IG10. The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.
- IG11. The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

<p>[paragraph AG4(a)]</p> <p>First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period.</p> <p>It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.</p>	<p>At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent.</p> <p>Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.</p>
<p>[paragraph AG(b)]</p> <p>Next, the entity calculates the present value of the cash flows</p>	<p>The contractual cash flows of the</p>

* 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.

<p>associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph AG4(a).</p>	<p>instrument at the end of the period are:</p> <ul style="list-style-type: none"> • Interest: CU12,000^a per year for each of years 2–10. • Principal: CU150,000 in year 10. <p>The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period LIBOR rate, plus the 3 per cent instrument-specific component.</p> <p>This gives a present value of CU152,367.^b</p>
<p>[paragraph AG4(c)]</p> <p>The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph AG4(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.</p>	<p>The market price of the liability at the end of the period is CU153,811.^c</p> <p>Thus, the entity discloses CU1,444, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.</p>
<p>a $CU150,000 \times 8\% = CU12,000$</p>	
<p>b $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$</p>	
<p>c $market\ price = [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$</p>	

Defaults and Breaches (paragraphs [2221](#) and [2322](#))

IG12. Paragraphs [2221](#) and [2322](#) require disclosures when there are any defaults or breaches of loans payable. Any defaults or breaches may affect the classification of the liability as current or non-current in accordance with IPSAS 1.

Total Interest Expense (paragraph [2423\(b\)](#))

IG13. Total interest expense disclosed in accordance with paragraph [2423\(b\)](#) is a component of the finance costs, which paragraph 102(b) of IPSAS 1 requires to be presented separately

in the statement of financial performance. The line item for finance costs may also include amounts associated with non-financial liabilities.

Fair Value (paragraphs [31-34](#)~~30-33~~)

- IG14. IPSAS 30 requires disclosures about the level in the fair value hierarchy in which fair value measurements are categorized for assets and liabilities measured in the statement of financial position. A tabular format is required unless another format is more appropriate. An entity might disclose the following for assets to comply with paragraph [33](#)~~32~~(a). (Disclosure of comparative information is also required, but is not included in the following example.)

Assets measured at fair value		Fair value measurement at end of the reporting period using:		
		Level 1	Level 2	Level 3
Description	Dec 31 20X2	CU million	CU million	CU million
Financial assets at fair value through surplus or deficit				
Trading securities	100	40	55	5
Trading derivatives	39	17	20	2
Available-for-sale financial assets				
Equity investments	75	30	40	5
Total	214	87	115	12

(Note: For liabilities, a similar table might be presented.)

- IG15. IPSAS 30 requires a reconciliation from beginning to ending balances for those assets and liabilities that are measured in the statement of financial position at fair value based on a valuation technique for which any significant input is not based on observable market data (Level 3). A tabular format is required unless another format is more appropriate. An entity might disclose the following for assets to comply with paragraph [33](#)~~32~~(b). (Disclosure of comparative information is also required, but is not included in the following example.)

Assets measured at fair value based on Level 3				
	Fair value measurement at the end of the reporting period			
	Financial assets at fair value through surplus or deficit	Trading derivative securities	Available-for-sale financial assets	Total
	Trading securities	Trading derivative securities	Equity investments	
	CU million	CU million	CU million	CU million
Opening balance	6	5	4	15
Total gains or losses in surplus or deficit in net assets/equity	(2)	(2)	-	(4)
Purchases	1	2	2	5
Issues	-	-	-	-
Settlements	-	(1)	-	(1)
Transfers out of Level 3	-	(2)	-	(2)
Closing balance	5	2	5	12
Total gains or losses for the period included in surplus or deficit for assets held at the end of the reporting period	(1)	(1)	-	(2)
(Note: For liabilities, a similar table might be presented.)				
Gains or losses included in surplus or deficit for the period (above) are presented in revenue as follows:				
Total gains or losses included in surplus or deficit for the period	Revenue			(4)
Total gains or losses for the period included in surplus or deficit for assets held at the end of the reporting period				(2)
(Note: For liabilities, a similar table might be presented.)				

IG16. The fair value at initial recognition of financial instruments that are not traded in active markets is determined in accordance with paragraph AG108 of IPSAS 29. However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognized in surplus or deficit in subsequent periods in accordance with IPSAS 29 and the entity's accounting policy. Such recognition reflects changes in factors (including time) that market participants would consider in setting a price (see paragraph AG108 of IPSAS 29). Paragraph 33 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 3433:

Background

On January 1 20X1 an entity purchases for CU15 million financial assets that are not traded in an active market. The entity has only one class of such financial assets.

The transaction price of CU15 million is the fair value at initial recognition.

After initial recognition, the entity will apply a valuation technique to establish the financial assets' fair value. This valuation technique includes variables other than data from observable markets.

At initial recognition, the same valuation technique would have resulted in an amount of CU14 million, which differs from fair value by CU1 million.

The entity has existing differences of CU5 million at January 1 20X1.

Application of requirements

The entity's 20X2 disclosure would include the following:

Accounting policies

The entity uses the following valuation technique to determine the fair value of financial instruments that are not traded in an active market: [description of technique, not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with IPSAS 29, is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].

In the notes to the financial statements

As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with IPSAS 29, the fair value of an instrument at inception is generally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].

The differences yet to be recognized in surplus or deficit are as follows:

	Dec 31 X2	Dec 31 X1
	CU million	CU million
Balance at beginning of year	5.3	5.0
New transactions	–	1.0
Amounts recognized in surplus or deficit during the year	(0.7)	(0.8)
Other increases	–	0.2
Other decreases	(0.1)	(0.1)
Balance at end of year	4.5	5.3

Nature and Extent of Risks Arising from Financial Instruments (paragraphs ~~38–49~~~~37–48~~ and AG6–AG30)

Qualitative Disclosures (paragraph ~~40~~~~39~~)

IG17. The type of qualitative information an entity might disclose to meet the requirements in paragraph ~~40~~~~39~~ includes, but is not limited to, a narrative description of:

- (a) The entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions.
- (b) The entity's policies and processes for accepting, measuring, monitoring and controlling risk, which might include:
 - (i) The structure and organization of the entity's risk management function(s), including a discussion of independence and accountability;
 - (ii) The scope and nature of the entity's risk reporting or measurement systems;
 - (iii) The entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and
 - (iv) The entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices.
- (c) The entity's policies and procedures for avoiding excessive concentrations of risk.

IG18. Information about the nature and extent of risks arising from financial instruments is more useful if it highlights any relationship between financial instruments that can affect the amount, timing or uncertainty of an entity's future cash flows. The extent to which a risk exposure is altered by such relationships might be apparent to users from the disclosures required by this Standard, but in some cases further disclosures might be useful.

IG19. In accordance with paragraph ~~40~~~~39~~(c), entities disclose any change in the qualitative information from the previous period and explain the reasons for the change. Such changes may result from changes in exposure to risk or from changes in the way those exposures are managed.

Quantitative Disclosures (paragraphs ~~41–49~~~~40–48~~ and AG7–AG30)

IG20. Paragraph ~~41~~~~40~~ requires disclosure of quantitative data about concentrations of risk. For example, concentrations of credit risk may arise from:

- (a) Industry sectors. Thus, if an entity's counterparties are concentrated in one or more industry sectors (such as retail or wholesale), it would disclose separately exposure to risks arising from each concentration of counterparties.
- (b) Credit rating or other measure of credit quality. Thus, if an entity's counterparties are concentrated in one or more credit qualities (such as secured loans or unsecured

loans) or in one or more credit ratings (such as investment grade or speculative grade), it would disclose separately exposure to risks arising from each concentration of counterparties.

- (c) Geographical distribution. Thus, if an entity's counterparties are concentrated in one or more geographical markets (such as Asia or Europe), it would disclose separately exposure to risks arising from each concentration of counterparties.
- (d) A limited number of individual counterparties or groups of closely related counterparties.

Similar principles apply to identifying concentrations of other risks, including liquidity risk and market risk. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realize liquid assets. Concentrations of foreign exchange risk may arise if an entity has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together.

- IG21. In accordance with paragraph AG8, disclosure of concentrations of risk includes a description of the shared characteristic that identifies each concentration. For example, the shared characteristic may refer to geographical distribution of counterparties by groups of countries, individual countries or regions within countries.
- IG22. When quantitative information at the end of the reporting period is unrepresentative of the entity's exposure to risk during the period, paragraph [4241](#) requires further disclosure. To meet this requirement, an entity might disclose the highest, lowest and average amount of risk to which it was exposed during the period. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest and average exposures.

Credit Risk (paragraphs [4342-44](#), AG9 and AG10)

- IG23. Paragraph [4342](#) requires an entity to disclose information about its exposure to credit risk by class of financial instrument. Financial instruments in the same class share economic characteristics with respect to the risk being disclosed (in this case, credit risk). For example, an entity might determine that residential mortgages, unsecured consumer loans, and commercial loans each have different economic characteristics.

Collateral and Other Credit Enhancements Pledged (paragraph [4342\(b\)](#))

- IG24. Paragraph [4342\(b\)](#) requires an entity to describe collateral available as security for assets it holds and other credit enhancements obtained. An entity might meet this requirement by disclosing:
 - (a) The policies and processes for valuing and managing collateral and other credit enhancements obtained;

- (b) A description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset in accordance with IPSAS 28);
- (c) The main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
- (d) Information about risk concentrations within the collateral or other credit enhancements.

Credit Quality (paragraph [4342\(c\)](#))

IG25. Paragraph [4342\(c\)](#) requires an entity to disclose information about the credit quality of financial assets with credit risk that are neither past due nor impaired. In doing so, an entity might disclose the following information:

- (a) An analysis of credit exposures using an external or internal credit grading system;
- (b) The nature of the counterparty;
- (c) Historical information about counterparty default rates; and
- (d) Any other information used to assess credit quality.

IG26. When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:

- (a) The amounts of credit exposures for each external credit grade;
- (b) The rating agencies used;
- (c) The amount of an entity's rated and unrated credit exposures; and
- (d) The relationship between internal and external ratings.

IG27. When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about:

- (a) The internal credit ratings process;
- (b) The amounts of credit exposures for each internal credit grade; and
- (c) The relationship between internal and external ratings.

Financial Assets that are either Past Due or Impaired (paragraph [4443](#))

IG28. A financial asset is past due when the counterparty has failed to make a payment when contractually due. As an example, an entity enters into a lending agreement that requires interest to be paid every month. On the first day of the next month, if interest has not been paid, the loan is past due. Past due does not mean that a counterparty will never pay, but it can trigger various actions such as renegotiation, enforcement of covenants, or legal proceedings.

- IG29. When the terms and conditions of financial assets that have been classified as past due are renegotiated, the terms and conditions of the new contractual arrangement apply in determining whether the financial asset remains past due.
- IG30. Paragraph [4443](#)(a) requires an analysis by class of the age of financial assets that are past due but not impaired. An entity uses its judgment to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:
- (a) Not more than three months;
 - (b) More than three months and not more than six months;
 - (c) More than six months and not more than one year; and
 - (d) More than one year.
- IG31. Paragraph [4443](#)(b) requires an analysis of impaired financial assets by class. This analysis might include:
- (a) The carrying amount, before deducting any impairment loss;
 - (b) The amount of any related impairment loss; and
 - (c) The nature and fair value of collateral available and other credit enhancements obtained.

Market Risk (paragraphs [47–49](#)~~46–48~~ and AG19–AG30)

- IG32. Paragraph [4746](#)(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. There are three types of market risk: interest rate risk, currency risk and other price risk. Other price risk may include risks such as equity price risk, commodity price risk, prepayment risk (i.e. the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (e.g. a lessor of motor cars that writes residual value guarantees is exposed to residual value risk). Risk variables that are relevant to disclosing market risk include, but are not limited to:
- (a) The yield curve of market interest rates. It may be necessary to consider both parallel and non-parallel shifts in the yield curve.
 - (b) Foreign exchange rates.
 - (c) Prices of equity instruments.
 - (d) Market prices of commodities.
- IG33. Paragraph [4746](#)(a) requires the sensitivity analysis to show the effect on surplus or deficit and net assets/equity of reasonably possible changes in the relevant risk variable. For example, relevant risk variables might include:
- (a) Prevailing market interest rates, for interest-sensitive financial instruments such as a variable rate loan; or

- (b) Currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds.
- IG34. For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:
- (a) Interest revenue and expense;
 - (b) Other line items of surplus or deficit (such as trading gains and losses); and
 - (c) When applicable, net assets/equity.

An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

- IG35. Because the factors affecting market risk vary depending on the specific circumstances of each entity, the appropriate range to be considered in providing a sensitivity analysis of market risk varies for each entity and for each type of market risk.
- IG36. The following example illustrates the application of the disclosure requirement in paragraph [4746\(a\)](#):

Interest rate risk

At December 31, 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, surplus for the year would have been CU1.7 million (20X1—CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings, and other revenue would have been CU2.8 million (20X1—CU3.2 million) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale. If interest rates had been 10 basis points higher, with all other variables held constant, surplus would have been CU1.5 million (20X1—CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings, revenue would have been CU3.0 million (20X1—CU3.4 million) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale. Surplus is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).^a

Foreign currency exchange rate risk

At December 31, 20X2, if the CU had weakened 10 per cent against the US dollar with all other variables held constant, surplus for the year would have been CU2.8 million (20X1—CU6.4 million) lower, revenue would have been CU1.2 million (20X1—CU1.1 million) higher. Conversely, if the CU had strengthened 10 per cent against the US dollar with all other variables held constant, surplus would have been CU2.8 million (20X1—CU6.4 million) higher, revenue would have been CU1.2 million (20X1—CU1.1 million) lower. The lower foreign currency exchange rate sensitivity in surplus in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt. Revenue is more sensitive in 20X2 than in 20X1 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt.

Paragraph 38(a) requires disclosure of a maturity analysis of liabilities.

Other Market Risk Disclosures (paragraph 4948)

IG37. Paragraph 4948 requires the disclosure of additional information when the sensitivity analysis disclosed is unrepresentative of a risk inherent in a financial instrument. For example, this can occur when:

- (a) A financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, e.g. options that remain out of (or in) the money for the chosen change in the risk variable;
- (b) Financial assets are illiquid, e.g. when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty; or
- (c) An entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

IG38. In the situation in paragraph IG37(a), additional disclosure might include:

- (a) The terms and conditions of the financial instrument (e.g. the options);
- (b) The effect on surplus or deficit if the term or condition were met (i.e. if the options were exercised); and
- (c) A description of how the risk is hedged.

For example, an entity may acquire a zero cost interest rate collar that includes an out-of-the-money leveraged written option (e.g. the entity pays ten times the amount of the difference between a specified interest rate floor and the current market interest rate). The entity may regard the collar as an inexpensive economic hedge against a reasonably possible increase in interest rates. However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates. Neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, the entity might provide the additional information described above.

IG39. In the situation described in paragraph IG38(b), additional disclosure might include the reasons for the lack of liquidity and how the entity hedges the risk.

IG40. In the situation described in paragraph IG38(c), additional disclosure might include:

- (a) The nature of the security (e.g. entity name);
- (b) The extent of holding (e.g. 15 per cent of the issued shares);
- (c) The effect on surplus or deficit; and
- (d) How the entity hedges the risk.

Comparison with IFRS 7

IPSAS 30, “Financial Instruments: Disclosures” is drawn primarily from IFRS 7, “Financial Instruments: Disclosures” (originally issued in 2005, including amendments published to April 2009). The main differences between IPSAS 30 and IFRS 7 are as follows:

- IPSAS 30 contains requirements related to concessionary loans. IFRS 7 does not require such disclosures.
- In certain instances, IPSAS 30 uses different terminology from IFRS 7. The most significant examples are the use of the terms “revenue,” “statement of financial performance” and “net assets/equity” in IPSAS 30. The equivalent terms in IFRS 7 are “income,” “statement of comprehensive income” and “equity.”



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