

Compiled Accounting Standard

AASB 132

Financial Instruments: Disclosure and Presentation

This compiled Standard applies to annual reporting periods beginning on or after 1 January 2006 but before 1 January 2007. Early application is permitted. It incorporates amendments made up to and including 8 September 2005.

Prepared on 20 February 2006 by the staff of the Australian Accounting Standards Board.



Australian Government

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BASIS FOR CONCLUSIONS ON IAS 32
(available to AASB online subscribers or through the IASB)

Australian Accounting Standard AASB 132 *Financial Instruments: Disclosure and Presentation* (as amended at 8 September 2005) is set out in paragraphs 1 – 95 and the Appendix. All the paragraphs have equal authority. Terms defined in this Standard are in *italics* the first time they appear in the Standard. AASB 132 is to be read in the context of other Australian Accounting Standards, including AASB 1048 *Interpretation and Application of Standards*, which identifies the Australian Accounting Interpretations. In the absence of explicit guidance, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies.

COMPILATION DETAILS

Accounting Standard AASB 132 *Financial Instruments: Disclosure and Presentation*

This compiled Standard applies to annual reporting periods beginning on or after 1 January 2006 but before 1 January 2007. Early application is permitted. It incorporates amendments made up to and including 8 September 2005. The compilation was prepared by the staff of the Australian Accounting Standards Board on 20 February 2006.

This compiled Standard is not a separate Accounting Standard made by the AASB. Instead, it is a representation of AASB 132 (July 2004) as amended by other Accounting Standards, which are listed in the Table below.

Table of Standards

| Standard | Date made | Application date (<i>annual reporting periods ... on or after ...</i>) | Application, saving or transitional provisions |
|-----------------|------------------|---|---|
| AASB 132 | 15 July 2004 | <i>(beginning)</i> 1 Jan 2005 | |
| AASB 2005-4 | 9 June 2005 | <i>(beginning)</i> 1 Jan 2006 | see (a) below |
| AASB 2005-9 | 6 Sept 2005 | <i>(beginning)</i> 1 Jan 2006 | see (b) below |
| AASB 2005-11 | 8 Sept 2005 | <i>(ending)</i> 31 Dec 2005 | see (c) below |

- (a) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2006. Entities that elect to apply the amendments in AASB 2005-4 in respect of AASB 139 *Financial Instruments: Recognition and Measurement* to such a period must also apply the amendments made to AASB 132 by AASB 2005-4.
- (b) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2006.
- (c) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 that end before 31 December 2005.

Table of Amendments

| Paragraph affected | How affected | By ... [paragraph] |
|--------------------|--------------------|---------------------------------------|
| 4(d) | amended | AASB 2005-9 [23] |
| 12 | amended | AASB 2005-9 [24] |
| 35 | amended | AASB 2005-11 [10] |
| 66 | amended | AASB 2005-4 [15] |
| 94 | amended | AASB 2005-4 [16] |
| AG8 | amended | AASB 2005-11 [11] |
| AG40 | amended amended | AASB 2005-4 [17] AASB 2005-11 [12] |

Erratum

Subsequent to the making of AASB 132 (15 July 2004), several editorial corrections were identified. The Erratum containing the corrections was issued in February 2006. The corrections are included in this Compiled Standard.

Table of Editorial Corrections

| Paragraph affected | How affected | By ... |
|--------------------|--------------|-------------------|
| 4(f)(i) | amended | Erratum, Feb 2006 |
| 94(h)(i) | amended | Erratum, Feb 2006 |

COMPARISON WITH INTERNATIONAL PRONOUNCEMENTS

AASB 132 and IAS 32

AASB 132 is equivalent to IAS 32 *Financial Instruments: Disclosure and Presentation* issued by the IASB. Paragraphs that have been added to this Standard (and do not appear in the text of the equivalent IASB Standard) are identified with the prefix “Aus”, followed by the number of the relevant IASB paragraph and decimal numbering.

Compliance with IAS 32

Entities that comply with AASB 132 will simultaneously be in compliance with IAS 32.

A parent that does not make use of the relief available to it in AASB 132 and complies with AASB 132 will simultaneously be in compliance with IAS 32.

A parent that makes use of the relief available to it in AASB 132 and complies with the remaining requirements of AASB 132 will not simultaneously be in compliance with IAS 32.

AASB 132 and IPSAS 15

International Public Sector Accounting Standards (IPSASs) are issued by the International Public Sector Accounting Standards Board of the International Federation of Accountants.

IPSAS 15 *Financial Instruments: Disclosure and Presentation* (December 2001) is drawn primarily from the 2000 version of IAS 32. The main differences between IPSAS 15 and AASB 132 are:

- (a) the inclusion in AASB 132 of additional guidance on the measurement of the components of a compound instrument on initial recognition;
- (b) the requirement in AASB 132 to classify derivatives based on an entity’s own shares; and
- (c) the inclusion in IPSAS 15 of fewer disclosure requirements than in AASB 132.

ACCOUNTING STANDARD AASB 132

The Australian Accounting Standards Board made Accounting Standard AASB 132 *Financial Instruments: Disclosure and Presentation* under section 334 of the *Corporations Act 2001* on 15 July 2004.

This compiled version of AASB 132 incorporates subsequent amendments contained in other AASB Standards made by the AASB up to and including 8 September 2005 (see Compilation Details).

ACCOUNTING STANDARD AASB 132

FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION

Objective

1. The objective of this Standard is to enhance financial statement users' understanding of the significance of *financial instruments* to an entity's financial position, performance, and cash flows.
2. This Standard contains requirements for the presentation of financial instruments and identifies the information that should be disclosed about them. The presentation requirements apply 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, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset. The Standard requires disclosure of information about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to those instruments. This Standard also requires disclosure of information about the nature and extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them, and management's policies for controlling those risks.
3. The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in AASB 139 *Financial Instruments: Recognition and Measurement*.

Application

- Aus3.1** This Standard applies to:
- (a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;
 - (b) general purpose financial reports of each other reporting entity; and
 - (c) financial reports that are, or are held out to be, general purpose financial reports.
- Aus3.2** This Standard applies to annual reporting periods beginning on or after 1 January 2005.
[Note: For application dates of paragraphs changed or added by an amending Standard, see Compilation Details.]
- Aus3.3** This Standard shall not be applied to annual reporting periods beginning before 1 January 2005.
- Aus3.4** The requirements specified in this Standard apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.
- Aus3.5** If a financial report contains both the separate financial statements of the parent and the consolidated financial statements of an entity the disclosures required by paragraphs 51-93, Aus94.1, and 94 and 95 need be presented only for the consolidated financial statements.¹
- Aus3.6** When applicable, this Standard supersedes:
- (a) *AASB 1033 Presentation and Disclosure of Financial Instruments* as notified in the *Commonwealth of Australia Gazette* No S 516, 29 October 1999; and
 - (b) *AAS 33 Presentation and Disclosure of Financial Instruments* as issued in October 1999.

¹ A parent that makes use of the relief available to it in this Standard will not simultaneously be in compliance with the requirements of IAS 32 *Financial Instruments: Disclosure and Presentation* paragraphs 51-95.

- Aus3.7 Both AASB 1033 and AAS 33 remain applicable until superseded by this Standard.
- Aus3.8 Notice of this Standard was published in the *Commonwealth of Australia Gazette* No S 294, 22 July 2004.

Scope

4. **This Standard shall be applied to all types of financial instruments except:**
- (a) **those interests in subsidiaries, associates, and joint ventures that are accounted for under AASB 127 *Consolidated and Separate Financial Statements*; AASB 128 *Investments in Associates*; or AASB 131 *Interests in Joint Ventures*. However, entities shall apply this Standard to an interest in a subsidiary, associate, or joint venture that according to AASB 127, AASB 128 or AASB 131 is accounted for under AASB 139. In these cases, entities shall apply the disclosure requirements in AASB 127, AASB 128, and AASB 131 in addition to those in this Standard. Entities shall also apply this Standard to all derivatives on interests in subsidiaries, associates or joint ventures;**
 - (b) **employers' rights and obligations under employee benefit plans, to which AASB 119 *Employee Benefits* applies;**
 - (c) **contracts for contingent consideration in a business combination (see AASB 3 *Business Combinations*). This exemption applies only to the acquirer;**
 - (d) **insurance contracts as defined in AASB 4 *Insurance Contracts*. However, this Standard applies to derivatives that are embedded in insurance contracts if AASB 139 requires the entity to account for them separately. Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies AASB 139 in recognising and measuring the contracts, but shall apply AASB 1023 *General Insurance Contracts* if the issuer elects, in accordance with paragraph 2.2(f) of AASB 1023, to apply AASB 1023 in recognising and measuring them;**
 - (e) **financial instruments that are within the scope of AASB 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15-32 and AG25-AG35 of this**

Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see AASB 139); and

- (f) **financial instruments, contracts and obligations under share-based payment transactions to which AASB 2 *Share-based Payment* applies, except for:**
 - (i) **contracts within the scope of paragraphs 8-10 of this Standard, to which this Standard applies; or**
 - (ii) **paragraphs 33 and 34 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.**
- 5. This Standard applies to recognised and unrecognised financial instruments. Recognised financial instruments include equity instruments issued by the entity and financial assets and financial liabilities that are within the scope of AASB 139. Unrecognised financial instruments include some financial instruments that, although outside the scope of AASB 139, are within the scope of this Standard (such as some loan commitments).
- 6. [Deleted by the IASB]
- 7. Other Standards specific to particular types of financial instrument contain additional presentation and disclosure requirements. For example, AASB 117 *Leases* and AAS 25 *Financial Reporting by Superannuation Plans* incorporate specific disclosure requirements relating to finance leases and retirement benefit plan investments, respectively. In addition, some requirements of other Australian Accounting Standards, particularly AASB 130 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, apply to financial instruments.
- 8. **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.**

9. 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 8 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.

10. 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 9(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Definitions (see also paragraphs AG3-AG24)

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

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 favourable 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 instruments that are themselves 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 unfavourable to the entity; or**

- (b) a contract that will or may be settled in the entity's own equity instruments and is:
 - (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

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.**

12. The following terms are defined in paragraph 9 of AASB 139 and are used in this Standard with the meaning specified in AASB 139:
- (a) amortised cost of a financial asset or financial liability;
 - (b) available-for-sale financial assets;
 - (c) derecognition;
 - (d) derivative;
 - (e) effective interest method;
 - (f) financial asset or financial liability at fair value through profit or loss;
 - (g) financial guarantee contract;
 - (h) firm commitment;
 - (i) forecast transaction;
 - (j) hedge effectiveness;

- (k) hedged item;
 - (l) hedging instrument;
 - (m) held-to-maturity investments;
 - (n) loans and receivables;
 - (o) regular way purchase or sale; and
 - (p) transaction costs.
13. 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.
14. In this Standard, ‘entity’ includes individuals, partnerships, incorporated bodies, trusts and government agencies.

Presentation

Liabilities and Equity (see also paragraphs AG25-AG29)

15. **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.**
16. When an issuer applies the definitions in paragraph 11 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.
- (a) The instrument includes no contractual obligation:
 - (i) to deliver cash or another financial asset to another entity;
or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

- (b) If the instrument will or may be settled in the issuer's own equity instruments, it is:
 - (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves 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.

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraph 16(a))

- 17. 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 unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of 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.
- 18. The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity 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; and

- (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. This is so 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, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. 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. 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 equal to their proportionate share of the asset value of the issuer. 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 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 equity and puttable instruments that do not (see Illustrative Example 8).
19. 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. 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; and
 - (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.
20. 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; and

- (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 21).

Settlement in the Entity's Own Equity Instruments (paragraph 16(b))

- 21. 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 (e.g. 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 CU100,² 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 ounces of gold. 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.
- 22. 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

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

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 equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

23. A contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (e.g. for the present value of the forward repurchase price, option exercise price, or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under AASB 139, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with AASB 139. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (e.g. a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).
24. 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 ounces of gold.

Contingent Settlement Provisions

25. 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, net income 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; or
- (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.

Settlement Options

- 26. 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.**
- 27. 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 8-10). Such contracts are financial assets or financial liabilities and not equity instruments.

Compound Financial Instruments (see also paragraphs AG30-AG35 and Illustrative Examples 9-12)

- 28. The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.**

29. An entity recognises 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 equity components separately on its balance sheet.
30. Classification of the liability and equity components of a convertible instrument 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.
31. AASB 139 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that 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 to its equity and liability components, the 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 other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

32. Under the approach described in paragraph 31, 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 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 AG36)³

33. **If an entity reacquires its own equity instruments, those instruments (“treasury shares”) shall be deducted from equity. No gain or loss shall be recognised in the profit or loss 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 consolidated group. Consideration paid or received shall be recognised directly in equity.**
34. The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes, in accordance with AASB 101 *Presentation of Financial Statements*. An entity provides disclosure in accordance with AASB 124 *Related Party Disclosures* if the entity reacquires its own equity instruments from related parties.

Interest, Dividends, Losses and Gains (see also paragraph AG37)

35. **Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be debited by the entity directly to equity, net of any related income tax benefit. Transaction costs of an equity transaction shall be accounted for as a deduction from equity, net of any related income tax benefit.**
36. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on

³ The Corporations Act prohibits a company from acquiring shares (or units of shares) in itself except in limited circumstances, and an entity subject to the Corporations Act cannot have treasury shares.

a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in profit or loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

37. 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. The transaction costs of an equity transaction are accounted for as a deduction from equity (net of any related income tax benefit) to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.
38. Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction (e.g. costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.
39. The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately under AASB 101. The related amount of income taxes recognised directly in equity is included in the aggregate amount of current and deferred income tax credited or charged to equity that is disclosed under AASB 112 *Income Taxes*.
40. Dividends classified as an expense may be presented in the income statement either with interest on other liabilities or as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends is subject to the requirements of AASB 101 and AASB 130. In some circumstances, because of the differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately in the income statement. Disclosures of the tax effects are made in accordance with AASB 112.
41. Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss 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 18(b)). Under AASB 101 the entity presents any gain or loss arising from remeasurement of such an

instrument separately on the face of the income statement when it is relevant in explaining the entity's performance.

**Offsetting a Financial Asset and a Financial Liability
(see also paragraphs AG38 and AG39)**

42. **A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:**
- (a) **currently has a legally enforceable right to set off the recognised amounts; and**
 - (b) **intends either to settle on a net basis, or to realise 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 AASB 139, paragraph 36).

43. 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.
44. Offsetting a recognised financial asset and a recognised 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 recognised item from the balance sheet but also may result in recognition of a gain or loss.
45. 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.

46. 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.
47. An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business 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 realise 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 76.
48. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised 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, realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.
49. The conditions set out in paragraph 42 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 (e.g. 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 (e.g. 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.
50. 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 are commonly used by financial institutions 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 realisation 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 business. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 42 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 76.

Disclosure

51. The purpose of the disclosures required by this Standard is to provide information to enhance understanding of the significance of financial instruments to an entity's financial position, performance and cash flows, and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments.

52. Transactions in financial instruments may result in an entity assuming or transferring to another party one or more of the financial risks described below. The required disclosures provide information to assist users of the financial report in assessing the extent of risk related to financial instruments.

- (a) *Market risk* – This includes three types of risk:
- (i) *currency risk* – the risk that the value of a financial instrument will fluctuate because of changes in foreign exchange rates;
 - (ii) *fair value interest rate risk* – the risk that the value of a financial instrument will fluctuate because of changes in market interest rates;
 - (iii) *price risk* – the risk that the value of a financial instrument will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all instruments traded in the market.

Market risk embodies not only the potential for loss but also the potential for gain.

- (b) *Credit risk* – the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.
- (c) *Liquidity risk* (also referred to as *funding risk*) – the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.
- (d) *Cash flow interest rate risk* – the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates. In the case of a floating rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value.

Format, Location and Classes of Financial Instruments

53. This Standard does not prescribe either the format of the information required to be disclosed or its location within the financial report. To the extent that the required information is presented on the face of the

financial statements, it is unnecessary to repeat it in the notes. Disclosures may include a combination of narrative descriptions and quantified data, as appropriate to the nature of the instruments and their relative significance to the entity.

54. Determining the level of detail to be disclosed about particular financial instruments requires the exercise of judgement taking into account the relative significance of those instruments. It is necessary to strike a balance between overburdening the financial report with excessive detail that may not assist users of the financial report and obscuring important information as a result of too much aggregation. For example, when an entity is party to a large number of financial instruments with similar characteristics and no single contract is individually material, a summary by classes of instruments is appropriate. On the other hand, information about an individual instrument may be important when it is, for example, a material component of an entity's capital structure.
55. The management of an entity groups financial instruments into classes that are appropriate to the nature of the information disclosed, taking into account matters such as the characteristics of the instruments and the measurement basis that has been applied. In general, classes distinguish items measured at cost or amortised cost from items measured at fair value. Sufficient information is provided to permit a reconciliation to relevant line items on the balance sheet. When an entity is a party to financial instruments not within the scope of this Standard, those instruments constitute a class or classes of financial assets or financial liabilities separate from those within the scope of this Standard. Disclosures about those financial instruments are dealt with by other Australian Accounting Standards.

Risk Management Policies and Hedging Activities

56. **An entity shall describe its financial risk management objectives and policies, including its policy for hedging each main type of forecast transaction for which hedge accounting is used.**
57. In addition to providing specific information about particular balances and transactions related to financial instruments, an entity provides a discussion of the extent to which financial instruments are used, the associated risks and the business purposes served. A discussion of management's policies for controlling the risks associated with financial instruments includes policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risk and requirements for collateral to mitigate credit risk. Such discussion provides a valuable additional perspective that is independent of the specific instruments held or outstanding at a particular time.

58. An entity shall disclose the following separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation (as defined in AASB 139):
- (a) a description of the hedge;
 - (b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date;
 - (c) the nature of the risks being hedged; and
 - (d) for cash flow hedges, the periods in which the cash flows are expected to occur, when they are expected to enter into the determination of profit or loss, and a description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur.
59. When a gain or loss on a hedging instrument in a cash flow hedge has been recognised directly in equity, through the statement of changes in equity, an entity shall disclose:
- (a) the amount that was so recognised in equity during the period;
 - (b) the amount that was removed from equity and included in profit or loss for the period; and
 - (c) the amount that was removed from equity during the period and included in the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged highly probable forecast transaction.

Terms, Conditions and Accounting Policies

60. For each class of financial asset, financial liability and equity instrument, an entity shall disclose:
- (a) information about the extent and nature of the financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and

(b) **the accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied.**

- 61. As part of the disclosure of an entity's accounting policies, an entity shall disclose, for each category of financial assets, whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see AASB 139, paragraph 38).**
62. The contractual terms and conditions of a financial instrument affect the amount, timing and certainty of future cash receipts and payments by the parties to the instrument. When financial instruments are significant, either individually or as a class, to the financial position of an entity or its future operating results, their terms and conditions are disclosed. If no single instrument is individually significant to the future cash flows of the entity, the essential characteristics of the instruments are described by reference to appropriate groupings of like instruments.
63. When financial instruments held or issued by an entity, either individually or as a class, create a potentially significant exposure to the risks described in paragraph 52, terms and conditions that warrant disclosure include:
- (a) the principal, stated, face or other similar amount, which, for some derivative instruments, such as interest rate swaps, might be the amount (referred to as the notional amount) on which future payments are based;
 - (b) the date of maturity, expiry or execution;
 - (c) early settlement options held by either party to the instrument, including the period in which, or date at which, the options can be exercised and the exercise price or range of prices;
 - (d) options held by either party to the instrument to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options can be exercised and the conversion or exchange ratio(s);
 - (e) the amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including instalment repayments and any sinking fund or similar requirements;

- (f) stated rate or amount of interest, dividend or other periodic return on principal and the timing of payments;
 - (g) collateral held, in the case of a financial asset, or pledged, in the case of a financial liability;
 - (h) in the case of an instrument for which cash flows are denominated in a currency other than the entity's functional currency, the currency in which receipts or payments are required;
 - (i) in the case of an instrument that provides for an exchange, information described in items (a)-(h) for the instrument to be acquired in the exchange; and
 - (j) any condition of the instrument or an associated covenant that, if contravened, would significantly alter any of the other terms (e.g. a maximum debt-to-equity ratio in a bond covenant that, if contravened, would make the full principal amount of the bond due and payable immediately).
64. When the balance sheet presentation of a financial instrument differs from the instrument's legal form, it is desirable for an entity to explain in the notes the nature of the instrument.
65. The usefulness of information about the extent and nature of financial instruments is enhanced when it highlights any relationship between individual instruments that can significantly affect the amount, timing or certainty of the future cash flows of an entity. For example, it may be important to disclose hedging relationships such as one that might exist when an entity holds an investment in shares for which it has purchased a put option. The extent to which a risk exposure is altered by the relationship among the assets and liabilities may be apparent to financial report users from information of the type described in paragraph 63, but in some circumstances further disclosure is necessary.
66. In accordance with AASB 101, an entity provides disclosure of all significant accounting policies, including the general principles adopted and the method of applying those principles to transactions, other events and conditions arising in the entity's business. In the case of financial instruments, such disclosure includes:
- (a) the criteria applied in determining when to recognise a financial asset or financial liability and when to derecognise it;

- (b) the basis of measurement applied to financial assets and financial liabilities on initial recognition and subsequently;
- (c) the basis on which income and expenses arising from financial assets and financial liabilities are recognised and measured; and
- (d) for financial assets or financial liabilities designated as at fair value through profit or loss:
 - (i) the criteria for so designating such financial assets or financial liabilities on initial recognition;
 - (ii) how the entity has satisfied the conditions in paragraph 9, 11A or 12 of AASB 139 for such designation. For instruments designated in accordance with paragraph 9(b)(i) of AASB 139, 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 9(b)(ii) of AASB 139, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy; and
 - (iii) the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss.

Interest Rate Risk

- 67. For each class of financial assets and financial liabilities, an entity shall disclose information about its exposure to interest rate risk, including:**
- (a) contractual repricing or maturity dates, whichever dates are earlier; and**
 - (b) effective interest rates, when applicable.**
68. An entity provides information about its exposure to the effects of future changes in the prevailing level of interest rates. Changes in market interest rates have a direct effect on the contractually determined cash flows associated with some financial assets and financial liabilities (cash flow interest rate risk) and on the fair value of others (fair value interest rate risk).

69. Information about maturity dates (or repricing dates when they are earlier) indicates the length of time for which interest rates are fixed, and information about effective interest rates indicates the levels at which they are fixed. Disclosure of this information provides users of the financial report with a basis for evaluating the fair value interest rate risk to which an entity is exposed and, thus, the potential for gain or loss. For instruments that are repriced to a market rate of interest before maturity, disclosure of the period until the next repricing is more important for this purpose than disclosure of the period to maturity.
70. To supplement the information about contractual repricing and maturity dates, an entity may elect to disclose information about expected repricing or maturity dates when those dates differ significantly from the contractual dates. For example, such information may be particularly relevant when an entity is able to predict, with reasonable reliability, the amount of fixed rate mortgage loans that will be repaid before maturity and it uses this information as the basis for managing its interest rate risk exposure. The additional information includes disclosure that it is based on management's expectations of future events and an explanation of the assumptions made about repricing or maturity dates and how those assumptions differ from the contractual dates.
71. An entity indicates which of its financial assets and financial liabilities are:
- (a) exposed to fair value interest rate risk, such as financial assets and financial liabilities with a fixed interest rate;
 - (b) exposed to cash flow interest rate risk, such as financial assets and financial liabilities with a floating interest rate that is reset as market rates change; and
 - (c) not directly exposed to interest rate risk, such as some investments in equity instruments.
72. The requirement in paragraph 67(b) applies to bonds, notes, loans and similar financial instruments involving future payments that create a return to the holder and a cost to the issuer reflecting the time value of money. The requirement does not apply to financial instruments such as investments in equity instruments and derivative instruments that do not bear a determinable effective interest rate. For example, even though instruments such as interest rate derivatives (including swaps, forward rate agreements and options) are exposed to fair value or cash flow risk from changes in market interest rates, disclosure of an effective interest rate is not required. However, when providing

effective interest rate information, an entity discloses the effect on its interest rate risk exposure of hedging transactions such as interest rate swaps.

73. An entity may become exposed to interest rate risk as a result of a transaction in which no financial asset or financial liability is recognised on its balance sheet. In such circumstances, the entity discloses information that permits users of its financial report to understand the nature and extent of its exposure. For example, where an entity has a commitment to lend funds at a fixed interest rate, the disclosure normally includes the stated principal, interest rate and term to maturity of the amount to be lent and the significant terms of the transaction giving rise to the exposure to interest rate risk.
74. The nature of an entity's business and the extent of its activity in financial instruments determine whether information about interest rate risk is presented in narrative form, in tables or by using a combination of the two. When an entity has a variety of financial instruments exposed to fair value or cash flow interest rate risk, it may adopt one or more of the following approaches to presenting information.
- (a) The carrying amounts of financial instruments exposed to interest rate risk may be presented in tabular form, grouped by those that are contracted to mature or be repriced in the following periods after the reporting date:
- (i) in one year or less;
 - (ii) in more than one year but not more than two years;
 - (iii) in more than two years but not more than three years;
 - (iv) in more than three years but not more than four years;
 - (v) in more than four years but not more than five years; and
 - (vi) in more than five years.
- (b) When the performance of an entity is significantly affected by the level of its exposure to interest rate risk or changes in that exposure, more detailed information is desirable. An entity such as a bank may disclose, for example, separate groupings of the carrying amounts of financial instruments contracted to mature or be repriced:
- (i) in one month or less after the reporting date;

- (ii) in more than one month but not more than three months after the reporting date; and
 - (iii) in more than three but not more than twelve months after the reporting date.
- (c) Similarly, an entity may indicate its exposure to cash flow interest rate risk through a table indicating the aggregate carrying amount of groups of floating rate financial assets and financial liabilities maturing within various future time periods.
- (d) Interest rate information may be disclosed for individual financial instruments. Alternatively, weighted average rates or a range of rates may be presented for each class of financial instrument. An entity may group into separate classes instruments denominated in different currencies or having substantially different credit risks when those factors result in instruments having substantially different effective interest rates.
75. In some circumstances, an entity may be able to provide useful information about its exposure to interest rate risks by indicating the effect of a hypothetical change in market interest rates on the fair value of its financial instruments and future profit or loss and cash flows. Such information may be based on, for example, an assumed one percentage point (100 basis points) change in market interest rates occurring at the reporting date. The effects of a change in interest rates include changes in interest income and expense relating to floating rate financial instruments and gains or losses resulting from changes in the fair value of fixed rate instruments. The reported interest rate sensitivity may be restricted to the direct effects of an interest rate change on interest-bearing financial instruments recognised at the reporting date because the indirect effects of a rate change on financial markets and individual entities cannot normally be predicted reliably. When disclosing interest rate sensitivity information, an entity indicates the basis on which it has prepared the information, including any significant assumptions.

Credit Risk

76. **For each class of financial assets and other credit exposures, an entity shall disclose information about its exposure to credit risk, including:**
- (a) **the amount that best represents its maximum credit risk exposure at the reporting date, without taking account of the fair value of any collateral, in the event of other parties**

failing to perform their obligations under financial instruments; and

(b) significant concentrations of credit risk.

77. An entity provides information relating to credit risk to permit users of its financial report to assess the extent to which failures by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets recognised at the reporting date or require a cash outflow from other credit exposures (such as a credit derivative or an issued guarantee of the obligations of a third party). Such failures give rise to a loss recognised in an entity's profit or loss. Paragraph 76 does not require an entity to disclose an assessment of the probability of losses arising in the future.
78. The purposes of disclosing amounts exposed to credit risk without regard to potential recoveries from realisation of collateral ('an entity's maximum credit risk exposure') are:
- (a) to provide users of the financial report with a consistent measure of the amount exposed to credit risk for financial assets and other credit exposures; and
 - (b) to take into account the possibility that the maximum exposure to loss may differ from the carrying amount of financial assets recognised at the reporting date.
79. In the case of financial assets exposed to credit risk, the carrying amount of the assets in the balance sheet, net of any applicable provisions for loss, usually represents the amount exposed to credit risk. For example, in the case of an interest rate swap carried at fair value, the maximum exposure to loss at the reporting date is normally the carrying amount because it represents the cost, at current market rates, of replacing the swap in the event of default. In these circumstances, no additional disclosure beyond that provided on the balance sheet is necessary. On the other hand, an entity's maximum potential loss from some financial instruments may differ significantly from their carrying amount and from other disclosed amounts such as their fair value or principal amount. In such circumstances, additional disclosure is necessary to meet the requirements of paragraph 76(a).
80. A financial asset subject to a legally enforceable right of set-off against a financial liability is not presented on the balance sheet net of the liability unless settlement is intended to take place on a net basis or simultaneously. Nevertheless, an entity discloses the existence of the legal right of set-off when providing information in accordance with paragraph 76. For example, when an entity is due to receive the

proceeds from realisation of a financial asset before settlement of a financial liability of equal or greater amount against which the entity has a legal right of set-off, the entity has the ability to exercise that right of set-off to avoid incurring a loss in the event of a default by the counterparty. However, if the entity responds, or is likely to respond, to the default by extending the term of the financial asset, an exposure to credit risk would exist if the revised terms are such that collection of the proceeds is expected to be deferred beyond the date on which the liability is required to be settled. To inform users of the financial report of the extent to which exposure to credit risk at a particular point in time has been reduced, the entity discloses the existence and effect of the right of set-off when the financial asset is expected to be collected in accordance with its terms. When the financial liability against which a right of set-off exists is due to be settled before the financial asset, the entity is exposed to credit risk on the full carrying amount of the asset if the counterparty defaults after the liability has been settled.

81. An entity may have entered into one or more master netting arrangements that serve to mitigate its exposure to credit loss but do not meet the criteria for offsetting. When a master netting arrangement significantly reduces the credit risk associated with financial assets not offset against financial liabilities with the same counterparty, an entity provides additional information concerning the effect of the arrangement. Such disclosure indicates that:
- (a) the credit risk associated with financial assets subject to a master netting arrangement is eliminated only to the extent that financial liabilities due to the same counterparty will be settled after the assets are realised; and
 - (b) the extent to which an entity's overall exposure to credit risk is reduced through a master netting arrangement may change substantially within a short period following the reporting date because the exposure is affected by each transaction subject to the arrangement.

It is also desirable for an entity to disclose the terms of its master netting arrangements that determine the extent of the reduction in its credit risk.

82. An entity may be exposed to credit risk as a result of a transaction in which no financial asset is recognised on its balance sheet, such as for a financial guarantee or credit derivative contract. Guaranteeing an obligation of another party creates a liability and exposes the guarantor to credit risk that is taken into account in making the disclosures required by paragraph 76.

83. Concentrations of credit risk are disclosed when they are not apparent from other disclosures about the nature of the business and financial position of the entity and result in a significant exposure to loss in the event of default by other parties. Identification of such concentrations requires judgement by management taking into account the circumstances of the entity and its debtors. AASB 114 *Segment Reporting* provides guidance in identifying industry and geographical segments within which credit risk concentrations may arise.
84. Concentrations of credit risk may arise from exposures to a single debtor or to groups of debtors having such a similar characteristic that their ability to meet their obligations is expected to be affected similarly by changes in economic or other conditions. Characteristics that may give rise to a concentration of risk include the nature of the activities undertaken by debtors, such as the industry in which they operate, the geographical area in which activities are undertaken and the level of creditworthiness of groups of borrowers. For example, a manufacturer of equipment for the oil and gas industry will normally have trade accounts receivable from sale of its products for which the risk of nonpayment is affected by economic changes in the oil and gas industry. A bank that normally lends on an international scale may have many loans outstanding to less developed nations and the bank's ability to recover them may be adversely affected by local economic conditions.
85. Disclosure of concentrations of credit risk includes a description of the shared characteristic that identifies each concentration and the amount of the maximum credit risk exposure associated with all financial assets sharing that characteristic.

Fair Value

86. **Except as set out in paragraph 90 and 91A, for each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with the corresponding carrying amount in the balance sheet (AASB 139 provides guidance for determining fair value).**
87. Fair value information is widely used for business purposes in determining an entity's overall financial position and in making decisions about individual financial instruments. It is also relevant to many decisions made by users of the financial report because, in many circumstances, it reflects the judgement of the financial markets about the present value of expected future cash flows relating to an instrument. Fair value information permits comparisons of financial instruments having substantially the same economic characteristics,

regardless of why they are held and when and by whom they were issued or acquired. Fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities. When an entity does not measure a financial asset or financial liability in its balance sheet at fair value, it provides fair value information through supplementary disclosures.

88. For financial instruments such as short-term trade receivables and payables, no disclosure of fair value is required when the carrying amount is a reasonable approximation of fair value.
89. In disclosing fair values, an entity groups financial assets and financial liabilities into classes and offsets them only to the extent that their related carrying amounts are offset in the balance sheet.
90. **If investments in unquoted equity instruments or derivatives linked to such equity instruments are measured at cost under AASB 139 because their fair value cannot be measured reliably, that fact shall be disclosed together with a description of the financial instruments, their carrying amount, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is highly likely to lie. Furthermore, if financial assets whose fair value previously could not be reliably measured are sold, that fact, the carrying amount of such financial assets at the time of sale and the amount of gain or loss recognised shall be disclosed.**
91. If investments in unquoted equity instruments or derivatives linked to such equity instruments are measured at cost under AASB 139 because their fair values cannot be measured reliably, the information about fair value set out in paragraphs 86 and 92 is not required to be disclosed. Instead, information is provided to assist users of the financial report in making their own judgements about the extent of possible differences between the carrying amount of such financial assets and financial liabilities and their fair value. In addition to an explanation of the principal characteristics of the financial instruments that are pertinent to their value and the reason for not disclosing fair values, information is provided about the market for the instruments. In some cases, the terms and conditions of the instruments disclosed in accordance with paragraph 60 may provide sufficient information. When it has a reasonable basis for doing so, management may indicate its opinion on the relationship between fair value and the carrying amount of financial assets and financial liabilities for which it is unable to determine fair value reliably.

- 91A. Some financial assets and financial liabilities contain a discretionary participation feature as described in AASB 4. If an entity cannot measure reliably the fair value of that feature, the entity shall disclose that fact together with a description of the contract, its carrying amount, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is highly likely to lie.**
- 92. An entity shall disclose:**
- (a) the methods and significant assumptions applied in determining fair values of financial assets and financial liabilities separately for significant classes of financial assets and financial liabilities (paragraph 55 provides guidance for determining classes of financial assets);**
 - (b) whether fair values of financial assets and financial liabilities are determined directly, in full or in part, by reference to published price quotations in an active market or are estimated using a valuation technique (see AASB 139, paragraphs AG71-AG79);**
 - (c) whether its financial statements include financial instruments measured at fair values that are determined in full or in part using a valuation technique based on assumptions that are not supported by observable market prices or rates. If changing any such assumption to a reasonably possible alternative would result in a significantly different fair value, the entity shall state this fact and disclose the effect on the fair value of a range of reasonably possible alternative assumptions. For this purpose, significance shall be judged with respect to profit or loss and total assets or total liabilities; and**
 - (d) the total amount of the change in fair value estimated using a valuation technique that was recognised in profit or loss during the period.**
93. Disclosure of fair value information includes disclosure of the method used in determining fair value and the significant assumptions made in its application. For example, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses and interest or discount rates if they are significant.

Other Disclosures

Aus94.1 The financial report shall disclose separately the following information as at the end of the annual reporting period:

- (a) details of the credit standby arrangements of the entity, including the nature of each arrangement and the total amount of credit unused; and
- (b) a summary of the used and unused loan facilities of the entity and the extent to which these can be continued or extended.

Derecognition

94. (a) An entity may have either transferred a financial asset (see paragraph 18 of AASB 139) or entered into the type of arrangement described in paragraph 19 of AASB 139, in such a way that the arrangement does not qualify as a transfer of a financial asset. If the entity either continues to recognise all of the asset or continues to recognise the asset to the extent of the entity's continuing involvement (see AASB 139, paragraphs 29 and 30) it shall disclose for each class of financial asset:

- (i) the nature of the assets;
- (ii) the nature of the risks and rewards of ownership to which the entity remains exposed;
- (iii) when the entity continues to recognise all of the asset, the carrying amounts of the asset and of the associated liability; and
- (iv) when the entity continues to recognise the asset to the extent of its continuing involvement, the total amount of the asset, the amount of the asset that the entity continues to recognise and the carrying amount of the associated liability.

Collateral

- (b) An entity shall disclose the carrying amount of financial assets pledged as collateral for liabilities, the carrying amount of financial assets pledged as collateral for contingent liabilities, and (consistently with paragraphs

60(a) and 63(g) any material terms and conditions relating to assets pledged as collateral.

- (c) **When an entity has accepted collateral that it is permitted to sell or repledge in the absence of default by the owner of the collateral, it shall disclose:**
- (i) **the fair value of the collateral accepted (financial and non-financial assets);**
 - (ii) **the fair value of any such collateral sold or repledged and whether the entity has an obligation to return it; and**
 - (iii) **any material terms and conditions associated with its use of this collateral (consistently with paragraphs 60(a) and 63(g)).**

Compound financial instruments with multiple embedded derivatives

- (d) **If an entity has issued an instrument that contains both a liability and an equity component (see paragraph 28) and the instrument has multiple embedded derivative features whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features and the effective interest rate on the liability component (excluding any embedded derivatives that are accounted for separately).**

Financial assets and financial liabilities at fair value through profit or loss (see also paragraph AG40)

- (e) **An entity shall disclose the carrying amounts of:**
- (i) **financial assets that are classified as held for trading;**
 - (ii) **financial liabilities that are classified as held for trading;**
 - (iii) **financial assets that, upon initial recognition, were designated by the entity as financial assets at fair value through profit or loss (i.e. those that are not financial assets classified as held for trading); and**
 - (iv) **financial liabilities that, upon initial recognition, were designated by the entity as financial liabilities at fair**

value through profit or loss (i.e. those that are not financial liabilities classified as held for trading).

- (f) An entity shall disclose separately net gains or net losses on financial assets or financial liabilities designated by the entity as at fair value through profit or loss.**
- (g) If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it shall disclose:**
 - (i) the maximum exposure to credit risk (see paragraph 76(a)) at the reporting date of the loan or receivable (or group of loans or receivables);**
 - (ii) the amount by which any related credit derivative or similar instrument mitigates that maximum exposure to credit risk;**
 - (iii) 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 credit risk determined either 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 using an alternative method that more faithfully represents the amount of change in its fair value that is attributable to changes in credit risk; and**
 - (iv) the amount of the change in the fair value of any related credit derivative or similar instrument that has occurred during the period and cumulatively since the loan or receivable was designated.**
- (h) If the entity has designated a financial liability as at fair value through profit or loss, it shall disclose:**
 - (i) the amount of change during the period and cumulatively in the fair value of the financial liability that is attributable to changes in credit risk determined either 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 paragraph AG40); or using an alternative method that more faithfully represents the amount of change in its fair value that is attributable to changes in credit risk; and**

- (ii) the difference between the carrying amount of the financial liability and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
- (i) The entity shall disclose:
 - (i) the methods used to comply with the requirement in (g)(iii) and (h)(i); and
 - (ii) if the entity considers that the disclosure it has given to comply with the requirements in (g)(iii) or (h)(i) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in credit risk, the reasons for reaching this conclusion and the factors the entity believes to be relevant.

Reclassification

- (j) If the entity has reclassified a financial asset as one measured at cost or amortised cost rather than at fair value (see AASB 139, paragraph 54), it shall disclose the reason for that reclassification.

Income statement and equity

- (k) An entity shall disclose material items of income, expense and gains and losses resulting from financial assets and financial liabilities, whether included in profit or loss or as a separate component of equity. For this purpose, the disclosure shall include at least the following items:
 - (i) total interest income and total interest expense (calculated using the effective interest method) for financial assets and financial liabilities that are not at fair value through profit or loss;
 - (ii) for available-for-sale financial assets, the amount of any gain or loss recognised directly in equity during the period and the amount that was removed from equity and recognised in profit or loss for the period; and
 - (iii) the amount of interest income accrued on impaired financial assets, in accordance with AASB 139, paragraph AG93.

Impairment

- (l) **An entity shall disclose the nature and amount of any impairment loss recognised in profit or loss for a financial asset, separately for each significant class of financial asset (paragraph 55 provides guidance for determining classes of financial assets).**

Defaults and breaches

- (m) **With respect to any defaults of principal, interest, sinking fund, or redemption provisions during the period on loans payable recognised as at the reporting date, and any other breaches during the period of loan agreements when those breaches can permit the lender to demand repayment (except for breaches that are remedied, or in response to which the terms of the loan are renegotiated, on or before the reporting date), an entity shall disclose:**
 - (i) **details of those breaches;**
 - (ii) **the amount recognised as at the reporting date in respect of the loans payable on which the breaches occurred; and**
 - (iii) **with respect to amounts disclosed under (ii), whether the default has been remedied or the terms of the loans payable renegotiated before the date the financial report was authorised for issue.**

95. For the purpose of disclosing information on breaches of loan agreements in accordance with paragraph 94(j), loans payable include issued debt instruments and financial liabilities other than short-term trade payables on normal credit terms. When such a breach occurred during the period, and the breach has not been remedied or the terms of the loan payable have not been renegotiated by the reporting date, the effect of the breach on the classification of the liability as current or non-current is determined under AASB 101.

Effective Date of IAS 32

96. [Deleted by the AASB]

97. [Deleted by the AASB]

Withdrawal of Other Pronouncements

98. [Deleted by the AASB]

99. [Deleted by the AASB]

100. [Deleted by the AASB]

APPENDIX

APPLICATION GUIDANCE

The Appendix is an integral part of AASB 132.

- 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 AASB 139 *Financial Instruments: Recognition and Measurement*.

Definitions (paragraphs 11-14)

Financial Assets and Financial Liabilities

- AG3. 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 recognised 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 cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.
- AG4. 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) trade 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).

- AG5. 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.
- AG6. ‘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 CU1,000.⁴ 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.
- AG7. 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.
- AG8. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender’s ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial

⁴ In this guidance, monetary amounts are denominated in ‘currency units’ (CU).

statements. Some of these contingent rights and obligations may be insurance contracts within the scope of AASB 4 *Insurance Contracts*.

- AG9. Under AASB 117 *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).
- AG10. 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.
- AG11. 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.
- AG12. Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in AASB 112 *Income Taxes*. Similarly, constructive obligations, as defined in AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

Equity Instruments

- AG13. Examples of equity instruments include non-puttable ordinary shares, some types of preference shares (see paragraphs AG25 and

AG26), 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. However, if such a contract contains an obligation for the entity to pay cash or another financial asset, it also gives rise to a liability for present value of the redemption amount (see paragraph AG27(a)). An issuer of nonputtable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following 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.

- AG14. 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. Instead, any consideration paid for such a contract is deducted from equity.

Derivative Financial Instruments

- AG15. 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.
- AG16. 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 favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally 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.⁵ Some

⁵ This is true of most, but not all derivatives, for example, in some cross-currency interest rate swaps principal is exchanged on inception (and re-exchanged on maturity).

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 favourable or unfavourable.

- AG17. 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 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 favourable conditions and the writer's obligation to exchange the financial asset under potentially unfavourable 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.
- AG18. 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 favourable to the purchaser and unfavourable 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.

- AG19. 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 standardised and traded on an exchange.

Contracts to Buy or Sell Non-Financial Items (paragraphs 8-10)

- AG20. 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 (e.g. an option, futures or forward contract on silver) are not financial instruments. Many commodity contracts are of this type. Some are standardised in form and traded on organised 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 8).

- AG21. A contract that involves 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 trade credit.
- AG22. 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.
- AG23. 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.
- AG24. Although the Standard was not developed to apply to commodity or other contracts that do not satisfy the definition of a financial instrument or fall within paragraph 8, entities may regard it as appropriate to apply the relevant disclosure requirements of this Standard to such contracts.

Presentation

Liabilities and Equity (paragraphs 15-27)

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraphs 17-20)

- AG25. 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 profits 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.
- AG26. 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 profit or loss for a period; or
- (f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Settlement in the Entity's Own Equity Instruments (paragraphs 21-24)

AG27. The following examples illustrate 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. Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from 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 recognises a financial liability for the present value of the redemption amount. 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. 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. One example is a net cash-settled share option.
- (d) 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 gold 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 gold. 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 25)

AG28. Paragraph 25 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

AG29. In consolidated financial statements, an entity presents minority interests – that is, the interests of other parties in the equity and income of its subsidiaries – in accordance with AASB 101 *Presentation of Financial Statements* and AASB 127 *Consolidated and Separate Financial Statements*. 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 group and the holders of the instrument in determining whether the group 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 subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the group may not have discretion over distributions or redemption.

Although the subsidiary 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 group and the holders of the instrument is considered to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group 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.

Compound Financial Instruments (paragraphs 28-32)

- AG30. Paragraph 28 applies only to issuers of non-derivative compound financial instruments. Paragraph 28 does not deal with compound financial instruments from the perspective of holders. AASB 139 deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.
- AG31. 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 28 requires the issuer of such a financial instrument to present the liability component and the equity component separately on the balance sheet, 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 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.
- AG32. On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may

be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

- AG33. 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 liability and equity 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 28-32.
- AG34. 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 recognised in profit or loss; and
 - (b) the amount of consideration relating to the equity component is recognised in equity.
- AG35. An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable 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 recognised as a loss in profit or loss.

Treasury Shares (paragraphs 33 and 34)

- AG36. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired. Paragraph 33 requires an entity that reacquires its own equity instruments to deduct those equity instruments from equity. However, when an entity holds its own equity on behalf of others, for example, a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.

Interest, Dividends, Losses and Gains (paragraphs 35-41)

AG37. The following example illustrates the application of paragraph 35 to a compound 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 recognised in profit or loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised as a distribution of profit or loss. 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 (e.g. commodity). However, if any unpaid dividends are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends are classified as interest expense.

Offsetting a Financial Asset and a Financial Liability (paragraphs 42-50)

AG38. To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognised amounts. An entity may have a conditional right to set off recognised amounts, such as in a master netting agreement or in some forms of non-recourse debt, but such rights are enforceable only on the occurrence of some future event, usually a default of the counterparty. Thus, such an arrangement does not meet the conditions for offset.

AG39. 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 synthesises 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 on an entity's balance sheet on a net basis unless they meet the criteria for offsetting in paragraph 42. Disclosures are provided about the significant terms and conditions of each financial instrument, although an entity may indicate in addition the nature of the relationship between the individual instruments (see paragraph 65).

Disclosure

Financial Assets and Financial Liabilities at Fair Value Through Profit or Loss (paragraph 94(f))

AG40. If an entity designates a financial liability or a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it is required to disclose the amount of change in the fair value of the financial instrument that is attributable to changes in credit risk. Unless an alternative method more faithfully represents this amount, the entity is required to determine this amount as the amount of change in the fair value of the financial instrument that is not attributable to changes in market conditions that give rise to market risk. Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, commodity price, foreign exchange rate or index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of an internal or external investment fund. If the only relevant changes in market conditions for a financial 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 start of the period and a discount rate equal to the sum of the observed (benchmark) interest rate at the end of the period and the instrument-specific component of the internal rate of return at the start of the period as determined in (a).

- (c) The amount determined in (b) is then adjusted for any cash paid or received on the liability during the period and increased to reflect the increase in fair value that arises because the contractual cash flows are one period closer to their due date.
- (d) The difference between the observed market price of the liability at the end of the period and the amount determined in (c) 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.

The above example assumes that changes in fair value that do not arise from changes in the instrument's credit risk or from changes in interest rates are not significant. If, in the above example, the instrument contained an embedded derivative, the change in fair value of the embedded derivative would be excluded in determining the amount in paragraph 94(h)(i).

ILLUSTRATIVE EXAMPLES

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ILLUSTRATIVE EXAMPLES

The examples accompany, but are not part of, AASB 132.

Accounting for Contracts on Equity Instruments of an Entity

IE1. The following examples¹ illustrate the application of AASB 132, paragraphs 15-27 and AASB 139 to the accounting for contracts on an entity's own equity instruments.

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 | 1 February 2002 |
| Maturity date | 31 January 2003 |
| Market price per share on 1 February 2002 | CU100 |
| Market price per share on 31 December 2002 | CU110 |
| Market price per share on 31 January 2003 | CU106 |
| Fixed forward price to be paid on 31 January 2003 | CU104 |
| Present value of forward price on 1 February 2002 | CU100 |
| Number of shares under forward contract | 1,000 |
| Fair value of forward on 1 February 2002 | CU0 |

¹ In these examples, monetary amounts are denominated in 'currency units' (CU).

| | |
|---|---------|
| Fair value of forward on 31 December 2002 | CU6,300 |
| Fair value of forward on 31 January 2003 | 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, that is, there is no receipt or delivery of the entity's own shares upon settlement of the forward contract.

On 1 February 2002, 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 31 January 2003 in exchange for a payment of CU104,000 in cash (i.e. CU104 per share) on 31 January 2003. The contract will be settled net in cash. Entity A records the following journal entries.

1 February 2002

The price per share when the contract is agreed on 1 February 2002 is CU100. The initial fair value of the forward contract on 1 February 2002 is zero.

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

31 December 2002

On 31 December 2002, 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.

31 January 2003

On 31 January 2003, the market price per share has decreased to CU106. The fair value of the forward contract is CU2,000 ($[(CU106 \times 1,000) - CU104,000]$).

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 ($CU106 \times 1,000$) 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. $CU4,300 = CU6,300 - CU2,000$).

| | | | |
|----|---------------|---------|---------|
| 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:

31 January 2003

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

| | | | |
|----|---------------|---------|---------|
| Dr | Equity | CU2,000 | |
| Cr | Forward asset | | CU2,000 |

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 ($CU104 \times 1,000$) 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.

1 February 2002

| | | | |
|----|-----------|-----------|-----------|
| Dr | Equity | CU100,000 | |
| Cr | Liability | | CU100,000 |

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see AASB 139, paragraph AG64).

31 December 2002

| | | | |
|----|------------------|---------|---------|
| Dr | Interest expense | CU3,660 | |
| Cr | Liability | | CU3,660 |

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

31 January 2003

| | | | |
|----|------------------|-------|-------|
| Dr | Interest expense | CU340 | |
| Cr | Liability | | CU340 |

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

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

| | | | |
|----|-----------|-----------|-----------|
| Dr | Liability | CU104,000 | |
| Cr | Cash | | CU104,000 |

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

(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 | 1 February 2002 |
| Maturity date | 31 January 2003 |
| Market price per share on 1 February 2002 | CU100 |
| Market price per share on 31 December 2002 | CU110 |
| Market price per share on 31 January 2003 | CU106 |
| Fixed forward price to be received on 31 January 2003 | CU104 |
| Present value of forward price on 1 February 2002 | CU100 |
| Number of shares under forward contract | 1,000 |
| Fair value of forward on 1 February 2002 | CU0 |
| Fair value of forward on 31 December 2002 | CU(6,300) |
| Fair value of forward on 31 January 2003 | CU(2,000) |

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

IE8. On 1 February 2002, 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 31 January 2003 in exchange for CU104,000 in cash (i.e. CU104 per share) on 31 January 2003. The contract will be settled net in cash. Entity A records the following journal entries.

1 February 2002

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

31 December 2002

| | | |
|----------------------|---------|---------|
| Dr Loss | CU6,300 | |
| Cr Forward liability | | CU6,300 |

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

31 January 2003

| | | |
|----------------------|---------|---------|
| 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:

31 January 2003

The contract is settled net in shares. Entity A has a right to receive CU104,000 ($\text{CU}104 \times 1,000$) worth of its shares and an obligation to deliver CU106,000 ($\text{CU}106 \times 1,000$) worth of its shares to Entity A. Thus, Entity A delivers a net amount of CU2,000 ($\text{CU}106,000 - \text{CU}104,000$) worth of its shares to Entity B, that is, 18.9 shares ($\text{CU}2,000 \div \text{CU}106$).

| | | | |
|----|-------------------|---------|---------|
| Dr | Forward liability | CU2,000 | |
| Cr | Equity | | CU2,000 |

To record the settlement of the forward contract. The issue of the entity's own shares is treated as an equity transaction.

(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 ($\text{CU}104 \times 1,000$) and an obligation to deliver 1,000 of its own shares in one year. Entity A records the following journal entries.

1 February 2002

No entry is made on 1 February. 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.

31 December 2002

No entry is made on 31 December 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.

31 January 2003

On 31 January 2003, Entity A receives CU104,000 in cash and delivers 1,000 shares.

| | | | |
|----|--------|-----------|-----------|
| Dr | Cash | CU104,000 | |
| Cr | Equity | | CU104,000 |

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 | 1 February 2002 |
| Exercise date | 31 January 2003 |
| | (European terms, i.e. it can be exercised only at maturity) |
| Exercise right holder | Reporting entity (Entity A) |

| | |
|--|---------|
| Market price per share on 1 February 2002 | CU100 |
| Market price per share on 31 December 2002 | CU104 |
| Market price per share on 31 January 2003 | CU104 |
| Fixed exercise price to be paid on 31 January 2003 | CU102 |
| Number of shares under option contract | 1,000 |
| Fair value of option on 1 February 2002 | CU5,000 |
| Fair value of option on 31 December 2002 | CU3,000 |
| Fair value of option on 31 January 2003 | CU2,000 |

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

IE13. On 1 February 2002, 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 31 January 2003 in exchange for CU102,000 in cash (i.e. CU102 per share) on 31 January 2003, 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.

1 February 2002

The price per share when the contract is agreed on 1 February 2002 is CU100. The initial fair value of the option contract on 1 February 2002 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.

31 December 2002

On 31 December 2002, 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.

31 January 2003

On 31 January 2003, 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:

31 January 2003

Entity A exercises the call option and the contract is settled net in shares. Entity B has an obligation to deliver CU104,000 ($\text{CU}104 \times 1,000$) worth of Entity A's shares to Entity A in exchange for CU102,000 ($\text{CU}102 \times 1,000$) worth of Entity A's shares. Thus, Entity B delivers the net amount of CU2,000 worth of shares to Entity A, that is, 19.2 shares ($\text{CU}2,000 \div \text{CU}104$).

| | | | |
|----|-------------------|---------|---------|
| Dr | 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 ($\text{CU}102 \times 1,000$) in cash, if Entity A exercises its option. Entity A records the following journal entries.

1 February 2002

| | | | |
|----|--------|---------|---------|
| Dr | 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 equity.

31 December 2002

No entry is made on 31 December 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.

31 January 2003

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 | 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 | 1 February 2002 |
| Exercise date | 31 January 2003 (European terms, i.e. it can be exercised only at maturity) |
| Exercise right holder | Counterparty (Entity B) |
| Market price per share on 1 February 2002 | CU100 |
| Market price per share on 31 December 2002 | CU104 |
| Market price per share on 31 January 2003 | CU104 |
| Fixed exercise price to be received on 31 January 2003 | CU102 |
| Number of shares under option contract | 1,000 |

| | |
|--|---------|
| Fair value of option on 1 February 2002 | CU5,000 |
| Fair value of option on 31 December 2002 | CU3,000 |
| Fair value of option on 31 January 2003 | 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 1 February 2002 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 31 January 2003 in exchange for CU102,000 in cash (i.e. CU102 per share) on 31 January 2003, 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.

1 February 2002

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

To recognise the written call option.

31 December 2002

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

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

31 January 2003

| | | | |
|----|------------------------|---------|---------|
| 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 ($\text{CU}104 \times 1,000$) to Entity B in exchange for CU102,000 ($\text{CU}102 \times 1,000$) 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:

31 January 2003

Entity B exercises the call option and the contract is settled net in shares. Entity A has an obligation to deliver CU104,000 ($\text{CU}104 \times 1,000$) worth of Entity A's shares to Entity B in exchange for CU102,000 ($\text{CU}102 \times 1,000$) worth of Entity A's shares. Thus, Entity A delivers the net amount of CU2,000 worth of shares to Entity B, that is, 19.2 shares ($\text{CU}2,000 \div \text{CU}104$).

| | | | |
|----|------------------------|---------|---------|
| Dr | Call option obligation | CU2,000 | |
| Cr | Equity | | CU2,000 |

To record the settlement of the option contract. The settlement is accounted for as an equity transaction.

(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 (CU102 × 1,000) in cash, if Entity B exercises its option. Entity A records the following journal entries.

1 February 2002

| | | | |
|----|--------|---------|---------|
| Dr | Cash | CU5,000 | |
| Cr | 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 equity. Upon exercise, the call would result in the issue of a fixed number of shares in exchange for a fixed amount of cash.

31 December 2002

No entry is made on 31 December 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.

31 January 2003

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 | |
| Cr | Equity | | CU102,000 |

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 | 1 February 2002 |
| Exercise date | 31 January 2003 (European terms, i.e. it can be exercised only at maturity) |
| Exercise right holder | Reporting entity (Entity A) |
| Market price per share on 1 February 2002 | CU100 |
| Market price per share on 31 December 2002 | CU95 |
| Market price per share on 31 January 2003 | CU95 |
| Fixed exercise price to be received on 31 January 2003 | CU98 |
| Number of shares under option contract | 1,000 |
| Fair value of option on 1 February 2002 | CU5,000 |
| Fair value of option on 31 December 2002 | CU4,000 |
| Fair value of option on 31 January 2003 | CU3,000 |

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

IE23. On 1 February 2002, 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 31 January 2003 at a strike price of CU98,000 (i.e. CU98 per share) on 31 January 2003, 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.

1 February 2002

The price per share when the contract is agreed on 1 February 2002 is CU100. The initial fair value of the option contract on 1 February 2002 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 | |
| Cr | Cash | | CU5,000 |

To recognise the purchased put option.

31 December 2002

On 31 December 2002 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 | |
| Cr | Put option asset | | CU1,000 |

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

31 January 2003

On 31 January 2003 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 | |
| Cr | Put option asset | | CU1,000 |

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:

31 January 2003

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, that is, 31.6 shares ($\text{CU}3,000 \div \text{CU}95$).

| | | | |
|----|------------------|---------|---------|
| Dr | 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.

1 February 2002

| | | | |
|----|--------|---------|---------|
| Dr | 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 equity. Upon exercise, it results in the issue of a fixed number of shares in exchange for a fixed price.

31 December 2002

No entry is made on 31 December 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.

31 January 2003

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 | 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 | 1 February 2002 |
| Exercise date | 31 January 2003 (European terms, i.e. it can be exercised only at maturity) |
| Exercise right holder | Counterparty (Entity B) |
| Market price per share on 1 February 2002 | CU100 |
| Market price per share on 31 December 2002 | CU95 |
| Market price per share on 31 January 2003 | CU95 |
| Fixed exercise price to be paid on 31 January 2003 | CU98 |
| Present value of exercise price on 1 February 2002 | CU95 |
| Number of shares under option contract | 1,000 |
| Fair value of option on 1 February 2002 | CU5,000 |
| Fair value of option on 31 December 2002 | CU4,000 |
| Fair value of option on 31 January 2003 | 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 1 February 2002, 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 31 January 2003 in exchange for CU98,000 in cash (i.e. CU98 per share) on 31 January 2003, 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.

1 February 2002

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

To recognise the written put option.

31 December 2002

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

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

31 January 2003

| | | | |
|----|----------------------|---------|---------|
| 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:

31 January 2003

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 x 1,000) to Entity A. Thus, Entity A delivers the net amount of CU3,000 worth of Entity A's shares to Entity B, that is, 31.6 shares (3,000 ÷ 95).

| | | | |
|----|----------------------|---------|---------|
| Dr | Put option liability | CU3,000 | |
| Cr | Equity | | CU3,000 |

To record the settlement of the option contract. The issue of Entity A's own shares is accounted for as an equity transaction.

(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 × 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.

1 February 2002

| | | | |
|----|--------|---------|---------|
| Dr | Cash | CU5,000 | |
| Cr | Equity | | CU5,000 |

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

| | | | |
|----|-----------|----------|----------|
| Dr | Equity | CU95,000 | |
| Cr | Liability | | CU95,000 |

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

31 December 2002

| | | | |
|----|------------------|---------|---------|
| Dr | Interest expense | CU2,750 | |
| Cr | Liability | | CU2,750 |

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

31 January 2003

| | | | |
|----|------------------|-------|-------|
| 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 Equity as Defined in AASB 132

Example 7: Entities with no equity

IE32. The following example illustrates an income statement and balance sheet format that may be used by entities such as mutual funds that do not have equity as defined in AASB 132. Other formats are possible.

Income statement for the year ended 31 December 20x1

| | <i>20x1</i> | <i>20x0</i> |
|--|---------------------|---------------------|
| | CU | CU |
| Revenue | 2,956 | 1,718 |
| Expenses (classified by nature or function) | <u>(644)</u> | <u>(614)</u> |
| Profit from operating activities | 2,312 | 1,104 |
| Finance costs | (47) | (47) |
| – other finance costs | | |
| – distributions to unitholders | <u>(50)</u> | <u>(50)</u> |
| Change in net assets attributable to unitholders | <u><u>2,215</u></u> | <u><u>1,007</u></u> |

Balance sheet at 31 December 20x1

| | 20x1 | | 20x0 | |
|--|-------------|---------------|-------------|---------------|
| | CU | CU | CU | CU |
| ASSETS | | | | |
| Non-current assets (classified in accordance with AASB 101 <i>Presentation of Financial Statements</i>) | | | | |
| | | 91,374 | | 78,484 |
| Total non-current assets | | 91,374 | | 78,484 |
| Current assets (classified in accordance with AASB 101) | | | | |
| | | 1,422 | | 1,769 |
| Total current assets | | 1,422 | | 1,769 |
| Total assets | | 92,796 | | 80,253 |
| LIABILITIES | | | | |
| Current liabilities (classified in accordance with AASB 101) | | | | |
| | | 647 | | 66 |
| Total current liabilities | | (647) | | (66) |
| Non-current liabilities excluding net assets attributable to unitholders (classified in accordance with AASB 101) | | | | |
| | | 280 | | 136 |
| | | (280) | | (136) |
| Net assets attributable to unitholders | | <u>91,869</u> | | <u>80,051</u> |

Example 8: Entities with some equity

IE33. The following example illustrates an income statement and balance sheet format that may be used by entities whose share capital is not equity as defined in AASB 132 because the entity has an obligation to repay the share capital on demand. Other formats are possible.

Income statement for the year ended 31 December 20x1

| | <i>20x1</i> | <i>20x0</i> |
|--|--------------|--------------|
| | CU | CU |
| Revenue | 472 | 498 |
| Expenses (classified by nature or function) | <u>(367)</u> | <u>(396)</u> |
| Profit from operating activities | 105 | 102 |
| Finance costs— other finance costs | (4) | (4) |
| — distributions to members | <u>(50)</u> | <u>(50)</u> |
| Change in net assets attributable to members | <u>51</u> | <u>48</u> |

Balance sheet at 31 December 20x1

| | <i>20x1</i> | | <i>20x0</i> | |
|--|-------------|--------------|-------------|--------------|
| | CU | CU | CU | CU |
| ASSETS | | | | |
| Non-current assets (classified in accordance with AASB 101) | <u>908</u> | | <u>830</u> | |
| Total non-current assets | | 908 | | 830 |
| Current assets (classified in accordance with AASB 101) | <u>383</u> | | <u>350</u> | |
| Total current assets | | <u>383</u> | | <u>350</u> |
| Total assets | | 1,291 | | 1,180 |
| LIABILITIES | | | | |
| Current liabilities (classified in accordance with AASB 101) | 372 | | 338 | |
| Share capital repayable on demand | <u>202</u> | | <u>161</u> | |
| Total current liabilities | | <u>(574)</u> | | <u>(499)</u> |
| Total assets less current liabilities | | <u>717</u> | | <u>681</u> |
| Non-current liabilities (classified in accordance with AASB 101) | <u>187</u> | | <u>196</u> | |
| | | 187 | | 196 |

RESERVES²

| | | |
|--|------------|------------|
| Reserves for example, revaluation reserve, retained earnings etc | <u>530</u> | <u>485</u> |
| | <u>530</u> | <u>485</u> |
| | <u>717</u> | <u>681</u> |

MEMORANDUM NOTE – Total Members' Interests

| | | |
|-----------------------------------|------------|------------|
| Share capital repayable on demand | 202 | 161 |
| Reserves | <u>530</u> | <u>485</u> |
| | <u>732</u> | <u>646</u> |

Accounting for Compound Financial Instruments

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

IE34. Paragraph 28 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.

² In this example, the entity has no obligation to deliver a share of its reserves to its members.

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 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 | <u>303,755</u> |
| Total liability component | 1,848,122 |
| Equity component (by deduction) | <u>151,878</u> |
| Proceeds of the bond issue | <u><u>2,000,000</u></u> |

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

IE37. The following example illustrates the application of paragraph 31 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.

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 31 is CU55 (CU57 – CU2) and the value allocated to the equity component is CU5 (CU60 – CU55).

Example 11: 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 its liability and equity components in the financial statements, that is, no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.

IE40. On 1 January 1999, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 maturing on 31 December 2008. 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 nonconvertible 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 |
| | 940 |
| Equity component | |
| (difference between CU1,000 total proceeds and CU940 allocated above) | 60 |
| Total proceeds | 1,000 |

IE42. On 1 January 2004, 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 | <u>585</u> | <u>676</u> | |
| | 962 | 1,081 | (119) |
| Equity component | <u>60</u> | <u>619³</u> | <u>(559)</u> |
| Total | <u>1,022</u> | <u>1,700</u> | <u>(678)</u> |

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

| | | |
|---|-------|---------|
| Dr Liability component | CU962 | |
| Dr Debt settlement expense (income statement) | CU119 | |
| Cr Cash | | CU1,081 |

To recognise the repurchase of the liability component.

| | | |
|-----------|-------|-------|
| Dr Equity | CU619 | |
| Cr Cash | | CU619 |

To recognise the cash paid for the equity component.

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

³ This amount represents the differences between the fair value amount allocated to the liability component and the repurchase price of CU1,700.

Example 12: 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 1 January 1999, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 with the same terms as described in Example 11. On 1 January 2000, to induce the holder to convert the convertible debenture promptly, Entity A reduces the conversion price to CU20 if the debenture is converted before 1 March 2000 (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> 50 shares</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 issued upon conversion | <u> 40 shares</u> |

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

 10 shares

Value of incremental ordinary shares issued upon conversion

CU40 per share × 10 incremental shares CU400

IE50. The incremental consideration of CU400 is recognised as a loss in profit or loss.