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Presentation and Disclosure of Financial Instruments

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Other enquiries:

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Defined words appear in *italics* the first time they appear in a section. The definitions are in Section 7. Standards are printed in **bold** type and commentary in light type.

MAIN FEATURES OF THE STANDARD

The Standard:

(a) defines “financial instrument” and the associated terms “financial asset”, “financial liability” and “equity instrument”, covering a wide range of items from cash and trade receivables to interest rate and currency options, swaps and other derivative financial instruments

(b) defines “converting financial instrument”

(c) requires the issuer of a converting financial instrument to classify the instrument on initial recognition as a financial liability to the extent that the holder of the instrument is not exposed to changes in the fair value of the issuer’s equity instruments and as equity to the extent that the holder is exposed to changes in the fair value of the issuer’s equity instruments

(d) requires the issuer of a financial instrument other than a converting financial instrument to classify the instrument or its component parts as a liability or as equity in accordance with the definitions of financial liability and equity instrument on initial recognition

(e) requires the issuer of a financial instrument, including a converting financial instrument, that incorporates both liability and equity component parts to account separately for the component parts, but includes a transitional provision that applies the requirement only to instruments issued on or after 1 January 1998

(f) includes transitional provisions that defer the requirements for converting financial instruments to which this Standard applies that were issued on or before 28 October 1999 for two years from the operative date of the Standard

(g) includes transitional provisions that require the separate disclosure of the financial liability and equity components of converting financial instruments issued after 31 December 1997 and before 29 October 1999 that are not classified in accordance with the Standard

(h) does not allow a financial instrument or the liability and equity component parts of a compound financial instrument to be reclassified by the issuer after initial recognition until a transaction or other specific action by the issuer or the holder alters the substance of the financial instrument or the instrument is removed from the statement of financial position

(i) requires the classification of interest, dividends, gains and losses as expenses, revenues, direct debits to equity or direct credits to equity to be consistent with the classification of the related financial instrument or component part in the statement of financial position

(j) requires financial assets and financial liabilities to be set off in the presentation of the statement of financial position when and only when:

  (i) there is a legally recognised right of set-off; and

  (ii) the entity intends to settle the asset and the liability on a net basis or simultaneously

(k) prescribes disclosure requirements in relation to the following aspects:

  (i) the terms and conditions of financial instruments and the accounting policies adopted

  (ii) objectives with regard to derivatives, the context of those objectives and the strategies for achieving them

  (iii) interest rate risk, by class of recognised and unrecognised financial asset and financial liability

  (iv) credit risk, by class of recognised and unrecognised financial asset

  (v) net fair value, by class of recognised and unrecognised financial asset and financial liability

  (vi) financial assets recognised at an amount exceeding net fair value

  (vii) hedges of anticipated future transactions

(l) applies the disclosure requirements to gold contracts and to other commodity contracts of a type normally settled other than by physical delivery in accordance with general market practice

(m) encourages other disclosures, such as policies for controlling the risks associated with financial instruments

(n) does not require a parent entity to comply with the disclosure requirements in some circumstances.

An Appendix to the Standard explains and illustrates the application of the Standard to various types of financial instruments, such as redeemable preference shares, "perpetual" debt, converting financial instruments and compound financial instruments. Some methods for measuring the component parts of compound instruments are illustrated.

AUSTRALIAN ACCOUNTING STANDARD

AAS 33 "PRESENTATION AND DISCLOSURE OF FINANCIAL INSTRUMENTS"

1 Application

1.1 Subject to paragraphs 1.2 and 1.3, this Standard applies to:

(a) ***general purpose financial reports*** **of each** ***reporting entity*** **to which Accounting Standards operative under the Corporations Law do not apply**

(b) **financial reports that are held out to be general purpose financial reports by an** ***entity*** **which is not a reporting entity, and to which Accounting Standards operative under the Corporations Law do not apply.**

1.1.1 Accounting Standards operative under the Corporations Law apply to companies and to other entities required by legislation, ministerial directive or other government authority to apply such Standards. Reporting entities which are not required to apply Accounting Standards operative under the Corporations Law are required to apply this Standard.

1.1.2 The standards specified in this Standard apply to the financial report where information resulting from their application is material, in accordance with Australian Accounting Standard AAS 5 "Materiality".

1.2 When the financial report of a ***parent entity*** **is presented with the** ***economic entity's*** **financial report, and the economic entity's financial report applies this Standard, the disclosure requirements set out in Section 5 need not be applied to the financial report of the parent entity.**

1.3 This Standard does not apply to:

(a) **interests in** ***subsidiaries***

(b) **interests in** ***associates***

(c) **interests in** ***joint venture entities***

(d) ***operating leases***

(e) **employers' and superannuation plans' obligations for post-employment benefits of all types, including superannuation benefits as described in Australian Accounting Standards AAS 30 "Accounting for Employee Entitlements" and AAS 25 "Financial Reporting by Superannuation Plans"**

(f) **employers' obligations under employee share option and share purchase plans**

(g) **obligations arising under insurance contracts.**

1.3.1 Although this Standard does not apply to an entity's interests in subsidiaries, it does apply to all *financial instruments* included in the consolidated financial report of a parent entity, regardless of whether those instruments are held or issued by the parent or by a subsidiary. Similarly, the Standard applies to financial instruments held or issued by a *joint venture operation* and included in the financial report of a *venturer*.

1.3.2 For the purposes of this Standard, an insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (or, in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption. When a contract takes the form of an insurance contract but in substance principally involves the transfer of financial risks (see paragraph 5.1.2), for example some types of financial reinsurance and guaranteed investment contracts issued by insurance and other entities, the contract is, for the purposes of this Standard, a financial instrument and the provisions of this Standard apply to the contract. Entities that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of this Standard in presenting and disclosing information about such obligations.

1.3.3 Other Standards specific to certain types of financial instruments contain additional presentation and disclosure requirements. For example, Australian Accounting Standards AAS 17 "Leases" and AAS 25 "Financial Reporting by Superannuation Plans" incorporate specific disclosure requirements relating to *finance leases* and superannuation plan investments, respectively. In addition, some requirements of other Standards, particularly Australian Accounting Standard AAS 6 "Accounting Policies", apply to financial instruments.

2 Operative Date

2.1 This Standard applies to reporting periods beginning on or after 1 January 2000.

2.2 This Standard may be applied to reporting periods beginning before 1 January 2000.

2.2.1 Paragraphs 6.2 and 6.3 provide that this Standard must be applied to *converting financial instruments* issued on or before 28 October 1999 as at the beginning of the first reporting period beginning on or after 1 January 2002. Paragraph 6.4 further provides that the compound *financial instrument* classification standards set out in paragraph 4.3 apply only to financial instruments (including converting financial instruments) issued on or after 1 January 1998.

2.2.2 Australian Accounting Standard AAS 33 "Presentation and Disclosure of Financial Instruments", as issued in December 1996, continues to apply to reporting periods that begin before 1 January 2000. However, where an *entity* elects to apply this Standard early in accordance with paragraph 2.2, it will not also be obliged to comply with AAS 33, as issued in December 1996, for the reporting periods to which the election applies.

2.3 When operative, this Standard supersedes Australian Accounting Standard AAS 33 "Presentation and Disclosure of Financial Instruments", as issued in December 1996.

3 Purpose of Standard

3.1 The purpose of this Standard is to prescribe certain financial report presentation requirements for *financial instruments* and to require disclosure in the financial report of information concerning financial instruments.

3.1.1 The dynamic nature of international financial markets has resulted in the widespread use of a variety of financial instruments ranging from traditional primary instruments such as bonds to various forms of derivative instruments such as interest rate swaps. The objective of this Standard is to enhance financial report users' understanding of the significance of *recognised* and unrecognised financial instruments to an *entity's* financial position, financial performance and cash flows.

3.1.2 This Standard prescribes certain requirements for the presentation of recognised financial instruments and identifies the information that must be disclosed about both recognised and unrecognised financial instruments. The presentation standards deal with the classification of financial instruments between *liabilities* and *equity*, the classification of related interest, dividends and gains and losses and the circumstances in which *financial assets* and *financial liabilities* should be set off. The disclosure standards deal with information about factors that affect the amount, timing and certainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to the instruments. In addition, this Standard encourages disclosure of information about the nature and extent of an entity's use of financial instruments, the business purposes that they serve, the risks associated with them and management's policies for managing those risks.

3.1.3 This Standard does not prescribe the basis on which financial assets and financial liabilities are recognised and measured. These issues will be dealt with in other Australian Accounting Standards.

4 Presentation

Liabilities and Equity

4.1 Subject to paragraph 4.2, the issuer of a *financial instrument* on initial *recognition* must classify the instrument, or its component parts, as a *liability* or as *equity* in accordance with the definitions of a *financial liability* and an *equity instrument*.

Substance Over Form

4.1.1 The substance of a financial instrument, rather than its legal form, governs its classification on the issuer's statement of financial position. While substance and legal form are commonly consistent, this is not always the case. For example, some financial instruments take the legal form of equity but are liabilities in substance. Others may combine features associated with equity instruments and features associated with financial liabilities, such as voting rights, rights to a return on capital in the form of interest or dividends, and liquidation priorities.

4.2 A *converting financial instrument* must be classified as a financial liability by the issuer on initial recognition to the extent that the holder of the instrument is not exposed to changes in the *fair value* of the issuer's equity instruments. The issuer must

classify the converting financial instrument as equity on initial recognition to the extent that the holder is exposed to changes in the fair value of the issuer's equity instruments.

Converting Financial Instruments

4.2.1 An equity instrument is a contract that evidences that the holder has a residual interest in the net *assets* of the issuer, that is, the holder participates in the residual risks and returns of the issuer. The holder of a converting financial instrument does not participate in the residual risks and returns of the issuer at initial recognition to the extent that the number of equity instruments of the issuer that are deliverable to the holder varies with the fair value of the equity instruments. Therefore, the issuer of a converting financial instrument is required by this Standard to classify the instrument as a financial liability on initial recognition to the extent that the holder is not exposed to changes in the fair value of the issuer's equity instruments. Consistent with paragraph 4.4, to the extent that a converting financial instrument is classified by the issuer as a financial liability, any periodic payments made to the holder are classified as *expenses*.

4.2.2 For the purpose of applying the other requirements of this Standard, a reference to a financial liability includes a financial liability arising from the classification of a converting financial instrument in accordance with paragraph 4.2.

4.2.3 The economic effect of issuing a converting financial instrument that converts to a number of equity instruments that varies with their fair value, for example, as at settlement date, is in substance similar to:

(a) issuing simultaneously a debt instrument and a forward contract under which the issuer is obliged to issue equity instruments at fair value on settlement date of the debt instrument and the total value of equity instruments to be issued equates to the settlement amount of the debt instrument. In this example, the settlement date of the debt instrument is equivalent to the date on which the number of equity instruments to be issued by the issuer of a converting financial instrument to the holder can be determined; or

(b) issuing simultaneously a debt instrument and a debt to equity swap under which the issuer is obliged to issue equity instruments at fair value in exchange for the settlement amount of the debt instrument.

Accordingly, the issuer of such a converting financial instrument can be viewed as if it had a contractual obligation to deliver cash to the holder of the instrument (a financial liability) and a forward contract or a debt to equity swap to deliver equity instruments to the holder of the issuer (an equity element). A forward contract or a debt to equity swap that requires the issuer to deliver its equity instruments at fair value at the time of issue of the equity instruments has little or no value at the date the forward contract or swap is issued.

4.2.4 The economic effect of issuing a financial instrument that mandatorily converts to equity instruments of the issuer if the issuer does not exercise an option to redeem the financial instrument by a certain date is substantially the same as issuing a financial instrument that gives the issuer an unconditional option to settle the instrument by paying cash or by issuing its own equity instruments. In substance, the issuer has a financial liability and an equity instrument, namely a put option to "sell" its equity instruments. A put option has little or no value where it entitles the issuer to issue equity instruments at their fair value at the time of the issue of the equity instruments.

4.2.5 Where the number of equity instruments that are deliverable by an issuer to a holder of a converting financial instrument is set at the date that cash or another *financial asset* is received from the holder, the instrument is classified as an equity instrument by the issuer on initial recognition. This is because the holder of such an instrument is exposed to changes in the fair value of the issuer's equity instruments from the date of initial recognition. Consistent with paragraph 4.4, the issuer classifies any periodic payments made to the holder over the term of the converting financial instrument as *direct debits to equity*.

Classification of a Financial Instrument

4.2.6 The classification of a financial instrument, or its component parts, is made in accordance with paragraphs 4.1 and 4.2 on initial recognition. The classification of a financial instrument, or its component parts, does not incorporate consideration of the probability of the various outcomes possible when an instrument includes terms that depend on uncertain future events or circumstances beyond the control of the issuer and the holder. The classification continues at each subsequent *reporting date* until a transaction or other specific action by the issuer or the holder, such as the exercise of an option (see paragraph 4.3.6), alters the substance of the financial instrument or the instrument is removed from the *entity's* statement of financial position. The classification

is not revised as a result of a mere reassessment of the likelihood that the instrument will be dealt with in one way or another. After the expiry of the conversion opportunities under a compound financial instrument, the amount *recognised* for the equity component is reclassified from contributed equity to another classification within the equity section of the statement of financial position, and is not recognised as *revenue*.

4.2.7 The issuer of a converting financial instrument that is classified as a financial liability reclassifies the financial liability to equity when the total number of equity instruments that are deliverable by the issuer to the holder can be determined. This date may not be the settlement date which is the date equity instruments are issued to the holder. For example, where a converting financial instrument provides that the number of equity instruments to be issued by the issuer is based on the fair value of the equity instruments two years from initial recognition, the issuer reclassifies the financial liability to equity as at that date regardless of when the equity instruments are actually delivered to the holder. In cases where the number of equity instruments that are deliverable by the issuer to the holder is based on the weighted average price over a period, the issuer reclassifies the financial liability to equity on the last day of the period.

Financial Liabilities

4.2.8 Where an issuer of a financial instrument has a contractual obligation to either deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the issuer, the instrument meets the definition of a financial liability regardless of the manner in which the contractual obligation will be settled. A restriction on the ability of the issuer to satisfy an obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the issuer's obligation or the holder's right under the instrument.

Preference Shares

4.2.9 When a preference share provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the share at or after a particular date for a fixed or determinable amount, the instrument meets the definition of a financial liability and is classified as such by the issuer.

4.2.10 A preference share that does not establish such a contractual obligation explicitly may establish it indirectly through its terms and conditions. For example, a preference share that does not provide for mandatory redemption or redemption at the option of the holder may have a contractually provided accelerating dividend such that, within the foreseeable future, the dividend yield is scheduled to be so high that the issuer will be economically compelled to redeem the instrument. In these circumstances, classification as a financial liability is appropriate because the issuer has little, if any, discretion to avoid redeeming the instrument. Similarly, if a financial instrument labelled as a share gives the holder an option to require redemption for a fixed or determinable amount upon the occurrence of a future event, classification as a financial liability on initial recognition reflects the substance of the instrument.

4.2.11 In accordance with paragraph 4.2, a preference share that mandatorily converts to equity instruments of the issuer is also classified on initial recognition as a financial liability by the issuer to the extent that the holder of the preference share is not exposed to changes in the fair value of the issuer's equity instruments.

Classification of Compound Financial Instruments by the Issuer

4.3 The issuer of a financial instrument that contains both a financial liability and an equity element must classify the instrument's component parts separately in accordance with paragraphs 4.1 and 4.2.

4.3.1 This Standard requires the separate presentation on an issuer's statement of financial position of liability and equity elements created by individual compound financial instruments. It is more a matter of form than substance that both liabilities and equity interests are created by a single financial instrument rather than two or more separate instruments. An issuer's financial position is more faithfully represented by separate presentation of liability and equity components contained in compound financial instruments according to their nature.

4.3.2 The issuer of a converting financial instrument takes into account the requirement in paragraph 4.2 in determining whether the converting financial instrument contains both a financial liability and an equity element.

4.3.3 An example of a financial instrument that contains both a financial liability and an equity element is a note or similar instrument that is

convertible at the option of the holder into equity instruments. The financial liability is a contractual obligation to deliver cash and the equity instrument is a call option granting the holder the right, for a specified period of time or at a specific date or dates, to convert into equity instruments of the issuer. The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument and options to purchase equity instruments, or issuing a debt instrument with detachable equity instrument purchase options. Accordingly, in such cases, the issuer presents liability and equity elements separately on its statement of financial position.

4.3.4 An issuer also recognises separately the component parts of a financial instrument that creates a primary financial liability of the issuer and provides the issuer with an option to convert it into an equity instrument of the issuer. The issuer in substance has a financial liability even though it has an option to settle in cash or by the issue of its equity instruments. The issuer is obligated to settle in cash until it exercises its put option, usually by formally notifying the holders of an intention to issue equity instruments in settlement. The option represents an equity instrument of the issuer. The value of the put option depends on the price at which the issuer can sell its equity instruments. For example, a put option that entitles the issuer to issue equity instruments at their fair value at the time of their issue has little or no value.

4.3.5 Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the manner that might be expected generally because, for example, the income tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The issuer's obligation to make future payments remains outstanding until it is extinguished through conversion, the maturity of the instrument or some other transaction.

4.3.6 When the issuer of a financial instrument that gives the issuer an option to settle the instrument at maturity either by paying cash or by issuing its own equity instruments to the holder elects to settle the liability by issuing its own equity instruments, the issuer reclassifies the liability component of the instrument as equity only to the extent that the holder is exposed to changes in the fair value of the issuer's equity instruments. For example, where an issuer elects to settle the liability by issuing its own equity instruments and the number of equity instruments to be issued varies with their fair

value at the time of their issue, the issuer does not reclassify the liability component of the instrument as equity until the number of equity instruments to be issued can be determined.

4.3.7 A financial instrument may contain components that are neither financial liabilities nor equity instruments of the issuer. For example, an instrument may give the holder the right to receive a non-financial asset such as a commodity in settlement and an option to exchange that right for shares of the issuer. The issuer recognises and presents the equity instrument (the exchange option) separately from the liability component of the compound instrument, whether the liability is financial or non-financial.

4.3.8 This Standard does not deal with measurement of financial assets, financial liabilities and equity instruments and does not therefore prescribe any particular method for assigning a *carrying amount* to liability and equity elements contained in a single instrument. Approaches that might be followed include:

(a) assigning to the less easily measurable component (often an equity instrument), the residual amount after deducting from the instrument as a whole the amount separately determined for the component that is more easily measurable

(b) measuring the liability and equity components separately and, to the extent necessary, adjusting these amounts on a pro rata basis so that the sum of the components equals the amount of the instrument as a whole.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the carrying amount that would be ascribed to the instrument as a whole. No gain or loss arises from recognising and presenting the components of the instrument separately. The amount assigned to the equity component on initial recognition is not subsequently remeasured over the life of the instrument.

4.3.9 Under the first approach described in paragraph 4.3.8, the issuer of a note convertible into ordinary shares first determines the carrying amount of the financial liability by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares may then be determined by deducting the carrying amount of the financial liability from the amount of the compound instrument as a whole.

Under the second approach, the issuer determines the value of the option directly either by reference to the *net fair value* of a similar option, if one exists, or by using an option pricing model. The value determined for each component is then adjusted on a pro rata basis to the extent necessary to ensure that the sum of the carrying amounts assigned to the components equals the amount of the consideration received for the convertible note.

Interest, Dividends, Gains and Losses

4.4 The classification of interest, dividends, gains and losses as expenses or revenues or as direct debits to equity or *direct credits to equity* must be consistent with the statement of financial position classification of the related financial instrument or component part as at the date when the interest, dividends, gains or losses are recognised.

4.4.1 Distributions to holders of a financial instrument classified as an equity instrument are recognised by the issuer as direct debits to equity. However, dividend payments on shares classified as liabilities are classified as expenses, in the same way as interest on a debenture, and recognised in the calculation of *net profit or loss/result*. Similarly, gains and losses associated with redemptions or refinancings of instruments classified as liabilities are recognised in the calculation of net profit or loss/result, while redemptions or refinancings of instruments classified as equity of the issuer are recognised as direct debits to equity or direct credits to equity. Paragraph 4.4 does not prevent interest on borrowings, for example, being recognised in some circumstances as part of the cost of construction of an asset, instead of being recognised as an expense when incurred.

4.4.2 Dividends classified as an expense may be presented in the calculation of net profit or loss/result either with interest on other liabilities or as a separate item. In some circumstances, because of significant differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately within the calculation of net profit or loss/result. Disclosures of the amounts of tax effects are made in accordance with Australian Accounting Standard AAS 3 "Accounting for Income Tax (Tax-effect Accounting)".

Set-off of a Financial Asset and a Financial Liability

4.5 A financial asset and a financial liability must be set off and the net amount recognised in the statement of financial position when, and only when, the entity:

(a) has a legally recognised right to set off the asset and the liability; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

4.5.1 This Standard requires the presentation of financial assets and financial liabilities on a net basis when this reflects an entity's right of set-off and the expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are normally presented separately from each other, consistent with their characteristics as resources or obligations of the entity. However, when a financial asset and a financial liability arises under an individual derivative financial instrument, such as a forward contract, a single (net) asset or liability must be recognised. The approach in this Standard to set-off is the same as in Australian Accounting Standard AAS 23 "Set-off and Extinguishment of Debt".

4.5.2 In some situations it can be difficult to determine whether in substance an entity has only a single financial asset or financial liability, or both a financial asset and a financial liability. If it has only a single asset or liability, the set-off conditions do not have any effect on the presentation of that item, except in assessing whether set-off with other assets or liabilities is required. This is also the case when a single asset or liability is recognised for derivative financial instruments such as forward contracts. As an additional example, a financial institution may support numerous accounts for an individual customer, with interest revenue or expense determined on the basis of the net balance of the accounts. The financial institution may treat the various accounts as a single asset or liability in substance, if the existence of the separate accounts is only a matter of form. This may be the case when prohibitive transaction costs would be incurred in frequently combining the accounts.

4.5.3 Setting off a recognised financial asset and a recognised financial liability and presenting the net amount differs from ceasing to recognise a financial asset or a financial liability. While setting off

does not give rise to recognition of a gain or loss, ceasing to recognise a financial instrument not only results in the removal of the previously recognised item from the statement of financial position but may also result in recognition of a gain or a loss.

4.5.4 A right of set-off is a debtor's legally recognised right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement among the three parties that clearly establishes the debtor's right of set-off. Since a legally recognised right of set-off comprises rights of set-off that are recognised at common law or in proceedings in equity, the conditions supporting the right may vary from one jurisdiction to another and care must be taken to establish which laws apply to the relationships between the parties.

4.5.5 The existence of a right to set off a financial asset and a financial liability affects the rights and obligations associated with the financial asset and the financial liability and may affect significantly an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for setting off. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. When an entity does intend to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without a legally recognised right to do so is not sufficient to justify setting off since the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

4.5.6 An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off but does not intend to settle net or to realise the asset and settle the liability simultaneously, the entity takes the right into account when determining its maximum credit risk exposure, provided that the financial asset is due before the financial liability. This is explained in paragraph 5.5.4. The effect of such rights may be disclosed in addition to the entity's maximum credit risk exposure, which is required by paragraph 5.5.

4.5.7 Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realisation of a financial asset and settlement of a financial liability are considered simultaneous only when the transactions occur at the same moment. Realisation and settlement of two instruments at the same nominal time but in different time zones does not amount to simultaneous settlement.

4.5.8 The conditions set out in paragraph 4.5 are generally not satisfied and therefore, setting off is not appropriate when:

(a) several different financial instruments are used to emulate the features of a single financial instrument (that is, a "synthetic instrument"); or

(b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties; or

(c) financial or other assets are pledged as collateral for non-recourse financial liabilities; or

(d) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance policy.

4.5.9 An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a "master netting arrangement" with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other events that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes effective and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in

other circumstances not expected to arise in the normal course of business. A master netting arrangement does not provide a basis for setting off unless both of the criteria in paragraph 4.5 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not set off, the arrangement may be disclosed as collateral and the effect of the arrangement on an entity's exposure to credit risk may be disclosed in addition to the specific credit risk disclosures required by paragraph 5.5.

5 Disclosures

5.1.1 The purpose of the disclosures required by this Standard is to provide users of financial reports with information that will enhance their understanding of the significance of *recognised* and unrecognised *financial instruments* to an *entity's* financial position, financial performance and cash flows and assist them in assessing the amounts, timing and certainty of future cash flows associated with those instruments. In addition to providing specific information about particular financial instrument balances and transactions, entities are encouraged to provide a discussion of the extent to which financial instruments are used, the associated risks and the business purposes served. A discussion of management's policies for controlling the risks associated with financial instruments, including policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risk and requirements for collateral to mitigate credit risks, provides a valuable additional perspective that is independent of the specific instruments outstanding at a particular time. Some entities provide such information in a commentary that accompanies their financial report rather than as part of the financial report.

5.1.2 Transactions in financial instruments may result in an entity assuming or transferring to another party one or more of the financial risks described below. The required disclosures provide information that assists users of financial reports in assessing the extent of risk related to both recognised and unrecognised financial instruments.

(a) Price risk — There are three types of price risk: currency risk, interest rate risk and market risk.

(i) Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates.

(ii) Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates.

(iii) Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual security or its issuer or factors affecting all securities traded in the market.

The term "price risk" embodies not only the potential for loss but also the potential for gain.

(b) Credit risk — Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

(c) Liquidity risk — Liquidity risk, also referred to as funding risk, is the risk that an entity will encounter difficulty in realising *assets* or otherwise raising funds to meet commitments associated with financial instruments.

(d) Cash flow risk — Cash flow risk is the risk that future cash flows associated with a *monetary financial instrument* will fluctuate in amount. In the case of a floating-rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its value.

5.1.3 This Standard does not prescribe either the format of the information required to be disclosed or its location within the financial report. With regard to recognised financial instruments, to the extent that the required information is presented on the face of the statement of financial position, it is not necessary for it to be repeated in the notes to the *financial statements*. With regard to unrecognised financial instruments, however, information in notes or supplementary schedules is the primary means of disclosure. Disclosures may include a combination of narrative descriptions and specific quantitative data as appropriate to the nature of the instruments and their relative significance to the entity.

5.1.4 Determination of the level of detail to be disclosed about particular financial instruments is a matter for the exercise of judgement taking into account the relative significance of those instruments. It is necessary to strike a balance between overburdening financial

reports with excessive detail that may not assist users of financial reports and obscuring material information as a result of too much aggregation. For example, when an entity is party to large numbers of financial instruments with similar characteristics and no one contract is individually material, summarised information by reference to particular classes of instruments is appropriate. On the other hand, specific information about an individual instrument may be material when that instrument represents, for example, a significant element in an entity's capital structure.

5.1.5 Management of an entity groups financial instruments into classes that are appropriate to the nature of the information to be disclosed, taking into account matters such as the characteristics of the instruments, whether they are recognised or unrecognised and, if they are recognised, the measurement basis that has been applied. In general, classes are determined on a basis that distinguishes items carried on a cost basis from items carried at *net fair value*. When amounts disclosed in notes or supplementary schedules relate to recognised assets and *liabilities*, it is desirable that sufficient information is provided to permit a reconciliation to relevant line items on the statement of financial position. When an entity is a party to financial instruments not dealt with by this Standard, such as obligations under superannuation plans or insurance contracts, those instruments constitute a class or classes of *financial assets* or *financial liabilities* disclosed separately from those dealt with by this Standard.

Disclosure of Terms, Conditions and Accounting Policies

5.2 For each class of financial asset, financial liability and *equity instrument*, both recognised and unrecognised, the following information must be disclosed:

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

(b) information about the extent and nature of the underlying financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

5.2.1 The contractual terms and conditions of a financial instrument are an important factor affecting the amount, timing and certainty of future cash receipts and payments by the parties to the instrument. When

recognised and unrecognised instruments (including derivative financial instruments) are material, either individually or as a class, in relation to the current financial position of an entity or its future operating results, their terms and conditions are disclosed. If no single instrument is individually material to the future cash flows of a particular entity, the essential characteristics of the instruments are described by reference to appropriate groupings of like instruments.

5.2.2 When financial instruments held or issued by an entity, either individually or as a class, create a potentially significant exposure to the risks described in paragraph 5.1.2, the following terms and conditions are normally disclosed unless the entity otherwise satisfies the general disclosure requirements in paragraph 5.2(b):

(a) the principal, stated, face, or other similar amount which, for some derivative instruments, such as interest rate swaps, may be the amount (referred to as the notional amount) on which future payments are based

(b) the stated rate or amount of interest, dividend or other periodic return on principal and the timing of payments

(c) the date of maturity, expiry or execution

(d) the collateral held, in the case of a financial asset, or pledged, in the case of a financial liability

(e) in the case of an instrument that provides for an exchange, the information described in items (a) to (d) for the instrument to be acquired in the exchange.

5.2.3 Other terms and conditions that may also warrant disclosure include:

(a) early settlement options held by either party to the instrument, including the period in which, or date at which, the options may be exercised and the exercise price or range of prices

(b) options held by either party to the instrument to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options may be exercised and the conversion or exchange ratio(s)

(c) the amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument,

including instalment repayments and any sinking fund or similar requirements

(d) in the case of an instrument for which cash flows are denominated in a currency other than the entity's reporting currency, the currency in which receipts or payments are required

(e) any condition of the instrument or an associated covenant that, if contravened, would significantly alter any of the other terms (for example, a maximum debt to *equity* ratio in a debenture covenant that, if contravened, would make the full principal amount of the debenture due and payable immediately).

5.2.4 Significant terms and conditions are disclosed whether the financial instruments are recognised or unrecognised. For example, an entity may retain exposure to credit risk associated with financial assets removed from its statement of financial position as a result of a transaction such as a securitisation. The entity's financial liability may not be recognised. Nevertheless, if the entity is obligated under recourse provisions of the transaction to indemnify the purchaser of the assets for credit losses, it normally discloses the nature of the assets removed from its statement of financial position, the amount and timing of the future cash flows contractually due from the assets, the terms of the recourse obligation and the maximum loss that could arise under that obligation.

5.2.5 When the statement of financial position presentation of a financial instrument differs from the instrument's legal form, it is desirable for an entity to explain in the notes to the financial statements the nature of the instrument.

5.2.6 The usefulness of information about the extent and nature of financial instruments is enhanced when it highlights any relationships between individual instruments that may affect the amount, timing or certainty of the future cash flows of an entity. For example, it is important to disclose hedging relationships such as might exist when an entity holds an investment in shares for which it has purchased a put option. Similarly, it is important to disclose relationships between the components of "synthetic instruments" such as fixed-rate debt created by borrowing at a floating rate and entering into a floating-to-fixed interest rate swap. In each case, an entity presents the individual financial assets and financial liabilities in its statement of financial position according to their nature, either separately or in the class of financial asset or financial liability to which they belong. The extent to which a risk

exposure is altered by the relationships among the assets and liabilities may be apparent to financial report users from information of the type described in paragraphs 5.2.2 and 5.2.3 but in some circumstances further disclosure may be necessary.

5.2.7 The existence of alternative accounting treatments for financial instruments makes it particularly important for entities to disclose their accounting policies. In accordance with Australian Accounting Standard AAS 6 "Accounting Policies", an entity provides a description of each specific accounting policy that is necessary for an understanding of the financial report, including both the general principles adopted and the method of applying those principles to significant transactions and circumstances arising in the entity's business. In the case of financial instruments, paragraph 5.2 requires disclosure of:

(a) the criteria applied in determining when to recognise a financial asset or financial liability on the statement of financial position and when to cease to recognise it

(b) the bases of measurement applied to financial assets and financial liabilities both on initial recognition and subsequently

(c) the bases on which *revenues* and *expenses* arising from financial assets and financial liabilities are recognised and measured.

5.2.8 Types of financial instrument transactions for which it may be necessary to disclose the relevant accounting policies include:

(a) transfers of financial assets when there is a continuing interest in, or involvement with, the assets by the transferor, such as securitisations of financial assets, repurchase agreements and reverse repurchase agreements

(b) acquisition or issuance of separate financial instruments as part of a series of transactions designed to synthesise the effect of acquiring or issuing a single instrument

(c) acquisition or issuance of financial instruments as hedges of risk exposures

(d) acquisition or issuance of monetary financial instruments bearing a stated interest rate that differs from the prevailing market rate at the date of issue.

5.2.9 To provide adequate information for users of financial reports to understand the basis on which financial assets and financial liabilities have been measured, disclosures of accounting policies indicate not only whether cost, net fair value or some other basis of measurement has been applied to a specific class of asset or liability but also the method of applying that basis. For example, for financial instruments carried on the cost basis, an entity may be required to disclose how it accounts for:

(a) costs of acquisition or issuance

(b) premiums and discounts on *monetary financial assets and financial liabilities*

(c) changes in the estimated amount of determinable future cash flows associated with a monetary financial instrument such as a debenture indexed to a commodity price

(d) changes in circumstances that result in significant uncertainty about the timely collection of all contractual amounts due from monetary financial assets

(e) declines in the net fair value of financial assets below their *carrying amount*

(f) restructured financial liabilities.

For financial assets and financial liabilities carried at net fair value, an entity indicates whether carrying amounts are determined from quoted market prices, independent appraisals, discounted cash flow analysis or another appropriate method, and discloses any material assumptions made in applying those methods.

5.2.10 An entity discloses the basis for reporting in *net profit or loss/result* on the statement of financial performance realised and unrealised gains and losses, interest, and other items of revenue and expense associated with financial assets and financial liabilities. This disclosure includes information about the basis on which revenue and expense arising from financial instruments held or issued for hedging purposes are recognised. When an entity presents revenue and expense items on a net basis even though the corresponding financial assets and financial liabilities have not been set off, the reason for that presentation is disclosed if the effect is material.

Disclosure of Objectives of Derivative Financial Instruments

5.3 The entity's objectives for holding or issuing derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives must be disclosed.

5.3.1 As noted in paragraph 5.1.1, qualitative disclosures about the business purposes served by financial instruments can provide a useful perspective to users of financial reports. This Standard requires such disclosure in relation to derivative financial instruments utilised by the entity, to assist users in understanding what the entity is trying to accomplish through derivative financial instruments. This disclosure normally addresses the financial risks faced by the entity in its activities (including the holding or issuing of derivatives), given that those risks are normally considered in determining the entity's objectives and strategies for using derivatives.

5.3.2 Disclosures about objectives and the financial risks of derivative financial instruments are likely to be even more useful when similar information is disclosed about other, related financial instruments or non-financial assets and liabilities. This would place the disclosures about derivative financial instruments in context, and enhance financial report users' understanding of an entity's risk management or other strategies.

Interest Rate Risk Disclosures

5.4 For each class of financial asset and financial liability, both recognised and unrecognised, information about the entity's exposure to interest rate risk must be disclosed, including:

(a) contractual repricing or maturity dates, whichever dates are earlier

(b) when applicable, effective interest rates or the weighted average effective interest rate.

5.4.1 An entity provides information concerning its exposure to the effects of future changes in the prevailing level of interest rates. Changes in market interest rates have a direct effect on the contractually determined cash flows associated with some financial assets and financial liabilities (cash flow risk) and on the net fair value of others (price risk).

5.4.2 Information about maturity dates, or repricing dates when they are earlier, indicates the length of time for which interest rates are fixed and information about effective interest rates indicates the levels at which they are fixed. Disclosure of this information provides financial report users with a basis for evaluating the interest rate price risk to which an entity is exposed and thus the potential for gain or loss. For instruments that reprice to a market rate of interest before maturity, disclosure of the period until the next repricing may be more relevant than disclosure of the period to maturity.

5.4.3 To supplement the information about contractual repricing and maturity dates, an entity may elect to disclose information about expected repricing or maturity dates when those dates differ significantly from the contractual dates. Such information may be particularly relevant when, for example, an entity is able to predict, with reasonable reliability, the amount of fixed-rate mortgage loans that will be repaid prior to maturity and it uses this data as the basis for managing its interest rate risk exposure. This additional information needs to indicate that it is based on management's expectations of future events and explain the assumptions made about repricing or maturity dates and how those assumptions differ from the contractual dates.

5.4.4 In determining suitable classes for interest rate risk disclosures, an entity considers which of its financial assets and financial liabilities are:

(a) exposed to interest rate price risk, such as monetary financial assets and financial liabilities with a fixed interest rate; or

(b) exposed to interest rate cash flow risk, such as monetary financial assets and financial liabilities with a floating interest rate that is reset as market rates change; or

(c) not exposed to interest rate risk, such as some investments in equity securities.

5.4.5 The effective interest rate (effective yield) of a monetary financial instrument is the rate that, when used in a present value calculation, results in the carrying amount of the instrument. The present value calculation applies the interest rate to the stream of future cash receipts or payments from the *reporting date* to the next repricing (maturity) date and to the expected carrying amount (principal amount) at that date. The rate is an historical rate for a fixed-rate instrument carried at amortised cost and a current market rate for a floating-rate instrument or an instrument carried at net fair value.

The effective interest rate is sometimes termed the level yield to maturity or to the next repricing date, and is the internal rate of return of the instrument for that period.

5.4.6 Interest rate information may be disclosed for individual financial instruments or weighted average rates or a range of rates may be presented for each class of financial instrument. It is desirable for an entity to group instruments denominated in different currencies or having substantially different credit risks into separate classes when these factors result in instruments having substantially different effective interest rates.

5.4.7 The requirement in paragraph 5.4(b) applies to debentures, notes and similar monetary financial instruments involving future payments that create a return to the holder and a cost to the issuer reflecting the time value of money. The requirement does not apply to financial instruments such as non-monetary and derivative instruments that do not bear a determinable effective interest rate. For example, while instruments such as interest rate derivatives, including swaps, forward rate agreements and options, are exposed to price or cash flow risk from changes in market interest rates, disclosure of an effective interest rate is not relevant. However, when providing effective interest rate information, an entity incorporates the effect on its interest rate risk exposure of hedging or "conversion" transactions, such as interest rate swaps.

5.4.8 An entity may retain an exposure to the interest rate risks associated with financial assets removed from its statement of financial position as a result of a transaction such as a securitisation. Similarly, it may become exposed to interest rate risks as a result of a transaction in which no financial asset or financial liability is recognised on its statement of financial position, such as a commitment to lend funds at a fixed interest rate. In such circumstances, the entity discloses information that will permit financial report users to understand the nature and extent of its exposure. In the case of a securitisation or similar transfer of financial assets, this information normally includes the nature of the assets transferred, their stated principal, interest rate and term to maturity, and the terms of the transaction giving rise to the retained exposure to interest rate risk. In the case of a commitment to lend funds, the disclosure normally includes the stated principal, interest rate and term to maturity of the amount to be lent and the significant terms of the transaction giving rise to the exposure to risk.

5.4.9 The nature of an entity's business and the extent of its activity in financial instruments will determine whether information about interest rate risk is presented in narrative form, in tables, or by a

combination of the two. When an entity has a significant number of financial instruments exposed to interest rate price or cash flow risks, it may adopt one or more of the following approaches to presenting information:

(a) The carrying amounts of financial instruments exposed to interest rate price risk may be presented in tabular form, grouped by those that are contracted to mature or be repriced:

  (i) within 1 year of the reporting date

  (ii) more than 1 and less than 5 years from the reporting date

  (iii) 5 years or more from the reporting date.

(b) When the performance of an entity is significantly affected by the level of its exposure to interest rate price risk or changes in that exposure, more detailed information is desirable. An entity such as a bank may disclose, for example, separate groupings of the carrying amounts of financial instruments contracted to mature or be repriced:

  (i) within 1 month of the reporting date

  (ii) more than 1 and less than 3 months from the reporting date

  (iii) more than 3 and less than 12 months from the reporting date.

(c) Similarly, an entity may indicate its exposure to interest rate cash flow risk through a table indicating the aggregate carrying amount of groups of floating-rate financial assets and financial liabilities maturing within various future time periods.

5.4.10 In some circumstances, an entity may be able to provide useful information about its exposure to interest rate risks by indicating the effect of a hypothetical change in the prevailing level of market interest rates on the net fair value of its financial instruments and future financial performance and cash flows. Such interest rate sensitivity information may be based on, for example, an assumed one percentage point change in market interest rates occurring at the reporting date. The effects of a change in interest rates includes changes in interest revenue and expense relating to floating-rate

financial instruments and gains or losses resulting from changes in the net fair value of fixed-rate instruments. The disclosed interest rate sensitivity may be restricted to the direct effects of an interest rate change on interest-bearing financial instruments on hand at the reporting date since the indirect effects of a rate change on financial markets and individual entities cannot normally be predicted reliably. When disclosing interest rate sensitivity information, it is useful if an entity indicates the basis on which it has prepared the information, including any significant assumptions.

Credit Risk Disclosures

5.5 For each class of financial asset, both recognised and unrecognised, information about the entity's exposure to credit risk must be disclosed, including:

(a) the amount that best represents its maximum credit risk exposure at the reporting date, without taking account of the value of any collateral or other security, in the event other parties fail to perform their obligations under financial instruments

(b) in respect of concentrations of credit risk that arise from exposures to a single debtor or to a group of debtors having a similar characteristic such that their ability to meet their obligations is expected to be affected similarly by changes in economic or other conditions:

(i) a description of the similar characteristic that identifies each concentration arising from exposure to a group of debtors

(ii) the amount that best represents the maximum credit risk exposure for each concentration, without taking account of the value of any collateral or other security held, in the event other entities fail to perform their obligations under financial instruments.

5.5.1 An entity provides information relating to credit risk to permit users of its financial report to assess the extent to which failures by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the reporting date. Such failures give rise to a financial loss recognised in the calculation of an entity's net profit or loss/result.

Paragraph 5.5 does not require an entity to disclose an assessment of the probability of losses arising in the future.

5.5.2 The purposes of disclosing amounts exposed to credit risk without regard to potential recoveries from realisation of collateral or other security (an entity's "maximum credit risk exposure") are:

(a) to provide users of financial reports with a consistent measure of the amount exposed to credit risk for both recognised and unrecognised financial assets

(b) to take into account the possibility that the maximum exposure to loss may differ from the carrying amount of a recognised financial asset or the value of an unrecognised financial asset that is otherwise disclosed in the financial report.

5.5.3 In the case of recognised financial assets exposed to credit risk, the carrying amount of these assets in the statement of financial position, net of any applicable provisions for loss, usually represents the amount exposed to credit risk. For example, in the case of an interest rate swap carried at net fair value, the maximum exposure to loss at the reporting date is normally the carrying amount since it represents the cost, at current market rates, of replacing the swap in the event of default. In these circumstances, no additional disclosure beyond that provided on the statement of financial position is necessary. On the other hand, as illustrated by the example in paragraph 5.5.4, an entity's maximum potential loss from some recognised financial assets may differ materially from their carrying amount and from other disclosed amounts such as their net fair value or principal amount. In such circumstances, additional disclosure is necessary to meet the requirements of paragraph 5.5(a).

5.5.4 To inform financial report users, an entity may disclose the extent to which exposure to credit risk at a particular point in time has been reduced by rights of set-off. A financial asset subject to a legally recognised right of set-off against a financial liability is not presented on the statement of financial position net of the liability unless settlement is intended to take place on a net basis or simultaneously. Nevertheless, in determining its maximum credit risk exposure, an entity takes into account the existence of a right of set-off even if it does not intend to settle on a net basis or simultaneously, provided that the financial asset is due before the financial liability. For example, when an entity is due to receive the proceeds from realisation of a financial asset before settlement of a financial liability of equal or greater amount against which the entity

has a right of set-off, the entity has the ability to exercise that right of set-off to avoid incurring a loss in the event of a default by the counterparty. However, if the entity responds, or is likely to respond, to a default by extending the term of the financial asset, an exposure to credit risk would exist on the full carrying amount of the asset if the revised terms are such that collection of the proceeds is expected to be deferred beyond the date on which the liability is required to be settled. Accordingly, when an entity has rights of set-off under which it does not intend to settle on a net basis or simultaneously, and the financial asset is due only after the financial liability, the rights of set-off do not reduce the entity's maximum credit risk exposure.

5.5.5 An entity may have entered into one or more master netting arrangements that serve to mitigate its exposure to credit loss but do not meet the set-off criteria. Such arrangements are treated as collateral or other security when determining an entity's maximum credit risk exposure. When a master netting arrangement significantly reduces the credit risk associated with financial assets not set off against financial liabilities with the same counterparty, an entity may provide additional information concerning the effect of the arrangement. It is desirable for such disclosure to indicate that:

(a) the credit risk associated with financial assets subject to a master netting arrangement is eliminated only to the extent that financial liabilities due to the same counterparty will be settled after the assets are realised

(b) the extent to which an entity's overall exposure to credit risk is reduced through a master netting arrangement may change substantially within a short period following the reporting date because the exposure is affected by each transaction subject to the arrangement.

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

5.5.6 When there is no credit risk associated with an unrecognised financial asset or the maximum exposure is equal to the principal, stated, face or other similar contractual amount of the instrument disclosed under paragraph 5.2 or the net fair value disclosed in accordance with paragraph 5.6, no additional disclosure is required to comply with paragraph 5.5(a). However, with some unrecognised financial assets, the maximum loss that would be recognised upon default by the other party to the underlying instrument may differ substantially from amounts disclosed under paragraphs 5.2 and 5.6.

For example, an entity may have a right to mitigate the loss it would otherwise bear by setting off an unrecognised financial asset against an unrecognised financial liability. In such circumstances, paragraph 5.5(a) requires disclosure in addition to that provided under paragraphs 5.2 and 5.6.

5.5.7 In addition to its maximum credit risk exposure, an entity may also disclose its policy with respect to obtaining collateral or other security from counterparties as a means of mitigating losses from defaults. Entities are encouraged to disclose an assessment of the adequacy of the collateral or other security held assuming a default had occurred, including its net fair value.

5.5.8 Concentrations of credit risk are disclosed when they are not apparent from other disclosures about the nature and financial position of the business and they result in a material exposure to loss in the event of default by other parties. Identification of material concentrations is a matter for the exercise of judgement by management taking into account the circumstances of the entity and its debtors. Australian Accounting Standard AAS 16 "Financial Reporting by Segments" provides useful guidance in identifying industry and geographic segments within which credit risk concentrations may arise.

5.5.9 Characteristics that may give rise to a concentration of risk include the nature of the activities undertaken by debtors, such as the industry in which they operate, the geographic area in which activities are undertaken and the level of creditworthiness of groups of borrowers. For example, a manufacturer of equipment for the oil and gas industry will normally have trade accounts receivable from the sale of its products for which the risk of non-payment is affected by economic changes in the oil and gas industry. A bank that normally lends on an international scale may have a significant amount of loans outstanding to less developed nations and the bank's ability to recover those loans may be adversely affected by local economic conditions.

5.5.10 Disclosure of concentrations of credit risk includes a description of the shared characteristic that identifies each concentration and the amount of the maximum credit risk exposure associated with all recognised and unrecognised financial assets sharing that characteristic.

Net Fair Value Disclosures

5.6 For each class of financial asset and financial liability, both recognised and unrecognised, the following information about net fair value must be disclosed:

(a) the aggregate net fair value as at the reporting date, showing separately the aggregate net fair value of those financial assets or financial liabilities which are not readily traded on organised markets in standardised form

(b) the method or methods adopted in determining net fair value

(c) any significant assumptions made in determining net fair value.

5.6.1 Net fair value information is widely used for business purposes in determining an entity's overall financial position and in making decisions about individual financial instruments. It is also relevant to many decisions made by users of financial reports since, in many circumstances, it reflects the judgement of the financial markets as to the present value of expected future cash flows relating to an instrument. Net fair value information permits comparisons of financial instruments having substantially the same economic characteristics, regardless of their purpose and when and by whom they were issued or acquired. Net fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities. When an entity does not recognise a financial asset or financial liability on its statement of financial position at net fair value, it provides net fair value information through supplementary disclosures.

5.6.2 The net fair value to an entity of a financial asset or financial liability takes into account the costs that would be incurred to exchange or settle the underlying financial instrument. The costs may be relatively insignificant for instruments traded in organised, liquid markets but may be substantial for other instruments. Transaction costs may include taxes and duties, fees and commissions paid to agents, advisers, brokers or dealers and levies by regulatory agencies or securities exchanges.

5.6.3 The net fair value of a financial asset or financial liability may be determined by one of several generally accepted methods. Disclosure of net fair value information includes disclosure of the

method adopted and any material assumptions made in its application.

5.6.4 Underlying the definition of net fair value is a presumption that an entity is a going concern without any intention or need to liquidate or otherwise wind up its operations or undertake a transaction on adverse terms. Net fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, an entity takes its current circumstances into account in determining the net fair values of its financial assets and financial liabilities. For example, the net fair value of a financial asset that an entity has decided to sell for cash in the immediate future is determined by the amount that it expects to receive from such a sale. The amount of cash to be realised from an immediate sale will be affected by factors such as the current liquidity and depth of the market for the asset.

5.6.5 When a financial instrument is traded in an active and liquid market, its quoted market price, adjusted for the transaction costs that would be incurred in an actual transaction, provides the best evidence of net fair value. 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 current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction may provide evidence of the current net fair value provided that there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an entity has matching asset and liability positions, it may appropriately use mid-market prices (the average of bid and offer prices) as a basis for establishing net fair values.

5.6.6 When there is infrequent activity in a market, the market is not well established (for example, some "over the counter" markets) or small volumes are traded relative to the number of trading units of a financial instrument to be valued, quoted market prices (adjusted for transaction costs) may not be indicative of the net fair value of the instrument. In these circumstances, as well as when a quoted market price is not available, estimation techniques may be used to determine net fair value with sufficient reliability to satisfy the requirements of this Standard. Techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. In applying discounted cash flow analysis, an entity uses a discount rate equal to the prevailing market rate of interest for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, 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.

5.6.7 When it is difficult to determine net fair value for a financial instrument or for a class of financial assets or financial liabilities, it may be useful to disclose a range of amounts within which the net fair value of the financial instrument or class is reasonably believed to lie. Nevertheless, a single amount needs to be determined as the net fair value of the instrument or class for inclusion in the aggregate net fair value disclosures required by paragraph 5.6.

5.6.8 The historical cost carrying amount of receivables and payables subject to normal trade credit terms usually approximates net fair value. Similarly, the net fair value of a deposit liability without a specified maturity or at call is the amount payable on demand at the reporting date.

5.6.9 Net fair value information relating to classes of financial assets or financial liabilities that are carried on the statement of financial position at other than net fair value is best provided in a way that permits comparison between the carrying amount and the net fair value. Under this approach, the net fair values of recognised financial assets and financial liabilities are grouped into classes and set off only to the extent that their related carrying amounts are set off. Net fair values of unrecognised financial assets and financial liabilities are normally presented in a class or classes separate from recognised items and are set off only to the extent that they meet the set-off criteria for recognised financial assets and financial liabilities.

Disclosure of Financial Assets Carried at an Amount in Excess of Net Fair Value

5.7 When one or more financial assets are recognised at an amount in excess of their net fair value, the following information must be disclosed:

(a) the carrying amount and the net fair value of either the individual assets or appropriate groupings of those individual assets

(b) the reasons for not reducing the carrying amount, including the nature of the evidence that provides the basis for management's belief that the carrying amount will be recovered.

5.7.1 Management exercises judgement in determining the amount it expects to recover from a financial asset. The information required by paragraph 5.7 provides users of the financial report with a basis for understanding management's exercise of judgement and assessing the possibility that circumstances may change and lead to a reduction in the asset's carrying amount in the future. When appropriate, the information required by paragraph 5.7(a) is grouped in a manner that reflects management's reasons for not reducing the carrying amount. Where non-current financial assets are carried at amounts in excess of their net fair value, the recoverable amount test in Australian Accounting Standard AAS 10 "Accounting for the Revaluation of Non-Current Assets" needs to be satisfied.

5.7.2 An entity's accounting policies with respect to recognition of declines in value of financial assets, disclosed in accordance with paragraph 5.2, assist in explaining why a particular financial asset is carried at an amount in excess of net fair value. In addition, the entity provides the reasons and evidence specific to the asset that provide management with the basis for concluding that the asset's carrying amount will be recovered. For example, the net fair value of a fixed-rate loan intended to be held to maturity may have declined below its carrying amount as a result of an increase in interest rates. In such circumstances, the lender may not have reduced the carrying amount because the lender expects to recover all amounts due under the loan.

Disclosure of Hedges of Anticipated Future Transactions

5.8 When a financial instrument has been accounted for as a hedge of risks associated with anticipated future transactions, the following information must be disclosed:

(a) a description of the anticipated transactions, including the period of time until they are expected to occur

(b) a description of the hedging instruments

(c) the amount of any deferred or unrecognised gain or loss and the expected timing of recognition as revenue or expense.

5.8.1 An entity's accounting policies indicate the circumstances in which a financial instrument is accounted for as a hedge and the nature of the special recognition and measurement treatment applied to the instrument. The information required by paragraph 5.8 permits the

users of an entity's financial report to understand the nature and effect of a hedge of an anticipated future transaction. The information may be provided on an aggregate basis when a hedged position comprises several anticipated transactions or has been hedged by several financial instruments.

5.8.2 The amount disclosed in accordance with paragraph 5.8(c) includes all accrued gains and losses on financial instruments designated as hedges of anticipated future transactions, without regard to whether those gains and losses have been recognised in the financial report. The accrued gain or loss may be unrealised but recorded in the entity's statement of financial position as a result of carrying the hedging instrument at net fair value, it may be unrecognised if the hedging instrument is carried on the cost basis, or it may have been realised if the hedging instrument has been sold or settled. In each case, however, the accrued gain or loss on the hedging instrument has not been recognised in the calculation of net profit or loss/result pending completion of the hedged transaction.

Disclosure of Commodity Contracts Regarded as Financial Instruments

5.9 Paragraphs 5.2 to 5.8 must be applied to the following types of *commodity contracts* as if the contracts were financial instruments giving rise to financial assets and financial liabilities:

(a) contracts for the delivery of gold

(b) other contracts of a type normally settled other than by physical delivery in accordance with general market practice, despite the contract terms requiring physical delivery.

5.9.1 Commodity contracts, as defined in this Standard, do not meet the definition of financial instrument because their contractual terms provide for settlement only by receipt or delivery of a physical asset. However, some commodity contracts are standardised in form and are readily traded on organised markets through cash transactions. For these commodity contracts it is normal market practice to close out an exposure under an outstanding contract by taking the opposite position in the contract or by negotiating a cash settlement, rather than settling the contract by physically delivering the underlying commodity. Commodity contracts which are normally settled other than by physical delivery and gold commodity contracts display many of the characteristics of financial instruments and may be used

for the same purposes (for example, for hedging or speculative purposes) and managed in a similar manner to financial instruments. Including deliverable gold contracts and commodity contracts which are normally settled other than by physical delivery, such as commodity contracts traded on a futures exchange, gold loans and gold forward contracts, in the disclosures required by this Standard will provide users of the financial report with useful information about both financial instruments and contracts that display the fundamental characteristics of financial instruments.

Other Disclosures

5.10.1 Additional disclosures are encouraged when they are likely to enhance financial report users' understanding of the entity's use of financial instruments. It may be desirable to disclose further quantitative information about derivative and other financial instruments. Appropriate methods of disclosure will differ for different entities and can be expected to evolve over time as management approaches and measurement techniques evolve. Possible disclosures include:

(a) the aggregate change in net fair value recognised as a revenue or an expense for those financial assets and financial liabilities measured and recognised at net fair value

(b) more details about positions at the reporting date and activity during the reporting period, for example, the total amount of deferred or unrecognised gain or loss on hedging instruments other than those relating to hedges of anticipated future transactions

(c) the sensitivity of equity, or of revenues and expenses, to several possible changes in market prices

(d) the duration of the financial instruments

(e) the average aggregate carrying amount during the reporting period of recognised financial assets and financial liabilities, the average aggregate principal, stated, notional or other similar amount during the reporting period of unrecognised financial assets and financial liabilities and the average aggregate net fair value during the reporting period of all financial assets and financial liabilities, particularly when the amounts on hand at the reporting date are unrepresentative of amounts on hand during the reporting period

(f) the entity's value at risk from derivative financial instruments and from other positions at the reporting date and the average value at risk during the reporting period.

This list is not exhaustive, and entities are encouraged to develop these and other ways of reporting the information.

6 Transitional Provisions

Financial Instruments That Do Not Contain Both a Financial Liability and an Equity Element

6.1 Subject to paragraph 6.2, the *liability* and *equity* classification standards set out in paragraphs 4.1 and 4.2 must be applied as at the beginning of the reporting period to which this Standard is first applied to *financial instruments* that do not contain both a *financial liability* and an equity element.

6.1.1 The transitional provisions apply to the liability and equity presentation requirements of the Standard and not to the disclosure requirements. The transitional provisions in paragraph 6.1 require the reclassification of financial instruments if the classification of the instruments is not in accordance with the requirements in paragraphs 4.1 and 4.2. For example, subordinated debt that is *recognised* as equity but meets the definition of a financial liability is reclassified as a liability.

6.1.2 Reclassifications between equity and liabilities under paragraph 6.1 are made by adjusting the *carrying amounts* of equity and liabilities as at the beginning of the reporting period to which this Standard is first applied. Interest, dividends or other distributions arising from the reclassified instruments after their reclassification are recognised as either *expenses* or distributions of equity (*direct debits to equity* or *direct credits to equity*) in accordance with paragraph 4.4. No adjustments are made for the classification of interest, dividends or other distributions adopted in earlier reporting periods.

6.2 For *converting financial instruments* issued on or before 28 October 1999 that do not contain both a financial liability and an equity element, the liability and equity classification standards set out in paragraph 4.2 must be applied as at the beginning of the first reporting period beginning on or after 1 January 2002.

6.2.1 An *entity* may have issued converting financial instruments that do not contain both a financial liability and an equity element prior to 29 October 1999. These converting financial instruments are not required to be classified in accordance with paragraph 4.2 until reporting periods beginning on or after 1 January 2002.

Financial Instruments That Contain Both a Financial Liability and an Equity Element

6.3 Subject to paragraph 6.4, the component part classification standards set out in paragraph 4.3 must be applied to converting financial instruments issued:

(a) after 28 October 1999, as at the beginning of the reporting period to which this Standard is first applied;

(b) on or before 28 October 1999, as at the beginning of the first reporting period beginning on or after 1 January 2002.

6.4 The component part classification standards set out in paragraph 4.3 need be applied only to financial instruments, including converting financial instruments, that were issued on or after 1 January 1998.

6.4.1 An entity may have issued compound financial instruments, for example, convertible notes, prior to 1 January 1998 that are accounted for as either a liability or as equity. The transitional provisions in paragraph 6.4 do not require the component parts of such instruments to be classified separately in accordance with paragraph 4.3. However, the instruments would normally be classified according to the predominant component part. The requirement in paragraph 6.4 acknowledges the difficulties involved in measuring the component parts when some time has passed since inception of a compound financial instrument.

Classification of Existing Converting Financial Instruments

6.5 Where a converting financial instrument is classified in a manner consistent with paragraph 4.2 and, where applicable, paragraph 4.3 as at 28 October 1999, the converting financial instrument must not be reclassified other than in accordance with this Standard.

Disclosure of Converting Financial Instruments

6.6 The following information must be disclosed for converting financial instruments that do not contain both a financial liability and an equity element issued before 29 October 1999 and converting financial instruments that contain both a financial liability and an equity element issued after 31 December 1997 and before 29 October 1999 that are not classified in accordance with paragraphs 4.2 and 4.3:

(a) the aggregate amount that would have been classified as a financial liability in the statement of financial position had the classification standards in paragraphs 4.2 and 4.3 been applied; and

(b) the aggregate amount that would have been classified as equity in the statement of financial position had the classification standards in paragraphs 4.2 and 4.3 been applied.

7 Definitions

7.1 In this Standard:

***assets* means future economic benefits controlled by the *entity* as a result of past transactions or other past events**

***associate* means an investee, not being:**

(a) a *subsidiary* of the investor; or

(b) a partnership the investor; or

(c) an investment acquired and held exclusively with a view to its disposal in the near future

over which the investor has significant influence

***carrying amount* means, in relation to an *asset* or a *liability*, the amount at which the asset or liability is recorded in the accounting records as at a particular date**

***commodity contract* means any contract that provides for settlement only by receipt or delivery of a physical asset**

converting financial instrument **means a** ***financial instrument*** **that mandatorily converts to** ***equity instruments*** **of the issuer**

direct credit to equity **means an increase in an item of** ***equity*****, where the increase is not** ***recognised*** **in** ***net profit or loss/result***

direct debit to equity **means a decrease in an item of equity, where the decrease is not recognised in net profit or loss/result**

economic entity **means a group of entities comprising the** ***parent entity*** **and each of its subsidiaries**

entity **means any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives**

equity **means the residual interest in the assets of the entity after deduction of its liabilities**

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

expenses **means consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period**

extraordinary items **means items of** ***revenue*** **and** ***expense*** **that are attributable to transactions or other events of a type that are outside the** ***ordinary activities*** **of the entity and are not of a recurring nature**

fair value **means the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction, and is determined as follows:**

(a) the quoted market price in an active and liquid market; or

(b) when there is infrequent activity in a market, the market is not well established, small volumes are

traded relative to the asset or liability to be valued, or a quoted market price is not available – an estimate of a price for the asset or liability in an active and liquid market

finance lease **means a lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incident to ownership of the leased asset and where legal ownership may or may not eventually be transferred**

financial asset **means any asset that is:**

(a) cash; or

(b) a contractual right to receive cash or another financial asset from another entity; or

(c) a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable; or

(d) an equity instrument of another entity

financial instrument **means any contract that gives rise to both a** ***financial asset*** **of one entity and a** ***financial liability*** **or equity instrument of another entity**

financial liability **means any liability that is a contractual obligation:**

(a) to deliver cash or another financial asset to another entity; or

(b) to exchange financial instruments with another entity under conditions that are potentially unfavourable

financial statements **means statement of financial performance, statement of financial position and statement of cash flows**

general purpose financial report **means a financial report intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs**

joint control **means the contractually agreed sharing of control over an economic activity. Joint control over an economic activity exists when two or more parties (*venturers*) must consent to all major decisions**

joint venture **means a contractual arrangement whereby two or more parties undertake an economic activity which is subject to *joint control***

joint venture entity **means a *joint venture* that is in the form of an entity and does not include:**

(a) an entity that is acquired and held exclusively with a view to its disposal in the near future

(b) an entity that operates under severe long-term restrictions which impair significantly its ability to make distributions to the venturer

joint venture operation **means a joint venture that is not a *joint venture entity* and does not include an entity that:**

(a) is acquired and held exclusively with a view to its disposal in the near future

(b) operates under severe long-term restrictions that impair significantly its ability to make distributions to the venturer

liabilities **means future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events**

monetary financial assets and financial liabilities **(also referred to as *monetary financial instruments*) means financial assets and financial liabilities to be received or paid in fixed or determinable amounts of money**

net fair value **means:**

(a) in relation to an asset, the *fair value* after deducting costs expected to be incurred were the asset to be exchanged

(b) in relation to a liability, the fair value plus costs expected to be incurred were the liability to be settled

***net profit or loss/result* means**

(a) in the case of an entity that is not an *economic entity*, profit or loss/result after income tax expense (income tax revenue) from ordinary activities and *extraordinary items*

(b) in the case of an entity that is an economic entity, profit or loss/result after income tax expense (income tax revenue) from ordinary activities and extraordinary items, before adjustment for that portion that can be attributed to *outside equity interest*

***operating lease* means a lease under which the lessor effectively retains substantially all the risks and benefits incident to ownership of the leased asset**

***ordinary activities* means activities that are undertaken by an entity as part of its business or to meet its objectives and related activities in which the entity engages in furtherance of, incidental to, or arising from activities undertaken to meet its objectives**

***outside equity interest* means the equity in the economic entity other than that which can be attributed to the ownership group of the parent entity**

***parent entity* means an entity which controls another entity**

***recognised* means reported on, or incorporated in amounts reported on, the face of the statement of financial performance or the statement of financial position (whether or not further disclosure of the item is made in the notes)**

***reporting date* means the end of the reporting period to which the financial report relates**

***reporting entity* means an entity (including an economic entity) in respect of which it is reasonable to expect the existence of users dependent on *general purpose financial reports* for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources**

***revenues* means inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity,**

other than those relating to contributions by owners, that result in an increase in equity during the reporting period

***subsidiary* means an entity which is controlled by a parent entity**

***venturer* means a party to a joint venture that has joint control over that joint venture.**

7.1.1 Guidance as to the definitions of assets, liabilities, equity, revenues and expenses is contained in Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements".

Financial Instruments

7.1.2 In this Standard, the terms "contract" and "contractual" refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

7.1.3 Parts of the definitions of a financial asset and a financial liability include the terms financial asset and financial instrument, but the definitions are not circular. When there is a contractual right or obligation to exchange financial instruments, the instruments to be exchanged give rise to financial assets, financial liabilities, or equity instruments. A chain of contractual rights or obligations may be established but it ultimately leads to the receipt or payment of cash or to the acquisition or issuance of an equity instrument.

7.1.4 Financial instruments include both primary instruments, such as receivables, payables and equity securities, and derivative instruments, such as financial options, futures and forwards, interest rate swaps and currency swaps. Derivative financial instruments, whether recognised or unrecognised, meet the definition of a financial instrument and, accordingly, are subject to this Standard.

7.1.5 Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. Derivative instruments do not result in a transfer of the underlying primary financial instrument on inception of the contract and such a transfer does not necessarily take place on maturity of the contract.

7.1.6 Physical assets such as inventories, property, plant and equipment, leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or other assets but it does not give rise to a present right to receive cash or other financial assets.

7.1.7 Assets, such as prepaid expenses, for which the future economic benefit is the receipt of goods or services rather than the right to receive cash or another financial asset are not financial assets. Similarly, items such as unearned revenue and most warranty obligations are not financial liabilities because the probable outflow of economic benefits associated with them is the delivery of goods and services rather than cash or another financial asset.

7.1.8 Liabilities or assets that are not contractual in nature, such as income taxes that are created as a result of statutory requirements imposed by governments, are not financial liabilities or financial assets. Accounting for income taxes is dealt with in Australian Accounting Standard AAS 3 "Accounting for Income Tax (Tax-effect Accounting)".

7.1.9 The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though many such assets and liabilities do not qualify for recognition in *financial statements* in their own right.

7.1.10 The outside equity interest that may be recognised on an entity's statement of financial position from consolidating a subsidiary is not a financial liability of the entity. In consolidated financial reports, an entity presents the interests of other parties in the equity of its subsidiaries in accordance with Australian Accounting Standard AAS 24 "Consolidated Financial Reports". Accordingly, a financial instrument classified as an equity instrument by a subsidiary is eliminated on consolidation when held by the parent entity, or presented by the parent on the consolidated statement of financial position as an outside equity interest separate from the equity of its

own shareholders. A financial instrument classified as a financial liability by a subsidiary remains a liability in the consolidated statement of financial position unless eliminated on consolidation as an intragroup balance. The accounting treatment by the parent on consolidation does not affect the basis of presentation by the subsidiary in its financial statements.

Commodity-linked Instruments

7.1.11 Contractual rights and obligations that do not involve the transfer of a financial asset do not fall within the scope of the definition of a financial instrument. For example, some contractual rights (obligations), such as those that arise under a commodity futures contract, can be settled only by the receipt (delivery) of non-financial assets. In this case, the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset.

CONFORMITY WITH INTERNATIONAL AND NEW ZEALAND ACCOUNTING STANDARDS

Conformity with International Accounting Standards

As at the date of issue of this Standard, compliance with this Standard will ensure conformity with International Accounting Standard IAS 32 "Financial Instruments: Disclosure and Presentation" and the amendments made by IAS 39 "Financial Instruments: Recognition and Measurement", with the following exceptions:

(a) the requirement to classify the component parts of compound instruments separately does not apply under this Standard to instruments issued prior to 1 January 1998. International Accounting Standards require retrospective application of component part accounting only when initial adjustments are reasonably determinable. The Australian Accounting Standards Board and the Public Sector Accounting Standards Board (the Boards) consider that in many cases it would be difficult to determine the initial adjustments required for retrospective application. Accordingly, this Standard does not require (but does allow) retrospective application. The significance of this exception will diminish over time.

(b) a parent entity need not comply with the disclosure requirements of this Standard when the parent entity's financial report is presented with the economic entity's financial report, and the economic entity's financial report applies the Standard; whereas IAS 32 does not require the preparation of parent entity financial reports or contain any exemption for parent entity reports when they are prepared. There is no difference in the scope of this Standard and IAS 32 in application to economic entity financial reports, which are the focus of the Boards' harmonisation policy.

Conformity with New Zealand Accounting Standards

As at the date of issue of this Standard, compliance with this Standard will ensure conformity with Financial Reporting Standard FRS-31 "Disclosure of Information about Financial Instruments", with the following exceptions:

(a) FRS-31 includes general disclosure requirements, such as the nature and extent of an entity's activities with respect to financial instruments

(b) FRS-31 requires disclosure of the face or contract amounts of unrecognised instruments, whereas this Standard encourages such disclosure

(c) FRS-31 also requires an entity to discuss its major management policies. These disclosures are suggested in commentary in this Standard as valuable, but are not required.

FRS-31 does not specifically address the classification of a converting financial instrument by the issuer of such an instrument.

This Appendix forms part of the commentary and is illustrative only. The purpose of the Appendix is to illustrate the application of the Standard to assist in clarifying its meaning.

APPENDIX

EXAMPLES OF THE APPLICATION OF THE STANDARD

1 This Appendix explains and illustrates the application of certain aspects of the Standard to various common financial instruments. The detailed examples are illustrative only and do not necessarily represent the only basis for applying the Standard in the specific circumstances discussed. Changing one or two of the facts assumed in the examples can lead to substantially different conclusions concerning the appropriate presentation or disclosure of a particular financial instrument. This Appendix does not address the application of all requirements of the Standard in the examples provided. In all cases, the provisions of the Standard prevail.

2 The Standard does not prescribe the basis for the recognition or measurement of financial instruments. Certain recognition and measurement practices may be assumed for purposes of illustration but they are not required to be applied in the preparation of a general purpose financial report.

Definitions

Common Types of Financial Instruments, Financial Assets and Financial Liabilities

3 Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

4 Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial

liabilities representing a contractual obligation to deliver cash in the future are:

(a) trade accounts receivable and payable

(b) notes receivable and payable

(c) loans receivable and payable

(d) bonds receivable and payable.

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

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

6 Under Australian Accounting Standard AAS 17 "Leases", a finance lease is effectively accounted for as a sale or purchase with delayed payment terms. The lease contract is considered to be primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. Accordingly, a finance lease is considered to be a financial instrument.

Equity Instruments

7 Examples of equity instruments include ordinary shares, certain types of preference shares, and warrants or options to subscribe for or purchase ordinary shares in the issuing entity. Options to subscribe for or purchase ordinary shares in the issuing entity are equity instruments of the issuer as the value of the option varies (not necessarily directly) with the fair value of the ordinary shares.

8 An option or other similar instrument acquired by an entity that gives it the right to reacquire its own equity instruments is not a financial asset of the entity. The entity will not receive cash or any other financial asset through exercise of the option. Exercise of the

option is not potentially favourable to the entity since it results in a reduction in equity and an outflow of assets.

Derivative Financial Instruments

9 On inception, derivative financial instruments give one party a contractual right to exchange financial assets with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets with another party under conditions that are potentially unfavourable. Some instruments embody both a right and an obligation to make an exchange. Since the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favourable or unfavourable.

10 A put or call option to exchange financial instruments gives the holder a right to obtain potential future economic benefits associated with changes in the value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forego potential future economic benefits or bear potential losses of economic benefits associated with changes in the value of the underlying financial instrument. The contractual right of the holder and contractual obligation of the writer meet the definition of a financial asset and a financial liability, respectively. The financial instrument underlying an option contract may be any financial asset, including shares and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would still constitute a financial asset of the holder if the option were exercised. The option holder's right to exchange the assets under potentially favourable conditions and the writer's obligation to exchange the assets under potentially unfavourable conditions are distinct from the underlying assets to be exchanged upon exercise of the option. The nature of the holder's right and the writer's obligation are not affected by the likelihood that the option will be exercised. An option to buy or sell an asset other than a financial asset (such as a commodity) for non-financial consideration does not give rise to a financial asset or financial liability because it does not fit the requirements of the definitions for the receipt or delivery of financial assets or exchange of financial instruments.

11 Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver $1,000,000 cash in exchange for $1,000,000 face amount of fixed-rate government bonds, and the other party (the seller) promises to deliver $1,000,000 face amount of fixed-rate government bonds in exchange for $1,000,000 cash.

During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above $1,000,000, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below $1,000,000, the effect will be the opposite. The purchaser has both a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). However, because the two parts of a forward contract are inseparable until the time of delivery or cash settlement, the financial asset and the financial liability are recognised on a net basis. A forward contract therefore may be recognised as either an asset or a liability depending on the value of the underlying instruments. The significant difference between a forward contract and an option contract is that both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

12 Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments, note issuance facilities and letters of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts. For example, one amount may be calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardised and traded on an exchange. Derivative instruments that embody for each party a contractual right and a contractual obligation to exchange financial instruments may be recognised as either an asset or a liability, depending on the value of the underlying instruments. This treatment is the same as the approach to recognising forward contracts explained in paragraph 11.

Commodity Contracts and Commodity-linked Financial Instruments

13 As indicated by paragraph 7.1.11 of the Standard, contracts that provide for settlement by receipt or delivery of a physical asset only (for example, an option, futures or forward contract on silver) are not financial instruments. Many commodity contracts are of this type. Some are standardised in form and traded on organised markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be readily bought and sold for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument.

14 A contract that involves receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.

15 Some contracts are commodity-linked but do not involve settlement through physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price but is settled only in cash. Such a contract constitutes a financial instrument.

16 The definition of a financial instrument encompasses also a contract that gives rise to a non-financial asset or liability in addition to a financial asset or liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time based on the value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder

concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created by the oil exchange option.

17 Although the Standard was not developed to apply generally to contracts that do not satisfy the definition of a financial instrument, the disclosure requirements in the Standard are extended to gold commodity contracts and to commodity contracts which are of a type normally settled other than by physical delivery in accordance with general market practice, as if the contracts were financial instruments giving rise to financial assets and financial liabilities. This approach is explained in paragraph 5.9.1 of the Standard. Entities may consider whether it is appropriate in their circumstances to apply the relevant disclosure standards to other commodity contracts, such as those that are expected to be settled in cash even though normal market practice is to settle by physical delivery.

Liabilities and Equity

18 It is relatively easy for issuers to classify certain types of financial instruments as liabilities or equity. Examples of equity instruments include ordinary shares and options that, if exercised, would require the writer of the option to issue ordinary shares. Ordinary shares do not oblige the issuer to transfer assets to shareholders, except when the issuer formally acts to make a distribution and becomes obligated to the shareholders to do so. This may be the case following determination of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

"Perpetual" Debt Instruments

19 "Perpetual" debt instruments, such as "perpetual" bonds, debentures and capital notes, normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8% applied to a stated par or principal amount of $1,000. Assuming 8% to be the market rate of interest for the instrument when issued, the issuer

assumes a contractual obligation to make a stream of future interest payments having a present value of $1,000. The holder and issuer of the instrument have a financial asset and financial liability, respectively, of $1,000 and corresponding interest revenue and expense of $80 each year in perpetuity.

Converting Financial Instruments

20 A converting financial instrument, where the number of equity instruments of the issuer that are deliverable to the holder varies with the fair value of the equity instruments at settlement date, is classified by the issuer as a financial liability on initial recognition in accordance with paragraph 4.2. The following example illustrates in greater detail how such an instrument may be accounted for over its term.

An entity issues a converting financial instrument with the following terms and conditions at the start of Year 1.

Issue price of converting financial instrument	$100,000
Coupon rate	6%
Coupon payments	Annually in arrears
Maturity	3 years
Settlement	Ordinary shares of the issuer
Number of ordinary shares to be issued on settlement	[Issue Price of one converting financial instrument] ÷ [90% of the market price of one ordinary share at settlement date]

Initial Recognition

The issuer recognises a liability of $100,000 on initial recognition. In accordance with paragraph 4.2, the issuer classifies the converting financial instrument as a financial liability because the holder is not exposed to changes in the share price of the issuer.

The following journal entry illustrates the accounting for the converting financial instrument on initial recognition:

	Dr $	Cr $
Cash	100,000	
Financial Liability		100,000

Subsequent to Initial Recognition

The following illustrates an approach that can be adopted by the issuer in accounting for the converting financial instrument subsequent to initial recognition.

To determine the amount of interest expense to be recognised in each year over the term of the converting financial instrument, the issuer ascertains the interest rate implicit in the instrument, which is the rate that discounts the amounts payable, including the value of the shares that will be issued at the date of conversion, to the present value on initial recognition.

The amounts payable over the term of the instrument are as follows:

	Coupon Payments $	Value of shares as at settlement date $
End of Year 1	6,000	
End of Year 2	6,000	
End of Year 3	6,000	111,111*

* The holder will receive shares worth $111,111 at settlement date, regardless of the share price at that date. Consistent with the treatment of the converting financial instrument as a financial liability, the discount of $1,111 is treated as an expense.

The interest rate implicit in the transaction is approximately 9.377%.

The present values of the liability at inception and at the end of each year during the term of the instrument (using the interest rate implicit in the instrument of 9.377%) are as follows:

Year	Opening Balance $	Interest Expense at 9.377% $	Annual Payment $	Increment in Liability $	Closing Balance $
1	100,000	9,377	6,000	3,377	103,377
2	103,377	9,694	6,000	3,694	107,071
3	107,071	10,040	6,000	4,040	111,111

The following journal entries illustrate the accounting over the term of the converting financial instrument:

	Dr $	Cr $
Year 1		
Interest expense	9,377	
Financial liability		3,377
Cash		6,000
Year 2		
Interest expense	9,694	
Financial liability		3,694
Cash		6,000
Year 3		
Interest expense	10,040	
Financial liability		4,040
Cash		6,000

Accounting for Settlement

The issuer reclassifies the financial liability as equity on settlement date as the number of ordinary shares to be issued by the issuer is determined at settlement date. The following journal entry illustrates the accounting by the issuer at this date.

	Dr $	Cr $
Financial liability	111,111	
Equity		111,111

Preference Shares

21 Preference shares may be issued with various rights, such as redemption rights of the issuer or the holder, rights of conversion into other financial instruments, and dividend or distribution rights. In classifying a preference share, or its component parts, as a liability or equity, an entity assesses the particular rights attaching to the instrument.

22 A preference share that provides for redemption for a fixed or determinable amount on a specific date or at the option of the holder meets the definition of a financial liability as the issuer has an obligation to transfer financial assets to the holder of the share.

23 In accordance with paragraph 4.2 of the Standard, a preference share that mandatorily converts to equity instruments of the issuer is classified by the issuer on initial recognition as a financial liability to the extent that the holder is not exposed to changes in the fair value of the issuer's equity instruments.

24 The inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether due to a lack of funds or a statutory restriction, does not negate the obligation. However, a preference share that has no maturity or redemption date but gives an option to the issuer to redeem the share does not (before any consideration of the effect of dividend or other rights) satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholder or to take any other specific action. The issuer can keep such shares on issue, without redemption. A financial liability arises, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of the impending redemption of the shares. At that time, the instrument is reclassified from equity to liabilities. This approach is consistent with the prohibition on reclassification of an instrument until a transaction or other specific action by the issuer or the holder alters the substance of the instrument, which is noted in paragraph 4.2.6.

25 When distributions to holders of non-redeemable preference shares are at the discretion of the issuer, the shares are equity instruments. On the other hand, if the terms of a non-redeemable preference share create a contractual obligation of the issuer to pay cumulative dividends of a fixed amount on determinable dates, that share constitutes a financial liability, the fair value of which represents the present value of the stream of the contractually required future dividends.

Compound Financial Instruments

26 Paragraph 4.3 of the Standard applies to compound financial instruments for the purpose of having the issuers present liability and equity components separately on their statements of financial position. That paragraph does not deal with compound instruments from the perspective of holders.

27 A common form of compound financial instrument is a debt security with an embedded conversion option, such as a note convertible into ordinary shares of the issuer. Paragraph 4.3 of the Standard requires the issuer of such a financial instrument to present the liability component and the equity component separately on the statement of financial position from the time of their initial recognition.

(a) The issuer's obligation to make scheduled payments of interest and principal constitutes a financial liability which exists as long as the instrument is not converted. On inception, the value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied by the market at that time to all instruments of comparable credit status and providing substantially the same cash flows on the same terms but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into equity of the issuer. The value of the option comprises its time value and its intrinsic value, if any. The intrinsic value of an option or other derivative financial instrument is the excess, if any, of the value of the underlying financial instrument over the contractual price at which the underlying instrument is to be acquired, issued, sold or exchanged. The time value of a derivative instrument is its aggregate value less its intrinsic value. The time value is associated with the length of the remaining term to maturity or expiry of the derivative instrument. It reflects the revenue foregone by the holder of the derivative instrument from not holding the underlying instrument, the cost avoided by the holder of the derivative instrument from not having to finance the underlying instrument and the value placed on the probability that the intrinsic value of the derivative instrument will increase prior to its maturity or expiry due to future volatility in the value of the underlying instrument. It is uncommon for the embedded option in a convertible bond or similar instrument to have any intrinsic value on issuance.

28 Another example of a compound financial instrument is an instrument that gives the issuer an unconditional option to settle the instrument at maturity either by paying cash or by issuing its own equity instruments to the holder. In substance, the issuer has a financial liability and a put option to "sell" its equity instruments. The put option is itself an equity element. The put option has little or no value where it entitles the issuer of the instrument to issue equity instruments at their fair value at the time of issue. The put option may have a greater value where the equity instruments can be issued at other than fair value at the date of issue. This may occur when the conversion rate is fixed at the inception of the compound instrument. In any case, the amount at which the put option is recognised as an equity element is not remeasured subsequently. The classification of the component parts of the compound financial instrument continues, as explained in paragraph 4.2.6 of the Standard, until the instrument is settled in cash or the issuer formally notifies the holders of the instrument of the impending settlement of the instrument by the issue of equity instruments. Where the issuer elects to settle the contractual obligation by issuing its equity instruments, the issuer reclassifies the financial liability component as equity only to the extent that the holder of the instrument is exposed to changes in the fair value of the equity instruments.

29 Paragraph 4.3.8 of the Standard describes how the components of a compound financial instrument may be valued on initial recognition. The following example illustrates in greater detail how such valuations may be made, showing both a residual valuation method and an option pricing model approach. The Standard does not require the use of particular measurement approaches.

An entity issues 2,000 convertible notes at the start of Year 1. The notes have a three-year term, and are issued at par with a face value of $1,000 per note, giving total proceeds of $2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each note is convertible at any time up to maturity into 250 ordinary shares.

When the notes are issued, the prevailing market interest rate for similar debt without conversion options is 9% and the market price of one ordinary share is $3. The dividends expected over the three-year term of the notes amount to $0.14 per share at the end of each year. The risk-free annual interest rate for a three-year term is 5%.

Residual valuation of equity component

Under this approach, the liability component is valued first, and the difference between the proceeds of the note issue and the value of

the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar notes having no conversion rights, as shown below.

	$
Present value of the principal – $2,000,000 payable at the end of three years	1,544,367
Present value of the interest – $120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity component (by deduction)	151,878
Proceeds of the note issue	2,000,000

Option pricing model valuation of equity component

Option pricing models may be used to determine the value of conversion options directly rather than by deduction as illustrated above. Option pricing models are often used by financial institutions for pricing day-to-day transactions. There are a number of models available, of which the Black-Scholes model is one of the most well-known, and each has a number of variants. The following example illustrates the application of a version of the Black-Scholes model that utilises tables available in finance textbooks and other sources. The steps in applying this version of the model are set out below.

1. This model first requires the calculation of two amounts that are used in the option valuation tables:

(a) Standard deviation of proportionate changes in the value of the asset underlying the option multiplied by the square root of the time to expiry of the option:

This amount relates to the potential for favourable (and unfavourable) changes in the price of the asset underlying the option, in this case the ordinary shares of the entity issuing the convertible notes. The volatility of the returns on the underlying asset is estimated by the standard deviation of the returns. The higher the standard deviation, the greater the value of the option. In this example, the standard deviation of the annual returns on the shares is assumed to be 30%. The time to expiry of the conversion rights is three years. The standard deviation of

proportionate changes in value of the shares multiplied by the square root of the time to expiry of the option is thus determined as:

$$0.3 \times \sqrt{3} = 0.5196$$

(b) Ratio of the value of the asset underlying the option to the present value of the option exercise price:

This amount relates the present value of the asset underlying the option to the cost that the option holder must pay to obtain that asset, and is associated with the intrinsic value of the option. The higher this amount, the greater the value of a call option. In this example, the market value of each share on issuance of the notes is $3. The present value of the expected dividends over the term of the option is deducted from the market price, since the payment of dividends reduces the value of the shares and thus the value of the option. The present value of a dividend of $0.14 per share at the end of each year, discounted (for the purposes of this example) at the risk-free rate of 5%, is $0.3813. The present value of the asset underlying the option is therefore:

$$\$3 - \$0.3813 = \$2.6187 \text{ per share}$$

The present value of the exercise price is $4 per share discounted at the risk-free rate of 5% over three years, assuming that the notes are converted at maturity, or $3.4554. The ratio is thus determined as:

$$\$2.6187 \div \$3.4554 = 0.7579$$

2. The note conversion option is a form of call option. The call option valuation table indicates that, for the two amounts calculated above (that is, 0.5196 and 0.7579), the value of the option is approximately 11.05% of the value of the underlying asset.

3. The valuation of the conversion options can therefore be calculated as:

$$0.1105 \times \$2.6187 \text{ per share} \times 250 \text{ shares per note} \times 2{,}000 \text{ notes} = \$144{,}683$$

4. The value of the debt component of the compound instrument calculated above by the present value method plus the value of the option calculated by the Black-Scholes option pricing

model does not equal the $2,000,000 proceeds from issuance of the convertible notes (that is, $1,848,122 + $144,683 = $1,992,805). The small difference can be prorated over the values of the two components to produce a value for the liability of $1,854,794 and a value for the option of $145,206.

30 Paragraph 4.2 of the Standard requires the issuer of a converting financial instrument to classify the instrument on initial recognition as a financial liability to the extent that the holder of the instrument is not exposed to changes in the fair value of the issuer's equity instruments. A converting financial instrument that sets a minimum or maximum or both minimum and maximum number of equity instruments that the issuer can issue is a compound instrument. For example, the issuer of a converting financial instrument that entitles the holder to a minimum number of equity instruments has in substance issued simultaneously a debt instrument that is payable in the issuer's equity instruments and an option that entitles the holder to acquire equity instruments at a fixed price. The following example illustrates in greater detail how the components of a converting financial instrument can be measured on initial recognition and how the instrument can be accounted for over the term of the instrument.

An entity issues a converting financial instrument with the following terms and conditions at the start of Year 1.

Issue price of converting financial instrument	$100,000
Coupon rate	6%
Coupon payments	Annually in arrears
Maturity	3 years
Settlement	Ordinary shares of the issuer
Number of ordinary shares to be issued on settlement	[Issue price of one converting financial instrument] ÷ [The lesser of $10.00 and the market price of one share at settlement date]
Market rate of interest for a similar liability that does not have an associated equity element	9%
Market price of one share at the issue date of the converting financial instrument	$10.00

Initial Recognition

In this example, the issuer has issued a compound financial instrument. It has sold an equity instrument as the holder is exposed to changes in the share price of the issuer if the share price exceeds $10.00. The issuer has, in substance, written a call option which gives the holder of the instrument a right to acquire its shares at $10.00 at the end of Year 3. The issuer also has a financial liability as the holder is not exposed to changes in the share price of the issuer if the share price is below $10.00 at the end of Year 3.

Paragraph 4.3.8 of the Standard provides suggestions as to how the components of a compound financial instrument can be measured on initial recognition. The following illustrates how the components can be measured using the approach as suggested in paragraph 4.3.8(a). Under paragraph 4.3.8(a), the liability component is valued first, and the difference between the proceeds of the instrument and the value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar debt that does not have a call option component.

	$
Present value of the face value of the instrument – $100,000 payable at the end of three years discounted at 9%	77,218
Present value of the interest – $6,000 payable annually in arrears for three years	15,188
Total liability component	92,406
Equity component (by deduction)	7,594
Proceeds from the instrument issue	100,000

The following journal entry illustrates the allocation on initial recognition of the $100,000 face value of the converting financial instrument between its liability and equity elements.

	Dr $	**Cr $**
Cash	100,000	
Financial liability		92,406
Equity		7,594

Subsequent to Initial Recognition

The following illustrates an approach that can be adopted by the issuer in the accounting for the above converting financial instrument subsequent to initial recognition.

The present values of the liability at inception and at the end of each year during the term of the instrument (using the market rate of interest at inception of 9%) are as follows:

Year	**Initial Recognition**	**End of Year 1**	**End of Year 2**	**End of Year 3**
	$	**$**	**$**	**$**
Present value of principal component	77,218	84,168	91,743	100,000
Present value of coupon component	15,188	10,555	5,505	–
Carrying amount of liability	92,406	94,723	97,248	100,000

Year	**Opening Balance**	**Interest Expense at 9%**	**Annual Payment**	**Increment in Liability**	**Closing Balance**
	$	**$**	**$**	**$**	**$**
1	92,406	8,317	6,000	2,317	94,723
2	94,723	8,525	6,000	2,525	97,248
3	97,248	8,752	6,000	2,752	100,000

The following journal entries illustrate the accounting over the term of the converting financial instrument:

	Dr	**Cr**
	$	**$**
Year 1		
Interest expense	8,317	
Financial liability		2,317
Cash		6,000

	Dr $	Cr $
Year 2		
Interest expense	8,525	
Financial liability		2,525
Cash		6,000
Year 3		
Interest expense	8,752	
Financial liability		2,752
Cash		6,000

Accounting for Settlement

The issuer reclassifies the financial liability as equity on settlement date as the number of ordinary shares to be issued by the issuer is determined at settlement date. The following journal entry illustrates the accounting by the issuer at this date.

	Dr $	Cr $
Financial liability	100,000	
Equity		100,000

Set-off of a Financial Asset and a Financial Liability

31 The Standard does not prescribe special treatment for so-called "synthetic instruments", which are groupings of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating-rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed-rate long-term debt. Each of the separate components of a "synthetic instrument" represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each component is exposed to risks that may differ from the risks to which other components are exposed. Accordingly, when one component of a "synthetic instrument" is an asset and another is a liability, they are not set off and presented on an entity's statement of financial position on a net basis unless they meet the criteria for setting off in paragraph 4.5 of the Standard. Those criteria often are not satisfied. Disclosures are provided about the significant terms and conditions of each financial instrument constituting a component of a "synthetic instrument" without regard to the existence of the "synthetic instrument", although an entity

may indicate in addition the nature of the relationship between the components (see paragraph 5.2.6 of the Standard).

Disclosure of Accounting Policies

32 Paragraph 5.2.8 of the Standard lists examples of broad categories of transactions that, when material, an entity addresses in its disclosure of accounting policies. In each case, an entity has a choice from among two or more different accounting treatments. The following discussion elaborates on the examples in paragraph 5.2.8 and provides further examples of circumstances in which an entity discloses its accounting policies.

(a) An entity may acquire or issue a financial instrument under which the obligations of each party are partially or completely unperformed (sometimes referred to as an unexecuted or executory contract or an agreement equally proportionately unperformed). Such a financial instrument may involve a future exchange and performance may be conditional on a future event. For example, neither the right nor the obligation to make an exchange under a forward contract results in any transaction in the underlying financial instrument until the maturity of the contract but the right and obligation constitute a financial asset and a financial liability, respectively. Similarly, a financial guarantee does not require the guarantor to satisfy the obligation to the holder of the guaranteed debt until an event of default has occurred. The guarantee is, however, a financial liability of the guarantor because it is a contractual obligation to exchange one financial instrument (usually cash) for another (a receivable from the defaulted debtor) under conditions that are potentially unfavourable.

(b) An entity may undertake a partial or incomplete transfer of a financial asset. For example, in a securitisation an entity acquires or transfers to another party some, but not all, of the future economic benefits associated with a financial instrument.

(c) An entity may be required, or intend, to link two or more individual financial instruments to provide specific assets to satisfy specific obligations. Such arrangements include, for example, non-recourse secured financing and sinking fund arrangements.

(d) An entity may use various risk management techniques to minimise exposures to financial risks. Such techniques include, for example, hedging, interest rate conversion from floating rate to fixed rate or fixed rate to floating rate, risk diversification, risk pooling, guarantees and various types of insurance (including sureties and loss limitation agreements). These techniques generally reduce the exposure to loss from only one of several different financial risks associated with a financial instrument and involve the assumption of additional but only partially offsetting risk exposures.

(e) An entity may link two or more separate financial instruments together notionally in a "synthetic instrument" or for some purposes other than those described in items (c) and (d) above.

(f) An entity may acquire or issue a financial instrument in a transaction in which the amount of the consideration exchanged for the instrument is uncertain. Such transactions may involve non-cash consideration or an exchange of several items.

(g) An entity may acquire or issue a bond, promissory note or other monetary instrument with a stated amount or rate of interest that differs from the prevailing market interest rate applicable to the instrument. Such financial instruments include zero coupon bonds and loans made on apparently favourable terms but involving non-cash consideration, for example, low interest rate loans to employees.

33 Paragraph 5.2.9 of the Standard lists several issues that an entity addresses in its disclosure of accounting policies when the issues are significant to the entity's application of the cost basis of measurement. In the case of uncertainty about the collectability of amounts realisable from a monetary financial asset or a decline in the net fair value of a financial asset below its carrying amount due to other causes, an entity indicates its policies for determining:

(a) when to reduce the carrying amount of the asset;

(b) the amount to which it reduces the carrying amount;

(c) how to recognise any revenue from the asset; and

(d) whether the reduction in carrying amount may be reversed in the future if circumstances change.

BACKGROUND TO REVISION

This section does not form part of the Standard. It is a summary of the reasons for the current revision to the Standard.

1 The reissue of the Standard is part of a program being undertaken by Public Sector Accounting Standards Board and the Australian Accounting Standards Board (the Boards) to achieve greater harmony between Australian accounting standards and those of the International Accounting Standards Committee.

2 The reissue of the Standard (hereafter referred to as the revised Standard) follows consideration of the responses received on Exposure Draft ED 98 "Presentation and Disclosure of Financial Instruments: Proposed Amendments to AASB 1033/AAS 33", which was prepared by the Boards and released in October 1998. ED 98 included proposals aimed at harmonising Australian Accounting Standard AAS 33 and Accounting Standard AASB 1033 "Presentation and Disclosure of Financial Instruments" with International Accounting Standard IAS 32 "Financial Instruments: Disclosure and Presentation" as revised by IAS 39 "Financial Instruments: Recognition and Measurement".

3 A representative of the Boards together with representatives of the national standard setters of Canada, New Zealand, the United Kingdom and the United States of America, and the IASC and representatives from the accounting bodies in Japan, Germany, France and the Nordic Federation have formed a Joint Working Group of Standard-setters (JWG). It is the objective of the JWG to produce a Standard on measurement and recognition of financial instruments in 2001. Accordingly, the extent of the amendments to AAS 33 are limited. The Boards will review all aspects of accounting for financial instruments including the classification of converting financial instruments when a Standard is completed by the JWG.

Changes to the Superseded Standard

4 The revised Standard amends the superseded Standard by specifically addressing the classification of converting financial instruments. Apart from this revision, the form, content and structure of the superseded Standard have been retained.

Principal Features of ED 98 Retained in the Standard

5 Consistent with the proposals in ED 98, the revised Standard requires an issuer of a converting financial instrument to classify the instrument as a financial liability on initial recognition to the extent that the holder of the instrument is not exposed to changes in the fair value of the issuer's equity instruments prior to the date when the number of equity instruments to be issued can be determined.

Noteworthy Differences from ED 98

6 ED 98 proposed that a financial instrument that mandatorily converts to ordinary equity instruments of the issuer must be classified as a financial liability by the issuer on initial recognition to the extent that the holder of the instrument is not exposed to changes in the fair value of the issuer's ordinary equity instruments at that date. ED 98 proposed to include a commentary paragraph explaining the nature of ordinary equity instruments of both incorporated entities and unincorporated entities.

7 Some respondents asked the Boards to clarify whether financial instruments that mandatorily convert to equity instruments other than ordinary equity instruments fall within the scope of the Standard. Other respondents expressed concerns that the guidance on the nature of ordinary equity instruments could be viewed by some to imply that only those instruments that are ordinary equity instruments can be classified as equity. The Boards decided that the proposed commentary paragraph which explained the nature of an ordinary equity instrument should be deleted and that there should not be any distinction between the different classes of equity instruments. The revised Standard clarifies that financial instruments that mandatorily convert to equity instruments of the issuer, regardless of the type of equity instruments that will be issued by the issuer, must be classified as a financial liability to the extent that the holder is not exposed to changes in the fair value of the equity instruments prior to the date when the number of equity instruments to be issued can be determined.