

**Compiled Accounting Standard**

**AASB 139**

# **Financial Instruments: Recognition and Measurement**

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This compiled Standard applies to annual reporting periods beginning on or after 1 January 2007 but before 1 July 2007 that end on or after 1 July 2008. Early application is not permitted. It incorporates relevant amendments made up to and including 18 December 2008.

Prepared on 17 July 2009 by the staff of the Australian Accounting Standards Board.



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IMPLEMENTATION GUIDANCE  
(available on the AASB website)

BASIS FOR CONCLUSIONS ON IAS 39  
(available on the AASB website)

Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* (as amended) is set out in paragraphs 1 – 108B and Appendix A. All the paragraphs have equal authority. Terms defined in this Standard are in *italics* the first time they appear in the Standard. AASB 139 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 139 *Financial Instruments: Recognition and Measurement as amended***

This compiled Standard applies to annual reporting periods beginning on or after 1 January 2007 but before 1 July 2007 that end on or after 1 July 2008. It takes into account amendments up to and including 18 December 2008 and was prepared on 17 July 2009 by the staff of the Australian Accounting Standards Board (AASB).

This compilation is not a separate Accounting Standard made by the AASB. Instead, it is a representation of AASB 139 (July 2004) as amended by other Accounting Standards, which are listed in the Table below.

**Table of Standards**

<b>Standard</b>	<b>Date made</b>	<b>Application date (annual reporting periods ... on or after ...)</b>	<b>Application, saving or transitional provisions</b>
AASB 139	15 Jul 2004	<i>(beginning)</i> 1 Jan 2005	
AASB 2004-2	22 Dec 2004	<i>(beginning)</i> 1 Jan 2005	–
AASB 2005-1	5 May 2005	<i>(beginning)</i> 1 Jan 2006	see (a) below
AASB 2005-4	9 Jun 2005	<i>(beginning)</i> 1 Jan 2006	see (a) below
AASB 2005-5	9 Jun 2005	<i>(beginning)</i> 1 Jan 2006	see (a) below
AASB 2005-9	6 Sep 2005	<i>(beginning)</i> 1 Jan 2006	see (a) below
AASB 2005-10	5 Sep 2005	<i>(beginning)</i> 1 Jan 2007	see (b) below
AASB 2005-11	8 Sep 2005	<i>(ending)</i> 31 Dec 2005	see (c) below
Erratum	24 Feb 2006	<i>(ending)</i> 24 Feb 2006	see (d) below
AASB 2007-2	15 Feb 2007	<i>(ending)</i> 28 Feb 2007	see (e) below
AASB 2007-4	30 Apr 2007	<i>(beginning)</i> 1 Jul 2007	not compiled*
AASB 2007-8	24 Sep 2007	<i>(beginning)</i> 1 Jan 2009	not compiled*
AASB 2007-10	13 Dec 2007	<i>(beginning)</i> 1 Jan 2009	not compiled*
AASB 2008-2	5 Mar 2008	<i>(beginning)</i> 1 Jan 2009	not compiled*
AASB 2008-3	6 Mar 2008	<i>(beginning)</i> 1 Jul 2009	not compiled*
AASB 2008-5	24 Jul 2008	<i>(beginning)</i> 1 Jan 2009	not compiled*
AASB 2008-8	27 Aug 2008	<i>(beginning)</i> 1 Jul 2009	not compiled*
AASB 2008-10	22 Oct 2008	<i>(ending)</i> 1 Jul 2008	see (f) below
AASB 2008-12	18 Dec 2008	<i>(ending)</i> 1 Jul 2008	see (f) below
AASB 2009-3	22 Apr 2009	<i>(ending)</i> 30 Jun 2009	not compiled*
AASB 2009-5	21 May 2009	<i>(beginning)</i> 1 Jan 2010	not compiled*

<b>Standard</b>	<b>Date made</b>	<b>Application date (annual reporting periods ... on or after ...)</b>	<b>Application, saving or transitional provisions</b>
AASB 2009-6	25 Jun 2009	(beginning) 1 Jan 2009 and (ending) 30 Jun 2009	not compiled*
AASB 2009-7	25 Jun 2009	(beginning) 1 Jul 2009	not compiled*

\* The amendments made by this Standard are not included in this compilation, which presents the principal Standard as applicable to annual reporting periods beginning on or after 1 January 2007 but before 1 July 2007 that end on or after 1 July 2008.

- (a) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2006.
- (b) Entities may elect to apply this Standard to annual reporting periods beginning on or after 1 January 2005 but before 1 January 2007.
- (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.
- (d) Entities may elect to apply the Erratum amendments to annual reporting periods beginning on or after 1 January 2005 that end before 24 February 2006.
- (e) Entities may elect to apply the relevant amendments to annual reporting periods beginning on or after 1 January 2005 that end before 28 February 2007.
- (f) Entities are not permitted to apply this Standard to earlier annual reporting periods.

#### **Table of Amendments**

<b>Paragraph affected</b>	<b>How affected</b>	<b>By ... [paragraph]</b>
1	amended	AASB 2005-10 [30]
2	amended amended amended	AASB 2005-5 [11] AASB 2005-9 [15] Erratum, Feb 2006
3	deleted	AASB 2005-9 [16]
4	amended	AASB 2005-9 [17]
8	amended	Erratum, Feb 2006
9	amended amended amended	AASB 2005-4 [7] AASB 2005-9 [18] AASB 2005-10 [31]
11A	added	AASB 2005-4 [8]
12	amended	AASB 2005-4 [9]
13	amended	AASB 2005-4 [9]
15	amended	AASB 2007-2 [10]
45	amended	AASB 2005-10 [32]
47	amended	AASB 2005-9 [19]
48	amended	AASB 2005-10 [33]

<b>Paragraph affected</b>	<b>How affected</b>	<b>By ... [paragraph]</b>
48A	added	AASB 2005-4 [10]
50	amended	AASB 2008-10 [6]
50B-50F	added	AASB 2008-10 [7]
80	amended	AASB 2005-1 [6]
88	amended	Erratum, Feb 2006
Heading after 102	amended	AASB 2005-1 [7]
103A-103B	note added	AASB 2005-9 [20]
Aus103H-Aus103I	added	AASB 2008-12 [5]
105	amended	AASB 2005-4 [11]
105A-105D	added	AASB 2005-4 [11]
108A-108B	added	AASB 2005-1 [8]
AG4	renumbered as AG3A renumbered from AG4A amended	AASB 2005-9 [21]
AG4A	renumbered as AG4 added	AASB 2005-9 [21] AASB 2005-9 [22]
AG4B-AG4K (and headings)	added	AASB 2005-4 [12]
AG8	amended amended	AASB 2008-10 [8] AASB 2008-12 [6]
AG23	amended	Erratum, Feb 2006
AG33A-AG33B (and preceding heading)	added	AASB 2005-4 [13]
AG51	amended	Erratum, Feb 2006
AG52	amended	AASB 2005-11 [14]
AG64	amended	Erratum, Feb 2006
AG66	amended	AASB 2005-11 [15]
AG76A	added	AASB 2004-2 [16]
AG77	amended	Erratum, Feb 2006
AG99A-AG99B	renumbered as AG99C- AG99D added	AASB 2005-1 [9]
AG133 (and preceding heading)	added	AASB 2005-1 [10]

## **COMPARISON WITH IAS 39**

### **AASB 139 and IAS 39**

AASB 139 *Financial Instruments: Recognition and Measurement* as amended incorporates IAS 39 *Financial Instruments: Recognition and Measurement* as issued and amended by the International Accounting Standards Board (IASB). Paragraphs that have been added to this Standard (and do not appear in the text of IAS 39) are identified with the prefix “Aus”, followed by the number of the preceding IASB paragraph and decimal numbering.

### **Compliance with IAS 39**

Entities that comply with AASB 139 as amended will simultaneously be in compliance with IAS 39 as amended.

## **ACCOUNTING STANDARD AASB 139**

The Australian Accounting Standards Board made Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* under section 334 of the *Corporations Act 2001* on 15 July 2004.

This compiled version of AASB 139 applies to annual reporting periods beginning on or after 1 January 2007 but before 1 July 2007 that end on or after 1 July 2008. It incorporates relevant amendments contained in other AASB Standards made by the AASB and other decisions of the AASB up to and including 18 December 2008 (see Compilation Details).

## **ACCOUNTING STANDARD AASB 139**

### ***FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT***

#### **Objective**

- 1 The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in AASB 132 *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in AASB 7 *Financial Instruments: Disclosures*.

#### **Application**

**Aus1.1 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.**

**Aus1.2 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.]

**Aus1.3 This Standard shall not be applied to annual reporting periods beginning before 1 January 2005.**

**Aus1.4 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*.**

Aus1.5 Notice of this Standard was published in the *Commonwealth of Australia Gazette* No S 294, 22 July 2004.

## Scope

**2 This Standard shall be applied by all entities 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 this Standard. Entities shall also apply this Standard to *derivatives* on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in AASB 132;**
- (b) rights and obligations under leases to which AASB 117 *Leases* applies. However:**
  - (i) lease receivables recognised by a lessor are subject to the *derecognition* and impairment provisions of this Standard (see paragraphs 15-37 and 58, 59, 63-65 and Appendix A paragraphs AG36-AG52 and AG84-AG93);**
  - (ii) finance lease payables recognised by a lessee are subject to the *derecognition* provisions of this Standard (see paragraphs 39-42 and Appendix A paragraphs AG57-AG63); and**

- (iii) derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 10-13 and Appendix A paragraphs AG27-AG33);
- (c) employers' rights and obligations under employee benefit plans, to which AASB 119 *Employee Benefits* applies;
- (d) financial instruments issued by the entity that meet the definition of an equity instrument in AASB 132 (including options and warrants). However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above;
- (e) rights and obligations arising under (i) an insurance contract as defined in AASB 4 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii) a contract that is within the scope of AASB 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of AASB 4 if the derivative is not itself a contract within the scope of AASB 4 (see paragraphs 10-13 and Appendix A paragraphs AG27-AG33). Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or AASB 1023 *General Insurance Contracts* to such financial guarantee contracts (see paragraphs AG4 and AG4A). The issuer may make that election contract by contract, but the election for each contract is irrevocable;
- (f) contracts for contingent consideration in a business combination (see AASB 3 *Business Combinations*). This exemption applies only to the acquirer;
- (g) contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date;
- (h) loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard

(see paragraphs 15-42 and Appendix A paragraphs AG36-AG63);

- (i) financial instruments, contracts and obligations under share-based payment transactions to which AASB 2 *Share-based Payment* applies, except for contracts within the scope of paragraphs 5-7 of this Standard, to which this Standard applies; and
- (j) rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognises as a provision in accordance with AASB 137, or for which, in an earlier period, it recognised a provision in accordance with AASB 137.

3 [Deleted by the IASB]

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

- (a) loan commitments that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class;
- (b) loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (e.g. a mortgage construction loan that is paid out in instalments in line with the progress of construction); and
- (c) commitments to provide a loan at a below-market interest rate. Paragraph 47(d) specifies the subsequent measurement of liabilities arising from these loan commitments.

5 **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or in 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 receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.**

- 6 There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:
- (a) when the terms of the contract permit either party to settle it net in cash or in another financial instrument or by exchanging financial instruments;
  - (b) when the ability to settle net in cash or in 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) and (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and accordingly, is within the scope of this Standard. Other contracts to which paragraph 5 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and accordingly, whether they are within the scope of this Standard.

- 7 A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 6(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

8 The terms defined in AASB 132 are used in this Standard with the meanings specified in paragraph 11 of AASB 132. AASB 132 defines the following terms:

- (a) financial instrument;
- (b) financial asset;
- (c) financial liability; and
- (d) equity instrument;

and provides guidance on applying those definitions.

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

### Definition of a Derivative

**A *derivative* is a financial instrument or other contract within the scope of this Standard (see paragraphs 2-7) with all three of the following characteristics:**

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

### Definitions of Four Categories of Financial Instruments

**A *financial asset or financial liability at fair value through profit or loss* is a financial asset or financial liability that meets either of the following conditions:**

- (a) **it is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:**
  - (i) **acquired or incurred principally for the purpose of selling or repurchasing it in the near term;**
  - (ii) **part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or**
  - (iii) **a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument); or**
- (b) **upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either:**
  - (i) **it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or**
  - (ii) **a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in AASB 124 *Related Party Disclosures*), for example the entity’s board of directors and chief executive officer.**

**In AASB 7, paragraphs 9-11 and B4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is**

consistent with the entity's documented risk management or investment strategy.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81), shall not be designated as at fair value through profit or loss.

It should be noted that paragraphs 48, 48A, 49 and Appendix A paragraphs AG69-AG82, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.

*Held-to-maturity investments* are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG16-AG25) other than:

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

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

- (i) are so close to maturity or the financial asset's call date (e.g. less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value;
- (ii) occur after the entity has collected substantially all of the financial asset's original principal

through scheduled payments or prepayments;  
or

- (iii) are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

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

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

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

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

### **Definition of a Financial Guarantee Contract**

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

## Definitions Relating to Recognition and Measurement

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

The *effective interest method* is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see AASB 118), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

*Derecognition* means the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

***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.<sup>1</sup>

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

***Transaction costs*** are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

## **Definitions Relating to Hedge Accounting**

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

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

***A hedging instrument*** is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 72-77 and Appendix A paragraphs AG94-AG97 elaborate on the definition of a hedging instrument).

***A hedged item*** is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 78-84 and Appendix A paragraphs AG98-AG101 elaborate on the definition of hedged items).

***Hedge effectiveness*** is the degree to which changes in fair value or cash flows attributable to a hedged risk are offset by

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<sup>1</sup> Paragraphs 48, 49 and AG69-AG82 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.

**changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105-AG113).**

## **Embedded Derivatives**

- 10 An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.
- 11 **An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:**
- (a) **the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG33);**
  - (b) **a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and**
  - (c) **the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a *financial asset or financial liability at fair value through profit or loss* is not separated).**

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

- 11A **Notwithstanding paragraph 11, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid**

**(combined) contract as a financial asset or financial liability at fair value through profit or loss unless:**

- (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or**
- (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.**

- 12 If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss.**
- 13 If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 12 applies and the hybrid (combined) instrument is designated as at fair value through profit or loss.

## **Recognition and Derecognition**

### **Initial Recognition**

- 14 An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)**

### **Derecognition of a Financial Asset**

- 15 In consolidated financial statements, paragraphs 16-23 and Appendix A paragraphs AG34-AG52 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with AASB 127 and the Interpretation 112 *Consolidation – Special*

*Purpose Entities* as identified in AASB 1048 *Interpretation and Application of Standards*, and then applies paragraphs 16-23 and Appendix A paragraphs AG34-AG52 to the resulting group.

- 16** Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17-23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows:
- (a) Paragraphs 17-23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions:
    - (i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17-23 are applied to the interest cash flows.
    - (ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all principal and interest cash flows of a debt instrument, paragraphs 17-23 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.
    - (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 17-23 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not

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

- (b) In all other cases, paragraphs 17-23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 17-23 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 17-26, the term 'financial asset' refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

**17** An entity shall derecognise a financial asset when, and only when:

- (a) the contractual rights to the cash flows from the financial asset expire; or
- (b) it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.

(See paragraph 38 for regular way sales of financial assets.)

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

- (a) transfers the contractual rights to receive the cash flows of the financial asset; or
- (b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.

**19** When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction

as a transfer of a financial asset if, and only if, all of the following three conditions are met.

- (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
- (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
- (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in AASB 107 *Cash Flow Statements*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

20 When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

- (a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer;
- (b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset;
- (c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:
  - (i) if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer;

- (ii) **if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 30).**

- 21 The transfer of risks and rewards (see paragraph 20) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g. because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sales price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (e.g. because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 19).
- 22 Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison is made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.
- 23 Whether the entity has retained control (see paragraph 20(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

**Transfers that Qualify for Derecognition  
(see paragraphs 20(a) and (c)(i))**

- 24 **If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the**

financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 27.

- 25 If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognise the new financial asset, financial liability or servicing liability at fair value.
- 26 On derecognition of a financial asset in its entirety, the difference between:
- (a) the carrying amount; and
  - (b) the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised directly in equity (see paragraph 55(b));

shall be recognised in profit or loss.

- 27 If the transferred asset is part of a larger financial asset (e.g. when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 16(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:
- (a) the carrying amount allocated to the part derecognised; and
  - (b) the sum of (i) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognised directly in equity (see paragraph 55(b));

shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in equity is allocated between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts.

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

**Transfers that Do Not Qualify for Derecognition (see paragraph 20(b))**

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

**Continuing Involvement in Transferred Assets (see paragraph 20(c)(ii))**

- 30 If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:
- (a) when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount');

- (b) when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG48); and
  - (c) when the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.
- 31 When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured such that the net carrying amount of the transferred asset and the associated liability is:
  - (a) the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or
  - (b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.
- 32 The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.
- 33 For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 55, and shall not be offset.
- 34 If an entity's continuing involvement is in only a part of a financial asset (e.g. when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the

**previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises based on the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 28 apply. The difference between:**

- (a) the carrying amount allocated to the part that is no longer recognised; and**
- (b) the sum of (i) the consideration received for the part no longer recognised and (ii) any cumulative gain or loss allocated to it that had been recognised directly in equity (see paragraph 55(b));**

**shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in equity is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts.**

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

#### **All Transfers**

- 36 **If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability (see AASB 132, paragraph 42).**
- 37 **If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows.**
- (a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its balance sheet (e.g. as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.**
  - (b) If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.**

- (c) **If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.**
- (d) **Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.**

### **Regular Way Purchase or Sale of a Financial Asset**

- 38** *A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see Appendix A paragraphs AG53-AG56).*

### **Derecognition of a Financial Liability**

- 39** **An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished – that is, when the obligation specified in the contract is discharged or cancelled or expires.**
- 40** **An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.**
- 41** **The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.**
- 42** **If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid,**

including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

## Measurement

### Initial Measurement of Financial Assets and Financial Liabilities

- 43 **When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.**
- 44 When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see Appendix A paragraphs AG53-AG56).

### Subsequent Measurement of Financial Assets

- 45 For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 9:
- (a) financial assets at fair value through profit or loss;
  - (b) *held-to-maturity investments*;
  - (c) *loans and receivables*; and
  - (d) *available-for-sale financial assets*.

These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisations when presenting information on the face of the financial statements. The entity shall disclose in the notes the information required by AASB 7.

- 46 **After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:**

- (a) loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the *effective interest method*;
- (b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and
- (c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

Financial assets that are designated as *hedged items* are subject to measurement under the hedge accounting requirements in paragraphs 89-102. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 58-70, and Appendix A paragraphs AG84-AG93.

### **Subsequent Measurement of Financial Liabilities**

- 47 After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:
- (a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured which shall be measured at cost;
  - (b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 apply to the measurement of such financial liabilities;
  - (c) financial guarantee contracts as defined in paragraph 9. After initial recognition, an issuer of such a contract shall (unless paragraph 47(a) or (b) applies) measure it at the higher of:

- (i) **the amount determined in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*; and**
  - (ii) **the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with AASB 118 *Revenue*; and**
- (d) **commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 47(a) applies) measure it at the higher of:**
- (i) **the amount determined in accordance with AASB 137; and**
  - (ii) **the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with AASB 118.**

**Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 89-102.**

### **Fair Value Measurement Considerations**

**48 In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, AASB 132 or AASB 7, an entity shall apply paragraphs AG69-AG82 of Appendix A.**

48A The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted

economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on any available observable market data.

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

## **Reclassifications**

### **50 An entity:**

- (a) **shall not reclassify a derivative out of the fair value through profit or loss category while it is held or issued;**
- (b) **shall not reclassify any financial instrument out of the fair value through profit or loss category if upon initial recognition it was designated by the entity as at fair value through profit or loss; and**
- (c) **may, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term (notwithstanding that the financial asset may have been acquired or incurred principally for the purpose of selling or repurchasing it in the near term), reclassify that financial asset out of the fair value through profit or loss category if the requirements in paragraph 50B or 50D are met.**

**An entity shall not reclassify any financial instrument into the fair value through profit or loss category after initial recognition.**

- 50B A financial asset to which paragraph 50(c) applies (except a financial asset of the type described in paragraph 50D) may be reclassified out of the fair value through profit or loss category only in rare circumstances.
- 50C If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50B, the financial asset shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in profit or loss shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

- 50D A financial asset to which paragraph 50(c) applies that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the fair value through profit or loss category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.
- 50E A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available-for-sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.
- 50F If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50D or out of the available-for-sale category in accordance with paragraph 50E, it shall reclassify the financial asset at its fair value on the date of reclassification. For a financial asset reclassified in accordance with paragraph 50D, any gain or loss already recognised in profit or loss shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable. For a financial asset reclassified out of the available-for-sale category in accordance with paragraph 50E, any previous gain or loss on that asset that has been recognised in other comprehensive income in accordance with paragraph 55(b) shall be accounted for in accordance with paragraph 54.
- 51 If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held-to-maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).**
- 52 Whenever sales or reclassifications of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in paragraph 9, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).**
- 53 If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 46(c) and 47), the asset or liability shall be remeasured at fair value, and**

the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55.

- 54 If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 46(c) and 47) or because the ‘two preceding annual reporting periods’ referred to in paragraph 9 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost, as applicable. Any previous gain or loss on that asset that has been recognised directly in equity in accordance with paragraph 55(b) shall be accounted for as follows.
- (a) In the case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount shall also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in equity is recognised in profit or loss in accordance with paragraph 67.
  - (b) In the case of a financial asset that does not have a fixed maturity, the gain or loss shall remain in equity until the financial asset is sold or otherwise disposed of, when it shall be recognised in profit or loss. If the financial asset is subsequently impaired any previous gain or loss that has been recognised directly in equity is recognised in profit or loss in accordance with paragraph 67.

### **Gains and Losses**

- 55 A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 89-102), shall be recognised, as follows.
- (a) A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss shall be recognised in profit or loss.
  - (b) A gain or loss on an available-for-sale financial asset shall be recognised directly in equity, through the statement of

changes in equity (see AASB 101 *Presentation of Financial Statements*), except for impairment losses (see paragraphs 67-70) and foreign exchange gains and losses (see Appendix A paragraph AG83), until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss. However, interest calculated using the effective interest method (see paragraph 9) is recognised in profit or loss (see AASB 118). Dividends on an available-for-sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established (see AASB 118).

- 56 For financial assets and financial liabilities carried at amortised cost (see paragraphs 46 and 47), a gain or loss is recognised in profit or loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 78-84, and Appendix A paragraphs AG98-AG101) the accounting for the gain or loss shall follow paragraphs 89-102.
- 57 If an entity recognises financial assets using settlement date accounting (see paragraph 38 and Appendix A paragraphs AG53-AG56), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognised in profit or loss or in equity, as appropriate under paragraph 55.

### **Impairment and Uncollectibility of Financial Assets**

- 58 An entity shall assess at each reporting date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.
- 59 A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably

estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

- (a) significant financial difficulty of the issuer or obligor;
- (b) a breach of contract, such as a default or delinquency in interest or principal payments;
- (c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- (e) the disappearance of an active market for that financial asset because of financial difficulties; or
- (f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
  - (i) adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
  - (ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

60 The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment

when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (e.g. a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

- 61 In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.
- 62 In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, the entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly, an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

#### **Financial Assets Carried at Amortised Cost**

- 63 If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.**
- 64 An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed

financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

- 65** If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in profit or loss.

#### **Financial Assets Carried at Cost**

- 66** If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81). Such impairment losses shall not be reversed.

#### **Available-for-Sale Financial Assets**

- 67** When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that had been recognised directly in equity shall be removed from equity and recognised in profit or loss even though the financial asset has not been derecognised.
- 68** The amount of the cumulative loss that is removed from equity and recognised in profit or loss under paragraph 67 shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss.

- 69** Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.
- 70** If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss.

## Hedging

- 71** If there is a designated hedging relationship between a *hedging instrument* and a hedged item as described in paragraphs 85-88 and Appendix A paragraphs AG102-AG104, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 89-102.

## Hedging Instruments

### Qualifying Instruments

- 72** This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 88 are met, except for some written options (see Appendix A paragraph AG94). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.
- 73** For hedge accounting purposes, only instruments that involve a party external to the reporting entity (i.e. external to the group, segment or individual entity that is being reported on) can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any such intragroup transactions are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group or in segment reporting provided that they are external to the individual entity or segment that is being reported on.

## Designation of Hedging Instruments

- 74 There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:
- (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and
  - (b) separating the interest element and the spot price of a forward contract.

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

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

## Hedged Items

### Qualifying Items

- 78 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.
- 79 Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.
- 80 For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities or segments in the same group only in the individual or separate financial statements of those entities or segments and not in the consolidated financial statements of the group. As an exception, the foreign currency risk of an intragroup monetary item (e.g. a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with AASB 121 *The Effects of Changes in Foreign Exchange Rates*. In accordance with AASB 121, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

### **Designation of Financial Items as Hedged Items**

- 81 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).
- 81A In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (e.g. an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a nonprepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

### **Designation of Non-Financial Items as Hedged Items**

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

### Designation of Groups of Items as Hedged Items

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

### Hedge Accounting

- 85 Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.
- 86 **Hedging relationships are of three types:**
- (a) ***fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability, or firm commitment, that is attributable to a particular risk and could affect profit or loss;**
  - (b) ***cash flow hedge*: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss; and**
  - (c) ***hedge of a net investment in a foreign operation as defined in AASB 121.***
- 87 A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

- 88** A hedging relationship qualifies for hedge accounting under paragraphs 89-102 if, and only if, all of the following conditions are met.
- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
  - (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105-AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
  - (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
  - (d) The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 46 and 47 and Appendix A paragraphs AG80 and AG81 for guidance on determining fair value).
  - (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the reporting periods for which the hedge was designated.

#### **Fair Value Hedges**

- 89** If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:
- (a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with AASB 121 (for a non-

derivative hedging instrument) shall be recognised in profit or loss; and

- (b) **the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is an available-for-sale financial asset.**

89A For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 89(b) may be met by presenting the gain or loss attributable to the hedged item either:

- (a) in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or
- (b) in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

The separate line items referred to in (a) and (b) above shall be presented next to financial assets or financial liabilities. Amounts included in these line items shall be removed from the balance sheet when the assets or liabilities to which they relate are derecognised.

90 If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph 55.

**91 An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:**

- (a) **the hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy);**
- (b) **the hedge no longer meets the criteria for hedge accounting in paragraph 88; or**
- (c) **the entity revokes the designation.**

**92 Any adjustment arising from paragraph 89(b) to the carrying amount of a hedged financial instrument for which the effective**

**interest method is used (or, in the case of a portfolio hedge of interest rate risk, to the separate balance sheet line item described in paragraph 89A) shall be amortised to profit or loss.**

**Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortising using a recalculated effective interest rate is not practicable, the adjustment shall be amortised using a straight-line method. The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.**

- 93 When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss (see paragraph 89(b)). The changes in the fair value of the hedging instrument are also recognised in profit or loss.
- 94 When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the balance sheet.

#### **Cash Flow Hedges**

- 95 **If a cash flow hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:**
- (a) **the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised directly in equity through the statement of changes in equity (see AASB 101); and**
  - (b) **the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.**

- 96 More specifically, a cash flow hedge is accounted for as follows:
- (a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
    - (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
    - (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;
  - (b) any remaining gain or loss on the hedging instrument or designated component of it (i.e. not an effective hedge) is recognised in profit or loss; and
  - (c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is recognised in accordance with paragraph 55.
- 97 **If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised directly in equity in accordance with paragraph 95 shall be reclassified into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised directly in equity will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered.**
- 98 **If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:**
- (a) **it reclassifies the associated gains and losses that were recognised directly in equity in accordance with paragraph 95 into profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation**

expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised directly in equity will not be recovered in one or more future periods, it shall reclassify into profit or loss the amount that is not expected to be recovered; or

- (b) it removes the associated gains and losses that were recognised directly in equity in accordance with paragraph 95, and includes them in the initial cost or other carrying amount of the asset or liability.

- 99 An entity shall adopt either (a) or (b) in paragraph 98 as its accounting policy and shall apply it consistently to all hedges to which paragraph 98 relates.
- 100 For cash flow hedges other than those covered by paragraphs 97 and 98, amounts that had been recognised directly in equity shall be recognised in profit or loss in the same period or periods during which the hedged forecast transaction affects profit or loss (e.g. when a forecast sale occurs).
- 101 In any of the following circumstances, an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95-100.
- (a) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that remains recognised directly in equity from the period when the hedge was effective (see paragraph 95(a)) shall remain separately recognised in equity until the forecast transaction occurs. When the transaction occurs, paragraphs 97, 98 or 100 applies.
  - (b) The hedge no longer meets the criteria for hedge accounting in paragraph 88. In this case, the cumulative gain or loss on the hedging instrument that remains recognised directly in equity from the period when the hedge was effective (see paragraph 95(a)) shall remain separately recognised in equity until the forecast transaction occurs. When the transaction occurs, paragraphs 97, 98 or 100 applies.
  - (c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that remains recognised directly in

equity from the period when the hedge was effective (see paragraph 95(a)) shall be recognised in profit or loss. A forecast transaction that is no longer highly probable (see paragraph 88(c)) may still be expected to occur.

- (d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognised directly in equity from the period when the hedge was effective (see paragraph 95(a)) shall remain separately recognised in equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraphs 97, 98 or 100 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognised directly in equity shall be recognised in profit or loss.

#### Hedges of a Net Investment

102 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see AASB 121), shall be accounted for similarly to cash flow hedges:

- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised directly in equity through the statement of changes in equity (see AASB 101); and
- (b) the ineffective portion shall be recognised in profit or loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in equity shall be recognised in profit or loss on disposal of the foreign operation.

#### Effective Date of AASB 139 and Transition

103 [Deleted by the AASB]

103A [Deleted by the AASB]

103B [Deleted by the AASB]

Aus103H *AASB 2008-10 Amendments to Australian Accounting Standards – Reclassification of Financial Assets*, issued in

November 2008, amended paragraphs 50 and AG8, and added paragraphs 50B-50F. An entity shall apply those amendments on or after 1 July 2008. An entity shall not reclassify a financial asset in accordance with paragraph 50B, 50D or 50E before 1 July 2008. Any reclassification of a financial asset made on or after 1 November 2008 shall take effect only from the date when the reclassification is made. Any reclassification of a financial asset in accordance with paragraph 50B, 50D or 50E shall not be applied retrospectively before 1 July 2008.

Aus103I *AASB 2008-12 Amendments to Australian Accounting Standards – Reclassification of Financial Assets – Effective Date and Transition*, issued in December 2008, amended paragraph Aus103H. An entity shall apply that amendment on or after 1 July 2008.

104 [Deleted by the AASB]

**105 When this Standard is first applied, an entity is permitted to designate a previously recognised financial asset as available for sale. For any such financial asset the entity shall recognise all cumulative changes in fair value in a separate component of equity until subsequent derecognition or impairment, when the entity shall transfer that cumulative gain or loss to profit or loss. The entity shall also:**

- (a) **restate the financial asset using the new designation in the comparative financial statements; and**
- (b) **disclose the fair value of the financial assets at the date of designation and their classification and carrying amount in the previous financial statements.**

**105A An entity shall apply paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the amendments made to paragraphs 9, 12 and 13 of this Standard by AASB 2005-4 for annual periods beginning on or after 1 January 2006. Earlier application is encouraged.**

**105B An entity that first applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the amendments made to paragraphs 9, 12 and 13 of this Standard by AASB 2005-4 in its annual period beginning before 1 January 2006:**

- (a) **is permitted, when those new and amended paragraphs are first applied, to designate as at fair value through profit or loss any previously recognised financial asset or financial liability that then qualifies for such designation. When the**

annual period begins before 1 September 2005, such designations need not be completed until 1 September 2005 and may also include financial assets and financial liabilities recognised between the beginning of that annual period and 1 September 2005. Notwithstanding paragraph 91, any financial assets and financial liabilities designated as at fair value through profit or loss in accordance with this subparagraph that were previously designated as the hedged item in fair value hedge accounting relationships shall be de-designated from those relationships at the same time they are designated as at fair value through profit or loss;

- (b) shall disclose the fair value of any financial assets or financial liabilities designated in accordance with subparagraph (a) at the date of designation and their classification and carrying amount in the previous financial statements;
- (c) shall de-designate any financial asset or financial liability previously designated as at fair value through profit or loss if it does not qualify for such designation in accordance with those new and amended paragraphs. When a financial asset or financial liability will be measured at amortised cost after de-designation, the date of de-designation is deemed to be its date of initial recognition; and
- (d) shall disclose the fair value of any financial assets or financial liabilities de-designated in accordance with subparagraph (c) at the date of de-designation and their new classifications.

**105C** An entity that first applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the amendments made to paragraphs 9, 12 and 13 of this Standard by AASB 2005-4 in its annual period beginning on or after 1 January 2006:

- (a) shall de-designate any financial asset or financial liability previously designated as at fair value through profit or loss only if it does not qualify for such designation in accordance with those new and amended paragraphs. When a financial asset or financial liability will be measured at amortised cost after de-designation, the date of de-designation is deemed to be its date of initial recognition;
- (b) shall not designate as at fair value through profit or loss any previously recognised financial assets or financial liabilities; and

- (c) shall disclose the fair value of any financial assets or financial liabilities de-designated in accordance with subparagraph (a) at the date of de-designation and their new classifications.

**105D** An entity shall restate its comparative financial statements using the new designations in paragraph 105B or 105C provided that, in the case of a financial asset, financial liability, or group of financial assets, financial liabilities or both, designated as at fair value through profit or loss, those items or groups would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the beginning of the comparative period or, if acquired after the beginning of the comparative period, would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the date of initial recognition.

106 [Deleted by the AASB]

107 [Deleted by the AASB]

108 [Deleted by the AASB]

**108A** An entity shall apply the last sentence of paragraph 80, and paragraphs AG99A and AG99B, for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity has designated as the hedged item an external forecast transaction that:

- (a) is denominated in the functional currency of the entity entering into the transaction;
- (b) gives rise to an exposure that will have an effect on consolidated profit or loss (i.e. is denominated in a currency other than the group's presentation currency); and
- (c) would have qualified for hedge accounting had it not been denominated in the functional currency of the entity entering into it;

it may apply hedge accounting in the consolidated financial statements in the period(s) before the date of application of the last sentence of paragraph 80, and paragraphs AG99A and AG99B.

**108B** An entity need not apply paragraph AG99B to comparative information relating to periods before the date of application of the last sentence of paragraph 80 and paragraph AG99A.

## **Withdrawal of Other Pronouncements**

109 [Deleted by the AASB]

110 [Deleted by the AASB]

## APPENDIX A

### APPLICATION GUIDANCE

*This Appendix is an integral part of AASB 139.*

#### **Scope (paragraph 2-7)**

- AG1 Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as ‘weather derivatives’.) If those contracts are not within the scope of AASB 4 *Insurance Contracts*, they are within the scope of this Standard.
- AG2 This Standard does not change the requirements relating to employee benefit plans that comply with AAS 25 *Financial Reporting by Superannuation Plans* and royalty agreements based on the volume of sales or service revenues that are accounted for under AASB 118 *Revenue*.
- AG3 Sometimes, an entity makes what it views as a ‘strategic investment’ in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor entity uses AASB 128 *Investments in Associates* or AASB 131 *Interests in Joint Ventures* to determine whether the equity method of accounting is appropriate for such an investment. Similarly, the investor entity uses to determine whether proportionate consolidation or the equity method is appropriate for such an investment. If the equity method is not appropriate, the entity applies this Standard to that strategic investment.
- AG3A This Standard applies to the financial assets and financial liabilities of insurers other than rights and obligations that paragraph 2(e) excludes because they arise under contracts within the scope of AASB 4.
- AG4 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)).
- (a) Although a financial guarantee contract meets the definition of an insurance contract in AASB 4 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such

contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or AASB 1023 to such financial guarantee contracts. If this Standard applies, paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29-37 and AG47-AG52 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

- (i) the amount determined in accordance with AASB 137; and
  - (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with AASB 118 (see paragraph 47(c)).
- (b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in AASB 4. Such guarantees are derivatives and the issuer applies this Standard to them.
- (c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies AASB 118 in determining when it recognises the revenue from the guarantee and from the sale of goods.

AG4A Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial report. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial report typically include a statement that the issuer has used those accounting requirements.

## Definitions (paragraphs 8 and 9)

### Designation as at Fair Value through Profit or Loss

- AG4B Paragraph 9 of this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.
- AG4C The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* requires the chosen policy to result in the financial report providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. In the case of designation as at fair value through profit or loss, paragraph 9 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 9, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

#### ***Paragraph 9(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise***

- AG4D Under AASB 139, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as available for sale (with most changes in fair value recognised directly in equity) and a liability the entity considers related would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial report would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.
- AG4E The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets

or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(i).

- (a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realised and/or unrealised investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through profit or loss means that changes in the fair value of the financial assets are recognised in profit or loss in the same period as related changes in the value of the liabilities.
- (b) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by AASB 4 *Insurance Contracts*, paragraph 24), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortised cost.
- (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (i.e. are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 are not met.
- (d) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:
  - (i) the entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale with fixed rate debentures whose changes in fair value tend to offset each other. Reporting both the assets and the debentures at fair value through profit or loss corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes reported in equity and the debentures at amortised cost; or

- (ii) the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

AG4F In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.

AG4G It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100<sup>1</sup> and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (e.g. individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (e.g. changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e. percentage) of a liability.

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<sup>1</sup> In this Standard, monetary amounts are denominated in 'currency units' (CU).

***Paragraph 9(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy***

AG4H An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

AG4I The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(ii).

- (a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value.

*AASB 128 Investments in Associates and AASB 131 Interests in Joint Ventures* allow such investments to be excluded from their scope provided they are measured at fair value through profit or loss. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of AASB 128 or AASB 131.

- (b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.

- (c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (i.e. interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 9(b)(ii)

may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 9(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (e.g. a year) or are subject to the insurer's discretion.

- AG4J As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.
- AG4K Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 9(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department – as approved by the entity's key management personnel – clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 9(b)(ii).

### **Effective Interest Rate**

- AG5 In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.
- AG6 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs, other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate, is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid or changes in market rates

since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

- AG7 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.
- AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense. If a financial asset is reclassified in accordance with paragraph 50B, 50D or 50E, and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognised as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

## **Derivatives**

- AG9 Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed

payment of CU1,000<sup>2</sup> if six-month LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

- AG10 The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g. a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g. a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 5-7).
- AG11 One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.
- AG12 A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 38 and AG53-AG56).
- AG12A The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

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

## **Transaction Costs**

AG13 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers, and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

## **Financial Assets and Financial Liabilities Held for Trading**

AG14 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

AG15 Financial liabilities held for trading include:

- (a) derivative liabilities that are not accounted for as hedging instruments;
- (b) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);
- (c) financial liabilities that are incurred with an intention to repurchase them in the near term (e.g. a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
- (d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

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

## **Held-to-Maturity Investments**

AG16 An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:

- (a) the entity intends to hold the financial asset for an undefined period;

- (b) the entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or
- (c) the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.

- AG17 A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants, and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.
- AG18 The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalised transaction costs in determining whether the carrying amount would be substantially recovered.
- AG19 A financial asset that is puttable (i.e. the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

- AG20 For most financial assets, fair value is a more appropriate measure than amortised cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 9 precludes the use of the exception for a reasonable period of time.
- AG21 A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.
- AG22 Sales before maturity could satisfy the condition in paragraph 9 – and therefore not raise a question about the entity's intention to hold other investments to maturity – if they are attributable to any of the following:
- (a) a significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable, and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 58 and 59), the deterioration in creditworthiness is often regarded as significant;
  - (b) a change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest income);
  - (c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the business combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk

position or credit risk policy may be consequential rather than anticipated);

- (d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment;
- (e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments; or
- (f) a significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.

AG23 An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

- (a) it does not have the financial resources available to continue to finance the investment until maturity; or
- (b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity – see paragraph AG18.)

AG24 Circumstances other than those described in paragraphs AG16-AG23 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

AG25 An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognised, but also at each subsequent reporting date.

## **Loans and Receivables**

AG26 Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, investments in debt instruments, and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph AG71) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 9 and AG16-AG25). On initial recognition of a financial asset that would

otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available for sale.

## **Embedded Derivatives (paragraphs 10-13)**

- AG27 If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.
- AG28 An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.
- AG29 Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see AASB 132 *Financial Instruments: Disclosure and Presentation*) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.
- AG30 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 11(a)) in the following examples. In these examples, assuming the conditions in paragraph 11(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.
- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.

- (b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under AASB 132, in which case it is excluded from the scope of this Standard).
- (c) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.
- (d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the value of equity instruments – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (e) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the price of a commodity (such as gold) – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under AASB 132).
- (g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance

contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under AASB 132.

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

AG31 An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a ‘puttable instrument’). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (i.e. the indexed principal payment) under paragraph 11 because the host contract is a debt instrument under paragraph AG27 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG30(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

AG32 In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the reporting date if the holder exercised its right to put the instrument back to the issuer.

AG33 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing

host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

- (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.
- (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g. a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because AASB 121 *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in profit or loss.
- (d) An embedded foreign currency derivative in a host contract that is an insurance contract or is not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
  - (i) the functional currency of any substantial party to the contract;
  - (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions);  
or

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

### **Instruments containing Embedded Derivatives**

AG33A When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that

reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.

AG33B Such designation may be used whether paragraph 11 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 11A would not justify designating the hybrid (combined) instrument as at fair value through profit or loss in the cases set out in paragraph 11A(a) and (b) because doing so would not reduce complexity or increase reliability.

## **Recognition and Derecognition (paragraphs 14-42)**

### **Initial Recognition (paragraph 14)**

AG34 As a consequence of the principle in paragraph 14, an entity recognises all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG49). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph AG50).

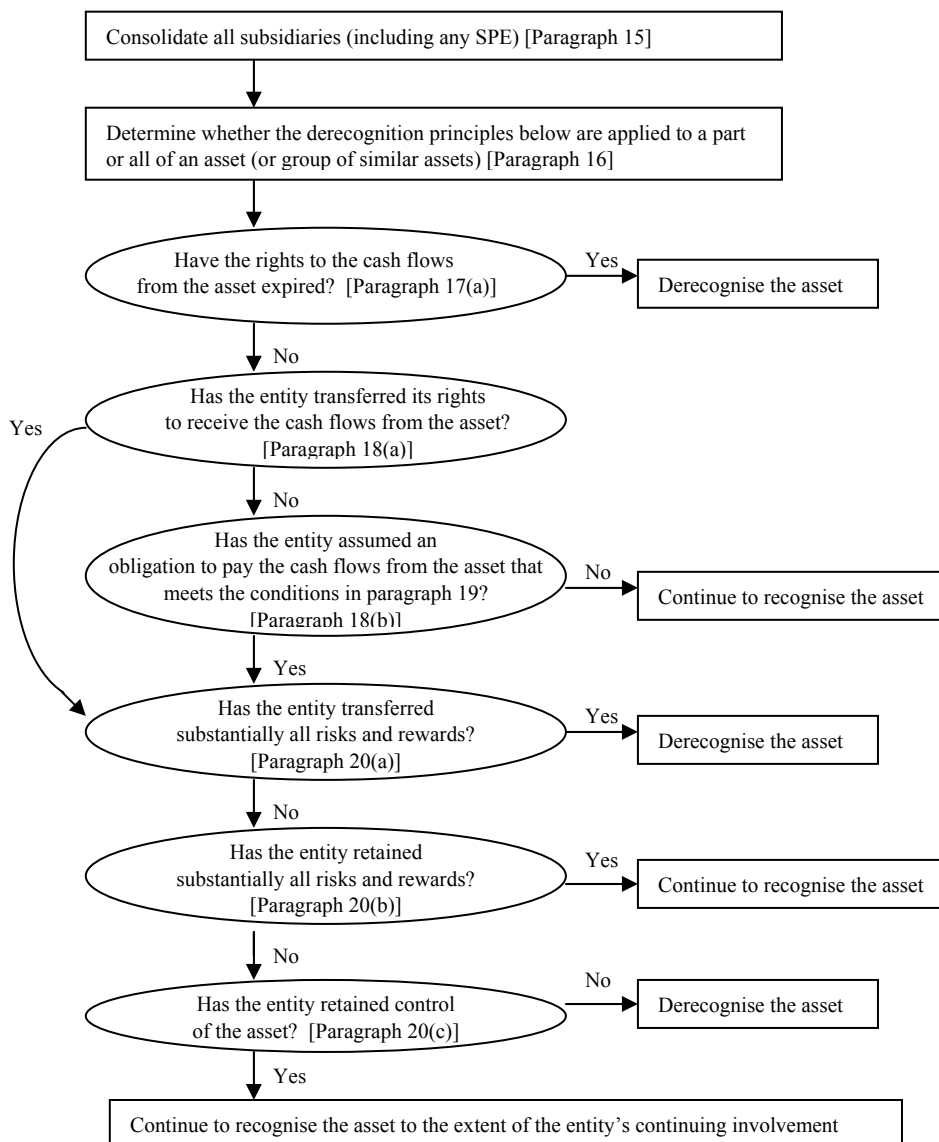
AG35 The following are examples of applying the principle in paragraph 14.

- (a) Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
- (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 5-7, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 93 and 94).

- (c) A forward contract that is within the scope of this Standard (see paragraphs 2-7) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation are not zero, the contract is recognised as an asset or liability.
- (d) Option contracts that are within the scope of this Standard (see paragraphs 2-7) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

## Derecognition of a Financial Asset (paragraphs 15-37)

AG36 The following flowchart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



***Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 18(b))***

- AG37 The situation described in paragraph 18(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 19 and 20 are met.
- AG38 In applying paragraph 19, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

***Evaluation of the transfer of risks and rewards of ownership (paragraph 20)***

- AG39 Examples of when an entity has transferred substantially all the risks and rewards of ownership are:
- (a) an unconditional sale of a financial asset;
  - (b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
  - (c) a sale of a financial asset together with a put or call option that is deeply out of the money (i.e. an option that is so far out of the money it is highly unlikely to go into the money before expiry).
- AG40 Examples of when an entity has retained substantially all the risks and rewards of ownership are:
- (a) a sale and repurchase transaction where the repurchase price is a fixed price or the sales price plus a lender's return;
  - (b) a securities lending agreement;
  - (c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

- (d) a sale of a financial asset together with a deep-in-the-money put or call option (i.e. an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
- (e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

AG41 If an entity determines that as a result of the transfer it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

***Evaluation of the transfer of control***

AG42 An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

AG43 The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

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

- (b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:
  - (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e. it must be a unilateral ability); and
  - (ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or "strings" to the transfer (e.g. conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

AG44 That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

#### **Transfers that Qualify for Derecognition**

AG45 An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivables between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

AG46 In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in paragraphs 48, 49 and AG68-AG82 in addition to paragraph 28.

#### **Transfers that Do Not Qualify for Derecognition**

AG47 The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

#### **Continuing Involvement in Transferred Assets**

AG48 The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30.

##### ***All assets***

- (a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportionate basis (see AASB 118) and the carrying value of the asset is reduced by any impairment losses.

##### ***Assets measured at amortised cost***

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

example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. Then the initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss.

*Assets measured at fair value*

- (c) If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money or (ii), the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95, and the time value of the option is CU5, then the carrying amount of the associated liability is CU75 (CU80 – CU5) and the carrying amount of the transferred asset is CU80 (i.e. its fair value).
- (d) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100, and the time value of the option is CU5, then the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price).

- (e) If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognises an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) – CU5]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

#### **All Transfers**

- AG49 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.
- AG50 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

## Examples

AG51 The following examples illustrate the application of the derecognition principles of this Standard.

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

agreement to repurchase the same asset at a fixed price or the sales price plus a lender's return, then the asset is not derecognised.

- (f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.* If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) *A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money or deeply out of the money.* If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph AG44). The entity transfers control of the asset if the put option is not

sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.

- (j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
- (k) *Cash settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG44 and (g), (h) and (i) above).
- (l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.
- (m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition

only to the extent of the amount of the assets that is subject to the call option.

- (n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some amount or all of its interest retained in the transferred asset. Alternatively, an entity may agree to provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
- (o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
- (p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) *Amortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of

the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

- AG52 This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

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

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

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

The entity calculates that CU9,090 (90% x CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90% share. The remainder of the consideration received, of CU25, represents consideration received for subordinating its retained interest to provide credit enhancement to

the transferee for credit losses. In addition, the excess spread of 0.5% represents consideration received for the credit enhancement. Accordingly the total consideration received for the credit enhancement is CU 65 (CU25 + CU40).

The entity calculates the gain or loss on the sale of the 90 percent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 28 as follows:

	<b>Estimated Fair Value</b>	<b>Percentage</b>	<b>Allocated Carrying Amount</b>
Portion Transferred	9,090	90%	9,000
Portion Retained	1,010	10%	1,000
<b>Total</b>	<b>10,100</b>		<b>10,000</b>

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

In addition, the entity recognises the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises an asset of CU 1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of CU1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, CU1,000 plus the fair value of the subordination of CU65).

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

	<b>Debit</b>	<b>Credit</b>
Original Asset	-	9,000
Asset recognised for subordination or the residual interest	1,000	-
Asset for the consideration received in the form of excess spread	40	-
Profit or loss (gain on transfer)	-	90
Liability	-	1,065
Cash Received	9,115	-
<b>Total</b>	<b>10,155</b>	<b>10,115</b>

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

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

### **Regular Way Purchase or Sale of a Financial Asset (paragraph 38)**

AG53 A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as

described in paragraphs AG55 and AG56. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraph 9. For this purpose assets that are held for trading form a separate category from assets designated at fair value through profit and loss.

- AG54 A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- AG55 The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal, and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.
- AG56 The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets carried at cost or amortised cost; it is recognised in profit or loss for assets designated as financial assets at fair value through profit or loss; and it is recognised in equity for assets classified as available for sale.

### **Derecognition of a Financial Liability (paragraphs 39-42)**

- AG57 A financial liability (or part of it) is extinguished when the debtor either:
- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
  - (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor (if the debtor has given a guarantee this condition may still be met).

- AG58 If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.
- AG59 Payment to a third party, including a trust (sometimes called ‘in-substance defeasance’), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.
- AG60 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph AG57(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.
- AG61 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 15-37 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.
- AG62 For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.
- AG63 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:
- (a) recognises a new financial liability based on the fair value of its obligation for the guarantee; and

- (b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

## **Measurement (paragraphs 43-70)**

### **Initial Measurement of Financial Assets and Financial Liabilities (paragraph 43)**

- AG64 The fair value of a financial instrument on initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG74-AG79). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate, and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.
- AG65 If an entity originates a loan that bears an off-market interest rate (e.g. 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, i.e. net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest rate method.

### **Subsequent Measurement of Financial Assets (paragraphs 45 and 46)**

- AG66 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 47.
- AG67 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognised at CU102. The next financial reporting date occurs one day later, when the quoted market price of the asset is CU100. If the asset were sold, a

commission of CU3 would be paid. On that date, the asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognised in equity. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.

- AG68 Instruments that are classified as loans and receivables are measured at amortised cost without regard to the entity's intention to hold them to maturity.

### **Fair Value Measurement Considerations (paragraphs 48-49)**

- AG69 Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.
- AG70 This Standard uses the terms "bid price" and "asking price" (sometimes referred to as "current offer price") in the context of quoted market prices, and the term "the bid-ask spread" to include only transaction costs. Other adjustments to arrive at fair value (e.g. for counterparty credit risk) are not included in the term "bid-ask spread".

### **Active Market: Quoted Price**

- AG71 A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the reporting date in that instrument (i.e. without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market

and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

- AG72 The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (e.g. a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (e.g. because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.
- AG73 If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

#### **No Active Market: Valuation Technique**

- AG74 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been

demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

- AG75 The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.
- AG76 Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.
- AG76A The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. The application of paragraph AG76 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, AASB 139 requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.
- AG77 The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by

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

AG78 The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

AG79 In applying discounted cash flow analysis, an entity uses one or more a discount rates equal to the prevailing rate of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal, and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

### **No Active Market: Equity Instruments**

- AG80 The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
- AG81 There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

### **Inputs to Valuation Techniques**

- AG82 An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).
- (a) *The time value of money (i.e. interest at the basic or risk-free rate).* Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in

that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

- (b) *Credit risk.* The effect on fair value of credit risk (i.e. the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.
- (c) *Foreign currency exchange prices.* Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.
- (d) *Commodity prices.* There are observable market prices for many commodities.
- (e) *Equity prices.* Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.
- (f) *Volatility (i.e. magnitude of future changes in price of the financial instrument or other item).* Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.
- (g) *Prepayment risk and surrender risk.* Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount, see paragraph 49.)
- (h) *Servicing costs of a financial asset or a financial liability.* Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a

contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

### **Gains and Losses (paragraphs 55-57)**

AG83 An entity applies AASB 121 to financial assets and financial liabilities that are monetary items in accordance with AASB 121 and denominated in a foreign currency. Under AASB 121, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 95-101) or a hedge of a net investment (see paragraph 102). For the purpose of recognising foreign exchange gains and losses under AASB 121, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in profit or loss and other changes in carrying amount are recognised in accordance with paragraph 55(b). For available-for-sale financial assets that are not monetary items under AASB 121 (e.g. equity instruments), the gain or loss that is recognised directly in equity under paragraph 55(b) includes any related foreign exchange component. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in profit or loss.

### **Impairment and Uncollectibility of Financial Assets (paragraphs 58-70)**

#### **Financial Assets Carried at Amortised Cost (paragraphs 63-65)**

AG84 Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any

impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

- AG85 The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.
- AG86 The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range<sup>3</sup>, taking into account all relevant information available before the financial report is issued about conditions existing at the reporting date.
- AG87 For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtor's ability to pay all amounts due according to the contractual terms (e.g. on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status, and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.
- AG88 Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically

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<sup>3</sup> AASB 137, paragraph 39 contains guidance on how to determine the best estimate in a range of possible outcomes.

identifies losses on individually impaired assets in a group, those assets are removed from the group.

- AG89 Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.
- AG90 As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.
- AG91 When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.
- AG92 Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g. for

smaller balance loans) as long as they are consistent with the requirements in paragraphs 63-65 and AG87-AG91. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

### **Interest Income After Impairment Recognition**

AG93 Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

## **Hedging (paragraphs 71-102)**

### **Hedging Instruments (paragraphs 72-77)**

#### **Qualifying Instruments (paragraphs 72 and 73)**

- AG94 The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (e.g. a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.
- AG95 A held-to-maturity investment carried at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.
- AG96 An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) cannot be designated as a hedging instrument.

- AG97 An entity's own equity instruments are not financial assets or financial liabilities of the entity and, therefore, cannot be designated as hedging instruments.

## **Hedged Items (paragraphs 78-84)**

### **Qualifying Items (paragraphs 78-80)**

- AG98 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.
- AG99 An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.
- AG99A Paragraph 80 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and

equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

- AG99B If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised directly in equity in accordance with paragraph 95(a) shall be reclassified into profit or loss in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.
- AG99C If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g. only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (i.e. principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.
- AG99D In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of CU90, the effective yield would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR portion of 8 per cent that consists partly of the contractual interest cash flows and partly of the

difference between the current fair value (i.e. CU90) and the amount repayable on maturity (i.e. CU100).

### **Designation of Non-Financial Items as Hedged Items (paragraph 82)**

AG100 Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates or the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brazilian coffee using a forward contract to purchase Colombian coffee on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 88 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (e.g. a transaction in Brazilian coffee) and the hedging instrument (e.g. a transaction in Colombian coffee). If there is a valid statistical relationship between the two variables (i.e. between the unit prices of Brazilian coffee and Colombian coffee), the slope of the regression line can be used to establish the hedge ratio that will maximise expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximises expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognised in profit or loss during the term of the hedging relationship.

### **Designation of Groups of Items as Hedged Items (paragraphs 83 and 84)**

AG101 A hedge of an overall net position (e.g. the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on profit or loss of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has CU100 of assets and CU90 of liabilities with risks and terms of a similar nature and hedges the net CU10 exposure, it can designate as the hedged item CU10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are

variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of CU100 and a firm commitment to make a sale in the foreign currency of CU90, it can hedge the net amount of CU10 by acquiring a derivative and designating it as a hedging instrument associated with CU10 of the firm purchase commitment of CU100.

### **Hedge Accounting (paragraphs 85-102)**

- AG102 An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.
- AG103 An example of a cash flow hedge is use of a swap to change floating rate debt to fixed rate debt (i.e. a hedge of a future transaction where the future cash flows being hedged are the future interest payments).
- AG104 A hedge of a firm commitment (e.g. a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 87 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

### **Assessing Hedge Effectiveness**

- AG105 A hedge is regarded as highly effective only if both of the following conditions are met.
- (a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

- (b) The actual results of the hedge are within a range of 80-125 per cent. For example, if actual results are such that the loss on the hedging instrument is CU120 and the gain on the cash instruments CU100, offset can be measured by  $120 / 100$ , which is 120 per cent, or by  $100 / 120$ , which is 83 per cent. In this example, assuming the hedge meets the condition in (a), the entity would conclude that the hedge has been highly effective.

AG106 Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial report.

AG107 This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

AG107A If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG100.

AG108 If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

- (a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;
- (b) the fair value of the forward contract at inception is zero; and
- (c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and recognised in profit or loss or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

AG109 Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

AG110 To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

AG111 In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

AG112 In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

AG113 If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

### **Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk**

AG114 For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)-(i) and paragraphs AG115-AG132 below.

- (a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios (e.g. the entity may group its available-for-sale assets into a separate portfolio), in which case it applies the guidance below to each portfolio separately.
- (b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.
- (c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG126(b).
- (d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g. LIBOR).

- (e) The entity designates one or more hedging instruments for each repricing time period.
- (f) Using the designations made in (c)-(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.
- (g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged item as a gain or loss in profit or loss and in one of two line items in the balance sheet as described in paragraph 89A. The change in fair value need not be allocated to individual assets or liabilities.
- (h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognises it as a gain or loss in profit or loss. The fair value of the hedging instrument(s) is recognised as an asset or liability in the balance sheet.
- (i) Any ineffectiveness<sup>4</sup> will be recognised in profit or loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

AG115 This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

AG116 The portfolio identified in paragraph AG114(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

AG117 In applying paragraph AG114(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and

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<sup>4</sup> The same materiality considerations apply in this context as apply throughout Australian Accounting Standards.

throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates. However, the methodology for such an allocation shall be in accordance with the entity's risk management procedures and objectives.

AG118 As an example of the designation set out in paragraph AG114(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates as the hedged item assets in the amount of CU20 (a portion of the assets).<sup>5</sup> The designation is expressed as an 'amount of a currency' (e.g. an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn – that is all of the CU100 of assets in the above example – must be:

- (a) items whose fair value changes in response to changes in the interest rate being hedged; and
- (b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because the Standard<sup>6</sup> specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the

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<sup>5</sup> This Standard permits an entity to designate any amount of the available qualifying assets or liabilities, that is, in this example any amount of assets between CU0 and CU100.

<sup>6</sup> See paragraph 49.

above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG126(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 per cent<sup>7</sup> of the liabilities with no demand feature.

- AG119 The entity also complies with the other designation and documentation requirements set out in paragraph 88(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:
- (a) which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio;
  - (b) how the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates;
  - (c) the number and duration of repricing time periods;
  - (d) how often the entity will test effectiveness and which of the two methods in paragraph AG126 it will use;
  - (e) the methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the

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<sup>7</sup>  $CU30 \div (CU100 - CU40) = 50$  per cent.

entity tests effectiveness using the method described in paragraph AG126(b); and

- (f) when the entity tests effectiveness using the method described in paragraph AG126(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

The policies specified in designating and documenting the hedging relationship shall be in accordance with the entity's risk management procedures and objectives. Changes in policies shall not be made arbitrarily. They shall be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

AG120 The hedging instrument referred to in paragraph AG114(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG114(d) (e.g. a portfolio of interest rate swaps all of which contain exposure to LIBOR). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard<sup>8</sup> does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph AG114(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard<sup>9</sup> does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

AG121 When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG114(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 81 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 81A permits this to be achieved by designating the hedged item in terms of the change in

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<sup>8</sup> See paragraphs 77 and AG94.

<sup>9</sup> See paragraph 75.

the fair value that is attributable to changes in the designated interest rate on the basis of expected, rather than contractual, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (e.g. to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph AG126. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (e.g. changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

- AG122 The Standard does not specify the techniques used to determine the amount referred to in paragraph AG114(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.
- AG123 Paragraph 89A requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph AG114(g). Specific allocation to individual assets (or liabilities) is not required.
- AG124 Paragraph AG114(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

- (a) actual repricing dates being different from those expected, or expected repricing dates being revised;
- (b) items in the hedged portfolio becoming impaired or being derecognised;
- (c) the payment dates of the hedging instrument and the hedged item being different; and
- (d) other causes (e.g. when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness<sup>10</sup> shall be identified and recognised in profit or loss.

AG125 Generally, the effectiveness of the hedge will be improved:

- (a) if the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behaviour;
- (b) when the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behaviour can be predicted more accurately;
- (c) when the repricing time periods used are narrower (e.g. 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduces the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument; and
- (d) the greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g. because of changes in prepayment expectations).

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<sup>10</sup> The same materiality considerations apply in this context as apply throughout Australian Accounting Standards.

- AG126 An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it shall calculate the amount of effectiveness either:
- (a) as the difference between the change in the fair value of the hedging instrument (see paragraph AG114(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or
  - (b) using the following approximation. The entity:
    - (i) calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness;
    - (ii) applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate;
    - (iii) calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG114(g);
    - (iv) recognises ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG114(h)).

AG127 When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph AG121), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG126(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the

hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG126(b) are then repeated at the next date it tests effectiveness.

- AG128 Items that were originally scheduled into a repricing time period may be derecognised because of earlier than expected prepayment or writeoffs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph AG114(g) that relates to the derecognised item shall be removed from the balance sheet, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognised item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph AG114(g). When an item is derecognised, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.
- AG129 In addition, any amount relating to a particular time period that has not been derecognised when the time period expires is recognised in profit or loss at that time (see paragraph 89A). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item on the balance sheet was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets attributable to period 1 have been either realised or rescheduled into other periods. Therefore, CU7 is derecognised from the balance sheet and recognised in profit or loss. CU8 and CU10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG114(g).
- AG130 As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first repricing time period expires, CU100 of assets are derecognised because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG114(g) that relates to the first time

period is removed from the balance sheet, plus 10 per cent of the amount that relates to the second time period.

- AG131 If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognised, the amount included in the separate line item referred to in paragraph AG114(g) that relates to the reduction shall be amortised in accordance with paragraph 92.
- AG132 An entity may wish to apply the approach set out in paragraphs AG114-AG131 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with AASB 139. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 101(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG114-AG131 prospectively to subsequent reporting periods.

#### **Transition (paragraphs 103-108B)**

- AG133 An entity may have designated a forecast intragroup transaction as a hedged item at the start of an annual period beginning on or after 1 January 2005 (or, for the purpose of restating comparative information the start of an earlier comparative period) in a hedge that would qualify for hedge accounting in accordance with this Standard (as amended by the last sentence of paragraph 80). Such an entity may use that designation to apply hedge accounting in consolidated financial statements from the start of the annual period beginning on or after 1 January 2005 (or the start of the earlier comparative period). Such an entity shall also apply paragraphs AG99A and AG99B from the start of the annual period beginning on or after 1 January 2005. However, in accordance with paragraph 108B, it need not apply paragraph AG99B to comparative information for earlier periods.

## ILLUSTRATIVE EXAMPLE

*This example accompanies, but is not part of, AASB 139.*

### Facts

- IE1 On 1 January 20x1, Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.
- IE2 For risk management purposes, Entity A analyses the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (i.e. it has 60 separate monthly time periods).<sup>1</sup> The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.
- IE3 This example deals only with the repricing time period expiring in three months' time, that is the time period maturing on 31 March 20x1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of CU100 million and liabilities of CU80 million into this time period. All of the liabilities are repayable on demand.
- IE4 Entity A decides, for risk management purposes, to hedge the net position of CU20 million and accordingly enters into an interest rate swap<sup>2</sup> on 1 January 20x1 to pay a fixed rate and receive LIBOR, with a notional principal amount of CU20 million and a fixed life of three months.

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1 In this Example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in the fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this Example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

2 This Example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

IE5 This Example makes the following simplifying assumptions:

- (a) the coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;
- (b) the coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and
- (c) the interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise.

(The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap.)

IE6 It is also assumed that Entity A tests effectiveness on a monthly basis.

IE7 The fair value of an equivalent non-prepayable asset of CU20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows.

	<b>1 Jan 20x1</b>	<b>31 Jan 20x1</b>	<b>1 Feb 20x1</b>	<b>28 Feb 20x1</b>	<b>31 Mar 20x1</b>
Fair value (asset) (CU)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

IE8 The fair value of the swap at various times during the period of the hedge is as follows.

	<b>1 Jan 20x1</b>	<b>31 Jan 20x1</b>	<b>1 Feb 20x1</b>	<b>28 Feb 20x1</b>	<b>31 Mar 20x1</b>
Fair value (liability) (CU)	Nil	(47,408)	(47,408)	(23,795)	Nil

## Accounting Treatment

IE9 On 1 January 20x1, Entity A designates as the hedged item an amount of CU20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (i.e. the CU20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 88(d) and AG119 of the Standard.

IE10 Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

### End of month 1 (31 January 20x1)

IE11 On 31 January 20x1 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as CU96 million.

IE12 The fair value of the designated interest rate swap with a notional principal of CU20 million is (CU47,408)<sup>3</sup> (the swap is a liability).

IE13 Entity A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows.

- (a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (CU20 million ÷ CU100 million).
- (b) Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (CU96 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU19.2 million.
- (c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU19.2 million) that is attributable to changes in LIBOR. This is CU45,511 (CU47,408<sup>4</sup> × (CU19.2 million ÷ CU20 million))

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<sup>3</sup> See paragraph IE8.

<sup>4</sup> That is, CU20,047,408 – CU20,000,000. See paragraph IE7.

IE14 Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU172,097	
Cr	Income statement (interest income) <sup>5</sup>		CU172,097

*To recognise the interest received on the hedged amount (CU19.2 million).*

Dr	Income statement (interest expense)	CU179,268	
Cr	Income statement (interest income)		CU179,268
Cr	Cash		Nil

*To recognise the interest received and paid on the swap designated as the hedging instrument.*

Dr	Income statement (loss)	CU47,408	
Cr	Derivative liability		CU47,408

*To recognise the change in the fair value of the swap.*

Dr	Separate balance sheet line item	CU45,511	
Cr	Income statement (gain)		CU45,511

*To recognise the change in the fair value of the hedged amount.*

IE15 The net result on profit or loss (excluding interest income and interest expense) is to recognise a loss of (CU1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

### **Beginning of month 2**

IE16 On 1 February 20x1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold 8½ per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were

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<sup>5</sup> This Example does not show how amounts of interest income and interest expense are calculated.

scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

IE17 On this basis, Entity A computes that it has sold  $8\frac{1}{3}$  per cent of the assets allocated to the three month time period, that is CU8 million ( $8\frac{1}{3}$  per cent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.<sup>6</sup> On derecognition of the assets, Entity A also removes from the separate balance sheet line item an amount that represents the change in the fair value of the hedged assets that it has now sold. This is  $8\frac{1}{3}$  per cent of the total line item balance of CU45,511, that is CU3,793.

IE18 Entity A makes the following accounting entries to recognise the sale of the asset and the removal of part of the balance in the separate balance sheet line item.

Dr	Cash	CU8,018,400
Cr	Asset	CU8,000,000
Cr	Separate balance sheet line item	CU3,793
Cr	Income statement (gain)	CU14,607

*To recognise the sale of the asset at fair value and to recognise a gain on sale.*

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate no ineffectiveness arises.

IE19 Entity A now has CU88 million of assets and CU80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now CU8 million and, accordingly, it designates CU8 million as the hedged amount.

IE20 Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument CU8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of CU18,963.<sup>7</sup> It also complies with the other designation requirements in paragraphs 88(a)

<sup>6</sup> The amount realised on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in paragraph IE7.

<sup>7</sup> CU47,408 × 40 per cent.

and AG119 of the Standard. The CU12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognised in profit or loss, or is designated as the hedging instrument in a different hedge.<sup>8</sup>

- IE21 As at 1 February 20x1 and after accounting for the sale of assets, the separate balance sheet line item is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6 million<sup>9</sup> of assets. However, as at 1 February 20x1, Entity A is hedging only CU8 million of assets that have a cumulative change in fair value of CU18,963.<sup>10</sup> The remaining separate balance sheet line item of CU22,755<sup>11</sup> relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, that is it amortises CU22,755 over two months.
- IE22 Entity A determines that it is not practicable to use a method of amortisation based on a recalculated effective yield and hence uses a straight-line method.

**End of month 2 (28 February 20x1)**

- IE23 On 28 February 20x1 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of CU8 million is (CU9,518)<sup>12</sup> (the swap is a liability). Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at 28 February 20x1 as CU8,009,518.<sup>13</sup>
- IE24 Entity A makes the following accounting entries relating to the hedge in this time period:

Dr	Cash	CU71,707
Cr	Income statement (interest income)	CU71,707

*To recognise the interest received on the hedged amount (CU8 million).*

8 The entity could instead enter into an offsetting swap with a notional principal of CU12 million to adjust its position and designate as the hedging instrument all CU20 million of the existing swap and all CU12 million of the new offsetting swap.  
9 CU19.2 million – (8½% × CU19.2 million).  
10 CU41,718 × (CU8million ÷ CU17.6 million).  
11 CU41,718 – CU18,963.  
12 CU23,795 [see paragraph IE8] × [CU8 million ÷ CU20 million].  
13 CU20,023,795 [see paragraph IE7] × (CU8 million ÷ CU20 million).

Dr	Income statement (interest expense)	CU71,707
Cr	Income statement (interest income)	CU62,115
Cr	Cash	CU9,592

*To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).*

Dr	Derivative liability	CU9,445
Cr	Income statement (gain)	CU9,445

*To recognise the change in the fair value of the portion of the swap designated as the hedging instrument (CU8 million) (CU9,518 – CU18,963)*

Dr	Income statement (loss)	CU9,445
Cr	Separate balance sheet line item	CU9,445

*To recognise the change in the fair value of the hedged amount (CU8,009,518 – CU8,018,963).*

IE25 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE26 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Income statement (loss)	CU11,378
Cr	Separate balance sheet line item	CU11,378 <sup>14</sup>

*To recognise the amortisation charge for the period.*

### **End of month 3**

IE27 During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20x1 the assets and the swap mature and all balances are recognised in profit or loss.

IE28 Entity A makes the following accounting entries relating to this time period:

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<sup>14</sup> CU22,755 ÷ 2.

Dr	Cash	CU8,071,707
Cr	Asset (balance sheet)	CU8,000,000
Cr	Income statement (interest income)	CU71,707

*To recognise the interest and cash received on maturity of the hedged amount (CU8 million).*

Dr	Income statement (interest expense)	CU71,707
Cr	Income statement (interest income)	CU62,115
Cr	Cash	CU9,592

*To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).*

Dr	Derivative liability	CU9,518
Cr	Income statement (gain)	CU9,518

*To recognise the expiry of the portion of the swap designated as the hedging instrument (CU8 million).*

Dr	Income statement (loss)	CU9,518
Cr	Separate balance sheet line item	CU9,518

*To remove the remaining line item balance on expiry of the time period.*

IE29 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE30 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Income statement (loss)	CU11,377
Cr	Separate balance sheet line item	CU11,377 <sup>15</sup>

*To recognise the amortisation charge for the period.*

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<sup>15</sup> CU22,755 ÷ 2.

## **Summary**

IE31 The tables below summarise:

- (a) changes in the separate balance sheet line item;
- (b) the fair value of the derivative;
- (c) the profit or loss effect of the hedge for the entire three-month period of the hedge; and
- (d) interest income and interest expense relating to the amount designated as hedged.

Description	1 Jan 20x1	31 Jan 20x1	1 Feb 20x1	28 Feb 20x1	31 Mar 20x1
	CU	CU	CU	CU	CU
<b>Amount of asset hedged</b>	<b>20 million</b>	<b>19.2 million</b>	<b>8 million</b>	<b>8 million</b>	<b>8 million</b>

**(a) Changes in the separate balance sheet line item**

Brought forward:

Balance to be amortised	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortisation	Nil	Nil	Nil	(11,378)	(11,377)
<b>Carried forward:</b>	<hr/>				
<b>Balance to be amortised</b>	<b>Nil</b>	<b>Nil</b>	<b>22,755</b>	<b>11,377</b>	<b>Nil</b>
<b>Remaining balance</b>	<b>Nil</b>	<b>45,511</b>	<b>18,963</b>	<b>9,518</b>	<b>Nil</b>

**(b) The fair value of the derivative**

	<b>1 Jan 20x1</b>	<b>31 Jan 20x1</b>	<b>1 Feb 20x1</b>	<b>28 Feb 20x1</b>	<b>31 Mar 20x1</b>
CU20,000,000	Nil	47,408	-	-	-
CU12,000,000	Nil	-	28,445	No longer designated as the hedging instrument.	
CU8,000,000	Nil	-	18,963	9,518	Nil
<b>Total</b>	<b>Nil</b>	<b>47,408</b>	<b>47,408</b>	<b>9,518</b>	<b>Nil</b>

**(c) Profit or loss effect of the hedge**

	<b>1 Jan 20x1</b>	<b>31 Jan 20x1</b>	<b>1 Feb 20x1</b>	<b>28 Feb 20x1</b>	<b>31 Mar 20x1</b>
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
<b>Net effect</b>	<b>Nil</b>	<b>(1,897)</b>	<b>N/A</b>	<b>Nil</b>	<b>Nil</b>
<b>Amortisation</b>	<b>Nil</b>	<b>Nil</b>	<b>N/A</b>	<b>(11,378)</b>	<b>(11,377)</b>

In addition, there is a gain on sale of assets of CU14,607 at 1 February 20x1.

**(d) Interest income and interest expense relating to the amount designated as hedged**

<b>Profit or loss recognised for the amount hedged</b>	<b>1 Jan 20x1</b>	<b>31 Jan 20x1</b>	<b>1 Feb 20x1</b>	<b>28 Feb 20x1</b>	<b>31 Mar 20x1</b>
<b>Interest income</b>					
– on the asset	Nil	172,097	N/A	71,707	71,707
– on the swap	Nil	179,268	N/A	62,115	62,115
<b>Interest expense</b>					
– on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

## **DELETED IAS 39 TEXT**

*Deleted IAS 39 text is not part of AASB 139.*

### **Paragraph 103H**

*Reclassification of Financial Assets (Amendments to IAS 39 and IFRS 7), issued in October 2008, amended paragraphs 50 and AG8, and added paragraphs 50B-50F. An entity shall apply those amendments on or after 1 July 2008. An entity shall not reclassify a financial asset in accordance with paragraph 50B, 50D or 50E before 1 July 2008. Any reclassification of a financial asset made on or after 1 November 2008 shall take effect only from the date when the reclassification is made. Any reclassification of a financial asset in accordance with paragraph 50B, 50D or 50E shall not be applied retrospectively before 1 July 2008.*

### **Paragraph 103I**

*Reclassification of Financial Assets – Effective Date and Transition (Amendments to IAS 39 and IFRS 7), issued in November 2008, amended paragraph 103H. An entity shall apply that amendment on or after 1 July 2008.*