

Compiled AASB Standard

AASB 9

Financial Instruments

This compiled Standard applies to annual reporting periods beginning on or after 1 January 2015. Early application is permitted. It incorporates relevant amendments made up to and including 10 September 2012.

Prepared on 24 September 2012 by the staff of the Australian Accounting Standards Board.



Australian Government

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IMPLEMENTATION GUIDANCE ON IFRS 9
(available on the AASB website)

BASIS FOR CONCLUSIONS ON IFRS 9
(available on the AASB website)

Australian Accounting Standard AASB 9 *Financial Instruments* (as amended) is set out in paragraphs 1.1 – 7.2.16 and Appendices A and B. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. AASB 9 is to be read in the context of other Australian Accounting Standards, including AASB 1048 *Interpretation of Standards*, which identifies the Australian Accounting Interpretations. In the absence of explicit guidance, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies.

COMPILATION DETAILS

Accounting Standard AASB 9 *Financial Instruments* as amended

This compiled Standard applies to annual reporting periods beginning on or after 1 January 2015. It takes into account amendments up to and including 10 September 2012 and was prepared on 24 September 2012 by the staff of the Australian Accounting Standards Board (AASB).

This compilation is not a separate Accounting Standard made by the AASB. Instead, it is a representation of AASB 9 (December 2010) as amended by other Accounting Standards, which are listed in the Table below.

Table of Standards

Standard	Date made	Application date (<i>annual reporting periods ... on or after ...</i>)	Application, saving or transitional provisions
AASB 9	6 Dec 2010	(<i>beginning</i>) 1 Jan 2015	see (a) below
AASB 2011-8	2 Sep 2011	(<i>beginning</i>) 1 Jan 2013	see (b) below
AASB 2012-6	10 Sep 2012	(<i>beginning</i>) 1 Jan 2013	see (b) below

- (a) AASB 9 applies to annual reporting periods beginning on or after 1 January 2015 (instead of 1 January 2013) as a result of amendments made by AASB 2012-6 *Amendments to Australian Accounting Standards – Mandatory Effective Date of AASB 9 and Transition Disclosures*.
- (b) Entities may elect to apply the amendments to AASB 9 in this Standard as set out in paragraphs Aus1.3 and Aus1.4 of AASB 9.

Table of Amendments

Paragraph affected	How affected	By ... [paragraph]
Aus1.3	amended	AASB 2012-6 [13]
Aus1.7	amended	AASB 2012-6 [13]
3.2.1	amended	AASB 2012-6 [14]
3.2.14	amended	AASB 2012-6 [15]
4.3.7	amended	AASB 2012-6 [15]
5.1.1	amended	AASB 2012-6 [15]
5.1.1A	added	AASB 2012-6 [15]
5.2.1	amended	AASB 2012-6 [15]

Paragraph affected	How affected	By ... [paragraph]
5.4.1-5.4.3 and preceding heading	deleted	AASB 2012-6 [15]
5.6.2	amended	AASB 2012-6 [15]
7.1.2	added	AASB 2012-6 [14]
7.1.3	added	AASB 2012-6 [15]
7.2.5	amended	AASB 2012-6 [15]
7.2.10	amended	AASB 2012-6 [13]
7.2.11-7.2.12	amended	AASB 2012-6 [15]
7.2.14	amended	AASB 2012-6 [13]
Appendix A, definition of 'fair value'	amended	AASB 2011-8 [12]
B3.2.1-B3.2.3	amended	AASB 2012-6 [14]
B3.2.11	amended	AASB 2012-6 [15]
B3.2.17	amended	AASB 2012-6 [15]
B4.3.12	amended	AASB 2012-6 [14]
B5.1.1	amended	AASB 2012-6 [15]
B5.1.2A	added	AASB 2012-6 [15]
B5.2.2A	added	AASB 2012-6 [15]
B5.4.1-B5.4.13 and preceding headings	deleted	AASB 2012-6 [15]
B5.4.14 and preceding heading	amended	AASB 2012-6 [15]
B5.4.16	amended	AASB 2012-6 [15]
B5.7.15	amended	AASB 2012-6 [14]
B5.7.19	amended	AASB 2012-6 [13]
B5.7.20	amended	AASB 2012-6 [15]

COMPARISON WITH IFRS 9

AASB 9 and IFRS 9

AASB 9 *Financial Instruments* as amended incorporates IFRS 9 *Financial Instruments* as issued and amended by the International Accounting Standards Board (IASB). Paragraphs that have been added to this Standard (and do not appear in the text of IFRS 9) are identified with the prefix “Aus”, followed by the number of the preceding IASB paragraph and decimal numbering. Paragraphs that apply only to not-for-profit entities begin by identifying their limited applicability.

Compliance with IFRS 9

Entities that comply with AASB 9 as amended will simultaneously be in compliance with IFRS 9 as amended.

ACCOUNTING STANDARD AASB 9

The Australian Accounting Standards Board made Accounting Standard AASB 9 *Financial Instruments* under section 334 of the *Corporations Act 2001* on 6 December 2010.

This compiled version of AASB 9 applies to annual reporting periods beginning on or after 1 January 2015. It incorporates relevant amendments contained in other AASB Standards made by the AASB up to and including 10 September 2012 (see Compilation Details).

ACCOUNTING STANDARD AASB 9

FINANCIAL INSTRUMENTS

Chapter 1 Objective and application

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

Aus1.2 This Standard applies to:

- (a) each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;
- (b) general purpose financial statements of each other reporting entity; and
- (c) financial statements that are, or are held out to be, general purpose financial statements.

Aus1.3 This Standard applies to annual reporting periods beginning on or after 1 January 2015. Earlier application is permitted. However, if an entity elects to apply this Standard early and has not already applied AASB 9 *Financial Instruments* issued in December 2009 (as amended), it must apply all of the requirements in this Standard at the same time (but see also paragraph Aus1.7 of this Standard). If an entity applies this Standard in its financial statements for a period beginning before 1 January 2015, it shall disclose that fact and at the

same time apply the amendments in AASB 2010-7 *Amendments to Australian Accounting Standards arising from AASB 9 (December 2010)* (as amended).

- Aus1.4** This Standard may be applied from:
- (a) any date between the issue of this Standard and 31 December 2010, for entities initially applying this Standard before 1 January 2011; or
 - (b) the beginning of the first reporting period in which the entity adopts this Standard, for entities initially applying this Standard on or after 1 January 2011.
- Aus1.5** If the date of initial application is not at the beginning of a reporting period, the entity shall disclose that fact and the reasons for using that date of initial application.
- Aus1.6** The requirements specified in this Standard apply to the financial statements where information resulting from their application is material in accordance with AASB 1031 *Materiality*.
- Aus1.7** When applied or operative, this Standard supersedes AASB 9 issued in December 2009 (as amended). However, for annual reporting periods beginning before 1 January 2015, an entity may elect to apply AASB 9 issued in December 2009 (as amended) instead of applying this Standard.
- Aus1.8** When applied or operative, this Standard supersedes Interpretation 9 *Reassessment of Embedded Derivatives*, as identified in AASB 1048 *Interpretation of Standards*. The requirements added to AASB 9 in December 2010 incorporate the requirements previously set out in paragraphs 5 and 7 of Interpretation 9. As a consequential amendment, AASB 1 *First-time Adoption of Australian Accounting Standards* incorporates the requirements previously set out in paragraph 8 of Interpretation 9.

Chapter 2 Scope

- 2.1 An entity shall apply this Standard to all items within the scope of AASB 139 *Financial Instruments: Recognition and Measurement*.

Chapter 3 Recognition and derecognition

3.1 Initial recognition

3.1.1 An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument (see paragraphs B3.1.1 and B3.1.2). When an entity first recognises a financial asset, it shall classify it in accordance with paragraphs 4.1.1-4.1.5 and measure it in accordance with paragraphs 5.1.1 and 5.1.2. When an entity first recognises a financial liability, it shall classify it in accordance with paragraphs 4.2.1 and 4.2.2 and measure it in accordance with paragraph 5.1.1.

Regular way purchase or sale of financial assets

3.1.2 A *regular way purchase or sale* of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see paragraphs B3.1.3-B3.1.6).

3.2 Derecognition of financial assets

3.2.1 In consolidated financial statements, paragraphs 3.2.2-3.2.9, B3.1.1, B3.1.2 and B3.2.1-B3.2.17 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with AASB 10 *Consolidated Financial Statements* and then applies those paragraphs to the resulting group.

3.2.2 Before evaluating whether, and to what extent, *derecognition* is appropriate under paragraphs 3.2.3-3.2.9, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

- (a) Paragraphs 3.2.3-3.2.9 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.
 - (i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the

principal cash flows from a debt instrument, paragraphs 3.2.3-3.2.9 are applied to the interest cash flows.

- (ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 3.2.3-3.2.9 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.**
- (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 3.2.3-3.2.9 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.**
- (b) In all other cases, paragraphs 3.2.3-3.2.9 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 3.2.3-3.2.9 are applied to the financial asset (or a group of similar financial assets) in its entirety.**

In paragraphs 3.2.3-3.2.12, the term ‘financial asset’ refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

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

- (a) the contractual rights to the cash flows from the financial asset expire, or
- (b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6.

(See paragraph 3.1.2 for regular way sales of financial assets.)

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

- (a) transfers the contractual rights to receive the cash flows of the financial asset; or
- (b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 3.2.5.

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

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

3.2.6 When an entity transfers a financial asset (see paragraph 3.2.4), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

- (a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.**
- (b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.**
- (c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:**
 - (i) if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.**
 - (ii) if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 3.2.16).**

3.2.7 The transfer of risks and rewards (see paragraph 3.2.6) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (eg because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its *fair value* at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 3.2.5).

- 3.2.8 Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison are made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.
- 3.2.9 Whether the entity has retained control (see paragraph 3.2.6(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

Transfers that qualify for derecognition

- 3.2.10 If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 3.2.13.**
- 3.2.11 If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognise the new financial asset, financial liability or servicing liability at fair value.**
- 3.2.12 On derecognition of a financial asset in its entirety, the difference between:**
- (a) the carrying amount (measured at the date of derecognition); and**
 - (b) the consideration received (including any new asset obtained less any new liability assumed);**
- shall be recognised in profit or loss.**

3.2.13 If the transferred asset is part of a larger financial asset (eg when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 3.2.2(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:

- (a) the carrying amount (measured at the date of derecognition) allocated to the part derecognised; and
- (b) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed);

shall be recognised in profit or loss.

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

Transfers that do not qualify for derecognition

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

Continuing involvement in transferred assets

3.2.16 If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:

- (a) When the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').
- (b) When the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in the case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph B3.2.13).
- (c) When the entity's continuing involvement takes the form of a cash settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.

3.2.17 When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

- (a) the *amortised cost* of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost, or

- (b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

- 3.2.18** The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.
- 3.2.19** For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 5.7.1, and shall not be offset.
- 3.2.20** If an entity's continuing involvement is in only a part of a financial asset (eg when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 3.2.14 apply. The difference between:
- (a) the carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised; and
 - (b) the consideration received for the part no longer recognised;
- shall be recognised in profit or loss.
- 3.2.21** If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.

All transfers

- 3.2.22** If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability (see AASB 132 *Financial Instruments: Presentation* paragraph 42).
- 3.2.23** If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on

whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:

- (a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (eg as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.
- (b) If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.
- (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.
- (d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.

3.3 Derecognition of financial liabilities

- 3.3.1 An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires.
- 3.3.2 An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
- 3.3.3 The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

- 3.3.4 If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

Chapter 4 Classification

4.1 Classification of financial assets

4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:

- (a) the entity's business model for managing the financial assets; and**
- (b) the contractual cash flow characteristics of the financial asset.**

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

- (a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.**
- (b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions.

4.1.3 For the purpose of applying paragraph 4.1.2(b), interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.

4.1.4 A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.1.2.

Option to designate a financial asset at fair value through profit or loss

4.1.5 Despite paragraphs 4.1.1-4.1.4, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29-B4.1.32).

4.1.6 AASB 7 *Financial Instruments: Disclosures* requires the entity to provide disclosures about financial assets it has designated as at fair value through profit or loss.

4.2 Classification of financial liabilities

4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost using the *effective interest method*, except for:

- (a) *financial liabilities at fair value through profit or loss*. Such liabilities, including *derivatives* that are liabilities, shall be subsequently measured at fair value.
- (b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 3.2.15 and 3.2.17 apply to the measurement of such financial liabilities.
- (c) *financial guarantee contracts* as defined in Appendix A. After initial recognition, an issuer of such a contract shall (unless paragraph 4.2.1(a) or (b) applies) subsequently measure it at the higher of:
 - (i) the amount determined in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*; and
 - (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, cumulative amortisation recognised in accordance with AASB 118 *Revenue*.
- (d) commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a

commitment shall (unless paragraph 4.2.1(a) applies) subsequently measure it at the higher of:

- (i) the amount determined in accordance with AASB 137; and
- (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, cumulative amortisation recognised in accordance with AASB 118.

Option to designate a financial liability at fair value through profit or loss

4.2.2 An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:

- (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- (b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in *AASB 124 Related Party Disclosures*), for example the entity’s board of directors and chief executive officer.

4.2.3 AASB 7 requires the entity to provide disclosures about financial liabilities it has designated as at fair value through profit or loss.

4.3 Embedded derivatives

4.3.1 An embedded derivative is a component of a hybrid contract that also includes a non-derivative host – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the

contract. A derivative that is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

Hybrid contracts with financial asset hosts

4.3.2 If a hybrid contract contains a host that is an asset within the scope of this Standard, an entity shall apply the requirements in paragraphs 4.1.1-4.1.5 to the entire hybrid contract.

Other hybrid contracts

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

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);**
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and**
- (c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).**

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

4.3.5 Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this Standard, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:

- (a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or**
- (b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the**

embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

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

4.3.7 If an entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host. If the entity is unable to measure the fair value of the embedded derivative using this method, paragraph 4.3.6 applies and the hybrid contract is designated as at fair value through profit or loss.

4.4 Reclassification

4.4.1 When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1-4.1.4.

4.4.2 An entity shall not reclassify any financial liability.

4.4.3 The following changes in circumstances are not reclassifications for the purposes of paragraphs 4.4.1 and 4.4.2:

- (a) A derivative that was previously a designated and effective *hedging instrument* in a cash flow hedge or net investment hedge no longer qualifies as such.
- (b) A derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.

Chapter 5 Measurement

5.1 Initial measurement

5.1.1 At initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.

5.1.1A However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph B5.1.2A.

5.1.2 When an entity uses settlement date accounting for an asset that is subsequently measured at amortised cost, the asset is recognised initially at its fair value on the trade date (see paragraphs B3.1.3-B3.1.6).

5.2 Subsequent measurement of financial assets

5.2.1 After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 4.1.1-4.1.5 at fair value or amortised cost (see paragraphs 9 and AG5-AG8 of AASB 139).

5.2.2 An entity shall apply the impairment requirements in paragraphs 58-65 and AG84-AG93 of AASB 139 to financial assets measured at amortised cost.

5.2.3 An entity shall apply the hedge accounting requirements in paragraphs 89-102 of AASB 139 to a financial asset that is designated as a *hedged item* (see paragraphs 78-84 and AG98-AG101 of AASB 139).

5.3 Subsequent measurement of financial liabilities

5.3.1 After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 4.2.1-4.2.2 (see paragraphs 5.4.1-5.4.3 and B5.4.1-B5.4.17 and paragraphs 9 and AG5-AG8 of AASB 139).

5.3.2 An entity shall apply the hedge accounting requirements in paragraphs 89-102 of AASB 139 to a financial liability that is designated as a hedged item (see paragraphs 78-84 and AG98-AG101 of AASB 139).

5.4.1-5.4.3 [Deleted by the IASB]

5.5 Amortised cost measurement – not used

5.6 Reclassification of financial assets

5.6.1 If an entity reclassifies financial assets in accordance with paragraph 4.4.1, it shall apply the reclassification prospectively from the *reclassification date*. The entity shall not restate any previously recognised gains, losses or interest.

- 5.6.2 If, in accordance with paragraph 4.4.1, an entity reclassifies a financial asset so that it is measured at fair value, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss.
- 5.6.3 If, in accordance with paragraph 4.4.1, an entity reclassifies a financial asset so that it is measured at amortised cost, its fair value at the reclassification date becomes its new carrying amount.

5.7 Gains and losses

- 5.7.1 A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless:
- (a) it is part of a hedging relationship (see paragraphs 89-102 of AASB 139);
 - (b) it is an investment in an *equity instrument* and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5; or
 - (c) it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's *credit risk* in other comprehensive income in accordance with paragraph 5.7.7.
- 5.7.2 A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 89-102 of AASB 139) shall be recognised in profit or loss when the financial asset is derecognised, impaired or reclassified in accordance with paragraph 5.6.2, and through the amortisation process. A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 89-102 of AASB 139) shall be recognised in profit or loss when the financial liability is derecognised and through the amortisation process.
- 5.7.3 A gain or loss on financial assets or financial liabilities that are hedged items (see paragraphs 78-84 and AG98-AG101 of AASB 139) shall be recognised in accordance with paragraphs 89-102 of AASB 139.
- 5.7.4 If an entity recognises financial assets using settlement date accounting (see paragraph 3.1.2 and paragraphs B3.1.3 and B3.1.6), any change in the fair value of the asset to be received

during the period between the trade date and the settlement date is not recognised for assets measured at amortised cost (other than impairment losses). For assets measured at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate under paragraph 5.7.1.

Investments in equity instruments

5.7.5 At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is not *held for trading*.

5.7.6 If an entity makes the election in paragraph 5.7.5, it shall recognise in profit or loss dividends from that investment when the entity's right to receive payment of the dividend is established in accordance with AASB 118.

Liabilities designated as at fair value through profit or loss

5.7.7 An entity shall present a gain or loss on a financial liability designated as at fair value through profit or loss as follows:

- (a) **the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income (see paragraphs B5.7.13-B5.7.20); and**
- (b) **the remaining amount of change in the fair value of the liability shall be presented in profit or loss;**

unless the treatment of the effects of changes in the liability's credit risk described in (a) would create or enlarge an accounting mismatch in profit or loss (in which case paragraph 5.7.8 applies). Paragraphs B5.7.5-B5.7.7 and B5.7.10-B5.7.12 provide guidance on determining whether an accounting mismatch would be created or enlarged.

5.7.8 If the requirements in paragraph 5.7.7 would create or enlarge an accounting mismatch in profit or loss, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.

5.7.9 Despite the requirements in paragraphs 5.7.7 and 5.7.8, an entity shall present in profit or loss all gains and losses on loan commitments and

financial guarantee contracts that are designated as at fair value through profit or loss.

Chapter 6 Hedge accounting – not used

Chapter 7 Effective date and transition

7.1 Effective Date

7.1.1 [Deleted by the AASB]

7.1.2 AASB 2011-7 *Amendments to Australian Accounting Standards arising from the Consolidation and Joint Arrangements Standards*, issued in August 2011, amended paragraphs 3.2.1, B3.2.1-B3.2.3, B4.3.12(c) and B5.7.15. An entity shall apply those amendments when it applies AASB 10 and AASB 11 *Joint Arrangements*.

7.1.3 AASB 2011-8 *Amendments to Australian Accounting Standards arising from AASB 13*, issued in September 2011, amended paragraphs 3.2.14, 4.3.7, 5.1.1, 5.2.1, 5.6.2, 7.2.5, 7.2.11 and 7.2.12, amended the definition of fair value in Appendix A, amended paragraphs B3.2.11, B3.2.17, B5.1.1, B5.4.14, B5.4.16 and B5.7.20, deleted paragraphs 5.4.1–5.4.3 and B5.4.1–B5.4.13, and added paragraphs 5.1.1A, B5.1.2A and B5.2.2A. An entity shall apply those amendments when it applies AASB 13 *Fair Value Measurement*.

7.2 Transition

7.2.1 An entity shall apply this Standard retrospectively, in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 7.2.4-7.2.15. This Standard shall not be applied to items that have already been derecognised at the date of initial application.

7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1 and 7.2.3-7.2.16, the date of initial application is the date when an entity first applies the requirements of this Standard. The date of initial application may be:

- (a) any date between the issue of this Standard and 31 December 2010, for entities initially applying this Standard before 1 January 2011; or
- (b) the beginning of the first reporting period in which the entity adopts this Standard, for entities initially applying this Standard on or after 1 January 2011.

- 7.2.3 If the date of initial application is not at the beginning of a reporting period, the entity shall disclose that fact and the reasons for using that date of initial application.
- 7.2.4 At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraph 4.1.2(a) on the basis of the facts and circumstances that exist at the date of initial application. The resulting classification shall be applied retrospectively irrespective of the entity's business model in prior reporting periods.
- 7.2.5 If an entity measures a hybrid contract at fair value in accordance with paragraph 4.1.4 or paragraph 4.1.5 but the fair value of the hybrid contract had not been measured in comparative reporting periods, the fair value of the hybrid contract in the comparative reporting periods shall be the sum of the fair values of the components (ie the non-derivative host and the embedded derivative) at the end of each comparative reporting period.
- 7.2.6 At the date of initial application, an entity shall recognise any difference between the fair value of the entire hybrid contract at the date of initial application and the sum of the fair values of the components of the hybrid contract at the date of initial application:
- (a) in the opening retained earnings of the reporting period of initial application if the entity initially applies this Standard at the beginning of a reporting period; or
 - (b) in profit or loss if the entity initially applies this Standard during a reporting period.
- 7.2.7 At the date of initial application, an entity may designate:
- (a) a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.1.5; or
 - (b) an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5.

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

7.2.8 At the date of initial application, an entity:

- (a) shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that financial asset does not meet the condition in paragraph 4.1.5.
- (b) may revoke its previous designation of a financial asset as measured at fair value through profit or loss if that financial asset meets the condition in paragraph 4.1.5.

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

7.2.9 At the date of initial application, an entity:

- (a) may designate a financial liability as measured at fair value through profit or loss in accordance with paragraph 4.2.2(a).
- (b) shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with the condition now in paragraph 4.2.2(a) and such designation does not satisfy that condition at the date of initial application.
- (c) may revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with the condition now in paragraph 4.2.2(a) and such designation satisfies that condition at the date of initial application.

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

7.2.10 If it is impracticable (as defined in AASB 108) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58-65 and AG84-AG93 of AASB 139, the entity shall treat the fair value of the financial asset or financial liability at the end of each comparative period as its amortised cost if the entity restates prior periods. If it is impracticable (as defined in AASB 108) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58-65 and AG84-AG93 of AASB 139, the fair value of the financial asset or financial liability at the date of initial application shall be treated as the new amortised cost of that financial asset or financial liability at the date of initial application of this Standard.

- 7.2.11 If an entity previously accounted for an investment in an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) (or a derivative asset that is linked to and must be settled by delivery of such an equity instrument) at cost in accordance with AASB 139, it shall measure that instrument at fair value at the date of initial application. Any difference between the previous carrying amount and fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application.
- 7.2.12 If an entity previously accounted for a derivative liability that is linked to and must be settled by delivery of an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) at cost in accordance with AASB 139, it shall measure that derivative liability at fair value at the date of initial application. Any difference between the previous carrying amount and fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application.
- 7.2.13 At the date of initial application, an entity shall determine whether the treatment in paragraph 5.7.7 would create or enlarge an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of initial application. This Standard shall be applied retrospectively on the basis of that determination.
- 7.2.14 Despite the requirement in paragraph 7.2.1, an entity that adopts the classification and measurement requirements of this Standard for reporting periods:
- (a) beginning before 1 January 2012 need not restate prior periods and is not required to provide the disclosures set out in paragraphs 44S-44W of AASB 7;
 - (b) beginning on or after 1 January 2012 and before 1 January 2013 shall elect either to provide the disclosures set out in paragraphs 44S-44W of AASB 7 or to restate prior periods; and
 - (c) beginning on or after 1 January 2013 shall provide the disclosures set out in paragraphs 44S-44W of AASB 7. The entity need not restate prior periods.

If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting

period that includes the date of initial application. However, if an entity restates prior periods, the restated financial statements must reflect all of the requirements in this Standard.

- 7.2.15 If an entity prepares interim financial reports in accordance with AASB 134 *Interim Financial Reporting* the entity need not apply the requirements in this Standard to interim periods prior to the date of initial application if it is impracticable (as defined in AASB 108).

Entities that have applied early AASB 9 issued in 2009

- 7.2.16 An entity shall apply the transition requirements in paragraphs 7.2.1-7.2.15 at the relevant date of initial application. In other words, an entity shall apply paragraphs 7.2.4-7.2.11 if it applies AASB 9 (issued in 2009) or, not having done so, when it applies AASB 9 (December 2010) in its entirety. An entity is not permitted to apply those paragraphs more than once.

7.3 Withdrawal of IFRIC 9 and IFRS 9 (2009)

- 7.3.1 [Deleted by the AASB]
7.3.2 [Deleted by the AASB]

APPENDIX A

DEFINED TERMS

This appendix is an integral part of AASB 9.

Derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
derivative	<p>A financial instrument or other contract within the scope of this Standard (see paragraph 2.1) with all three of the following characteristics.</p> <ul style="list-style-type: none">(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.(c) It is settled at a future date.
fair value	<i>Fair value</i> is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See AASB 13.)
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

financial liability at fair value through profit or loss	<p>A financial liability that meets either of the following conditions.</p> <ul style="list-style-type: none"> (a) It meets the definition of held for trading. (b) Upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5.
held for trading	<p>A financial asset or financial liability that:</p> <ul style="list-style-type: none"> (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
reclassification date	<p>The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.</p>
regular way purchase or sale	<p>A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.</p>

The following terms are defined in paragraph 11 of AASB 132, paragraph 9 of AASB 139 or Appendix A of AASB 7 and are used in this Standard with the meanings specified in AASB 132, AASB 139 or AASB 7:

- (a) amortised cost of a financial asset or financial liability
- (b) credit risk
- (c) effective interest method

- (d) equity instrument
- (e) financial asset
- (f) financial instrument
- (g) financial liability
- (h) hedged item
- (i) hedging instrument
- (j) transaction costs.

APPENDIX B

APPLICATION GUIDANCE

This appendix is an integral part of AASB 9.

Recognition and derecognition (chapter 3)

Initial recognition (section 3.1)

- B3.1.1 As a consequence of the principle in paragraph 3.1.1, an entity recognises all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph B3.2.14). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph B3.2.15).
- B3.1.2 The following are examples of applying the principle in paragraph 3.1.1:
- (a) Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
 - (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard in accordance with paragraphs 5-7 of AASB 139, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 93 and 94 of AASB 139).

- (c) A forward contract that is within the scope of this Standard (see paragraph 2.1) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.
- (d) Option contracts that are within the scope of this Standard (see paragraph 2.1) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

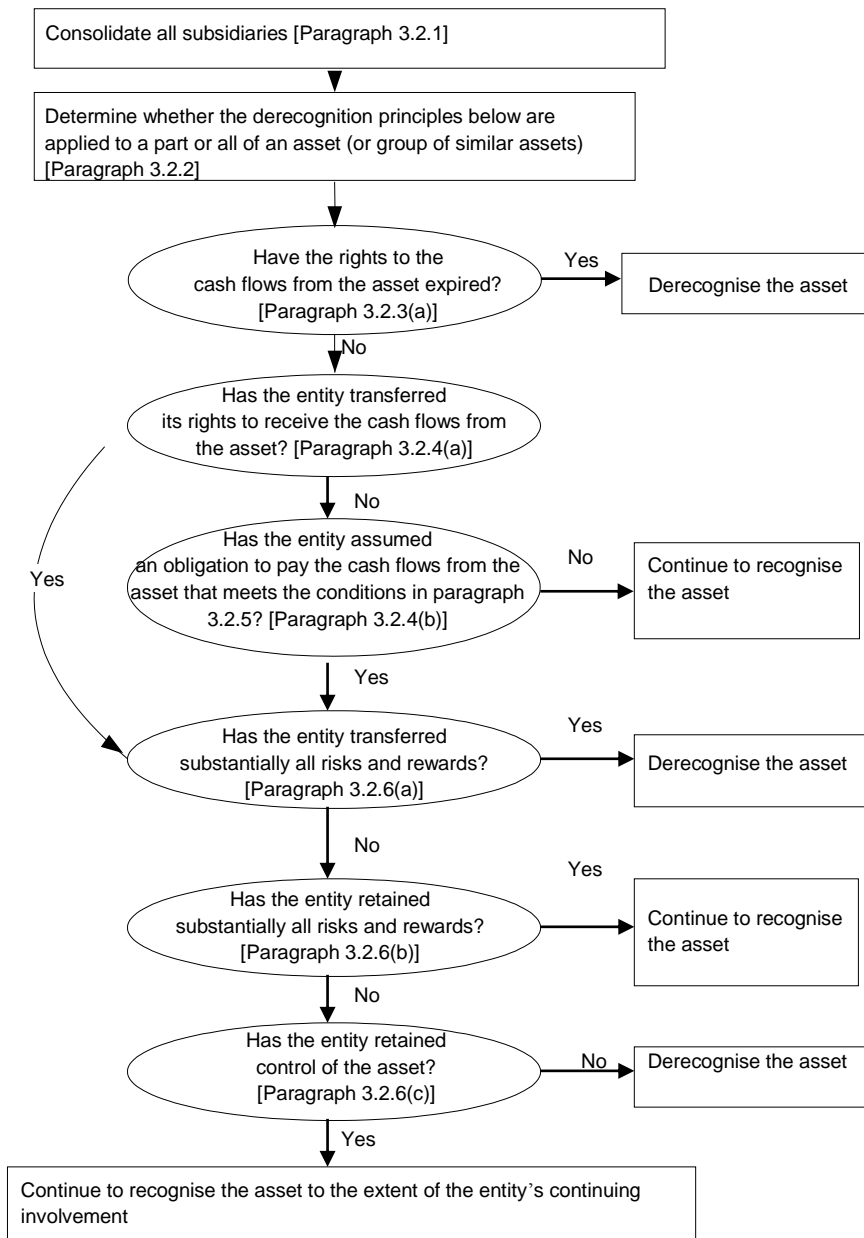
Regular way purchase or sale of financial assets

- B3.1.3 A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs B3.1.5 and B3.1.6. An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with this Standard. For this purpose assets that are mandatorily measured at fair value through profit or loss form a separate classification from assets designated as measured at fair value through profit or loss. In addition, investments in equity instruments accounted for using the option provided in paragraph 5.7.5 form a separate classification.
- B3.1.4 A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- B3.1.5 The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

B3.1.6 The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets measured at amortised cost; it is recognised in profit or loss for assets classified as financial assets measured at fair value through profit or loss; and it is recognised in other comprehensive income for investments in equity instruments accounted for in accordance with paragraph 5.7.5.

Derecognition of financial assets (section 3.2)

B3.2.1 The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 3.2.4(b))

- B3.2.2 The situation described in paragraph 3.2.4(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 3.2.5 and 3.2.6 are met.
- B3.2.3 In applying paragraph 3.2.5, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a subsidiary that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the transfer of risks and rewards of ownership (paragraph 3.2.6)

- B3.2.4 Examples of when an entity has transferred substantially all the risks and rewards of ownership are:
- (a) an unconditional sale of a financial asset;
 - (b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
 - (c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).
- B3.2.5 Examples of when an entity has retained substantially all the risks and rewards of ownership are:
- (a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
 - (b) a securities lending agreement;
 - (c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

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

B3.2.6 If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the transfer of control

B3.2.7 An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

B3.2.8 The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

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

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

B3.2.9 That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Transfers that qualify for derecognition

B3.2.10 An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 3.2.13, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to

compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

- B3.2.11 When measuring the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 3.2.13, an entity applies the fair value measurement requirements in AASB 13 in addition to paragraph 3.2.14.

Transfers that do not qualify for derecognition

- B3.2.12 The following is an application of the principle outlined in paragraph 3.2.15. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Continuing involvement in transferred assets

- B3.2.13 The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 3.2.16.

All assets

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

Assets measured at amortised cost

- (b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (ie the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss.

Assets measured at fair value

- (c) If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (CU80 – CU5) and the carrying amount of the transferred asset is CU80 (ie its fair value).
- (d) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option

exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price).

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

All transfers

- B3.2.14 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being

accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

- B3.2.15 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may measure its receivable at amortised cost if it meets the criteria in paragraph 4.1.2.

Examples

- B3.2.16 The following examples illustrate the application of the derecognition principles of this Standard.
- (a) *Repurchase agreements and securities lending.* If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its statement of financial position, for example, as a loaned asset or repurchase receivable.
 - (b) *Repurchase agreements and securities lending – assets that are substantially the same.* If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership.
 - (c) *Repurchase agreements and securities lending – right of substitution.* If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not

derecognised because the transferor retains substantially all the risks and rewards of ownership.

- (d) *Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership.
- (e) *Wash sale transaction.* The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised.
- (f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.* If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control.

However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.

- (i) *A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money.* If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph B3.2.9). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.
- (j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
- (k) *Cash-settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs B3.2.9 and (g), (h) and (i) above).
- (l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option

results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.

- (m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.
- (n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
- (o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.

- (p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) *Amortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

B3.2.17 This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

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

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

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

The entity calculates that CU9,090 (90 per cent \times CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90 per cent share. The remainder of the consideration received (CU25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 per cent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is CU65 (CU25 + CU40).

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 3.2.14 as follows:

	<i>Fair value</i>	<i>Percentage</i>	<i>Allocated carrying amount</i>
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	<u>10,100</u>		<u>10,000</u>

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

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

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

	<i>Debit</i>	<i>Credit</i>
Original asset	–	9,000
Asset recognised for subordination or the residual interest	1,000	–
Asset for the consideration received in the form of excess spread	40	–

Profit or loss (gain on transfer)	–	90
Liability	–	1,065
Cash received	9,115	–
Total	10,155	10,155

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

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

Derecognition of financial liabilities (section 3.3)

- B3.3.1 A financial liability (or part of it) is extinguished when the debtor either:
- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
 - (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

- B3.3.2 If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.
- B3.3.3 Payment to a third party, including a trust (sometimes called ‘in-substance defeasance’), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.
- B3.3.4 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.
- B3.3.5 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 3.2.1-3.2.23 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.
- B3.3.6 For the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

- B3.3.7 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:
- (a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and
 - (b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Classification (chapter 4)

Classification of financial assets (section 4.1)

The entity's business model for managing financial assets

- B4.1.1 Paragraph 4.1.1(a) requires an entity to classify financial assets as subsequently measured at amortised cost or fair value on the basis of the entity's business model for managing the financial assets. An entity assesses whether its financial assets meet this condition on the basis of the objective of the business model as determined by the entity's key management personnel (as defined in AASB 124).
- B4.1.2 The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Therefore, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.

B4.1.3 Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur. For example, the entity may sell a financial asset if:

- (a) the financial asset no longer meets the entity's investment policy (eg the credit rating of the asset declines below that required by the entity's investment policy);
- (b) an insurer adjusts its investment portfolio to reflect a change in expected duration (ie the expected timing of payouts); or
- (c) an entity needs to fund capital expenditures.

However, if more than an infrequent number of sales are made out of a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

B4.1.4 The following are examples of when the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive.

Example	Analysis
<p>Example 1</p> <p>An entity holds investments to collect their contractual cash flows but would sell an investment in particular circumstances.</p>	<p>Although an entity may consider, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective.</p>

Example	Analysis
<p data-bbox="472 553 600 584">Example 2</p> <p data-bbox="472 607 826 976">An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets with incurred credit losses. If payment on the loans is not made on a timely basis, the entity attempts to extract the contractual cash flows through various means – for example, by making contact with the debtor by mail, telephone or other methods.</p> <p data-bbox="472 1005 826 1162">In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.</p>	<p data-bbox="847 607 1177 792">The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio to make a profit by selling them.</p> <p data-bbox="847 822 1193 978">The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets have incurred credit losses).</p> <p data-bbox="847 1008 1204 1296">Moreover, the fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model. If the portfolio is not managed on a fair value basis, the objective of the business model could be to hold the assets to collect the contractual cash flows.</p>

Example	Analysis
<p>Example 3</p> <p>An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.</p> <p>The originating entity controls the securitisation vehicle and thus consolidates it.</p> <p>The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors.</p> <p>It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.</p>	<p>The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows.</p> <p>However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.</p>

- B4.1.5 One business model in which the objective is not to hold instruments to collect the contractual cash flows is if an entity manages the performance of a portfolio of financial assets with the objective of realising cash flows through the sale of the assets. For example, if an entity actively manages a portfolio of assets in order to realise fair value changes arising from changes in credit spreads and yield curves, its business model is not to hold those assets to collect the contractual cash flows. The entity's objective results in active buying and selling and the entity is managing the instruments to realise fair value gains rather than to collect the contractual cash flows.
- B4.1.6 A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 4.2.2(b)) is not held to collect contractual cash flows. Also, a portfolio of financial assets that meets the definition of

held for trading is not held to collect contractual cash flows. Such portfolios of instruments must be measured at fair value through profit or loss.

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

- B4.1.7 Paragraph 4.1.1 requires an entity (unless paragraph 4.1.5 applies) to classify a financial asset as subsequently measured at amortised cost or fair value on the basis of the contractual cash flow characteristics of the financial asset that is in a group of financial assets managed for the collection of the contractual cash flows.
- B4.1.8 An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated (see also paragraph B5.7.2).
- B4.1.9 Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include leverage. Thus such contracts do not meet the condition in paragraph 4.1.2(b) and cannot be subsequently measured at amortised cost.
- B4.1.10 Contractual provisions that permit the issuer (ie the debtor) to prepay a debt instrument (eg a loan or a bond) or permit the holder (ie the creditor) to put a debt instrument back to the issuer before maturity result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:
- (a) the provision is not contingent on future events, other than to protect:
 - (i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or
 - (ii) the holder or issuer against changes in relevant taxation or law; and

- (b) the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.
- B4.1.11 Contractual provisions that permit the issuer or holder to extend the contractual term of a debt instrument (ie an extension option) result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:
 - (a) the provision is not contingent on future events, other than to protect:
 - (i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations) or a change in control of the issuer; or
 - (ii) the holder or issuer against changes in relevant taxation or law; and
 - (b) the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.
- B4.1.12 A contractual term that changes the timing or amount of payments of principal or interest does not result in contractual cash flows that are solely principal and interest on the principal amount outstanding unless it:
 - (a) is a variable interest rate that is consideration for the time value of money and the credit risk (which may be determined at initial recognition only, and so may be fixed) associated with the principal amount outstanding; and
 - (b) if the contractual term is a prepayment option, meets the conditions in paragraph B4.1.10; or
 - (c) if the contractual term is an extension option, meets the conditions in paragraph B4.1.11.
- B4.1.13 The following examples illustrate contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
<p>Instrument A</p> <p>Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.</p> <p>However, if the interest payments were indexed to another variable such as the debtor's performance (eg the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the interest payments are not consideration for the time value of money and for credit risk associated with the principal amount outstanding. There is variability in the contractual interest payments that is inconsistent with market interest rates.</p>
<i>continued...</i>	

<i>...continued</i>	
Instrument	Analysis
<p>Instrument B</p> <p>Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money and for the credit risk associated with the instrument. The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument.</p> <p>However, if the borrower is able to choose to pay one-month LIBOR for three months and that one-month LIBOR is not reset each month, the contractual cash flows are not payments of principal and interest.</p> <p>The same analysis would apply if the borrower is able to choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate.</p> <p>However, if the instrument has a contractual interest rate that is based on a term that exceeds the instrument's remaining life, its contractual cash flows are not payments of principal and interest on the principal amount</p>
<i>continued...</i>	

<i>...continued</i>	
Instrument	Analysis
	<p>outstanding. For example, a constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity does not result in contractual cash flows that are payments of principal and interest on the principal amount outstanding. That is because the interest payable in each period is disconnected from the term of the instrument (except at origination).</p>
<p>Instrument C</p> <p>Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.</p>	<p>The contractual cash flows of both:</p> <ul style="list-style-type: none"> (a) an instrument that has a fixed interest rate; and (b) an instrument that has a variable interest rate; <p>are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money and for the credit risk associated with the instrument during the term of the instrument.</p> <p>Therefore, an instrument that is a combination of (a) and (b) (eg a bond with an interest rate cap) can have cash flows that are solely payments of principal and</p>
<i>continued...</i>	

<i>...continued</i>	
Instrument	Analysis
	interest on the principal amount outstanding. Such a feature may reduce cash flow variability by setting a limit on a variable interest rate (eg an interest rate cap or floor) or increase the cash flow variability because a fixed rate becomes variable.
Instrument D Instrument D is a full recourse loan and is secured by collateral.	The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

B4.1.14 The following examples illustrate contractual cash flows that are not payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
Instrument E Instrument E is a bond that is convertible into equity instruments of the issuer.	The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because the interest rate does not reflect only consideration for the time value of money and the credit risk. The return is also linked to the value of the equity of the issuer.
<i>continued...</i>	

<i>...continued</i>	
<p>Instrument F</p> <p>Instrument F is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates).</p>	<p>The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding.</p> <p>The interest amounts are not consideration for the time value of money on the principal amount outstanding.</p>
<p>Instrument G</p> <p>Instrument G is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.</p> <p>Instrument G pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards.</p> <p>Deferred interest does not accrue additional interest.</p>	<p>The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.</p> <p>If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.</p> <p>The fact that Instrument G is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest</p>
<i>continued...</i>	

<i>...continued</i>	
Instrument	Analysis
	<p>on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.</p> <p>Also, the fact that Instrument G is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal. Even if the callable amount includes an amount that compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding</p>

- B4.1.15 In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.1.2(b) and 4.1.3 of this Standard.
- B4.1.16 This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, the contractual cash flows may include payment for factors other than consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. As a result, the instrument would not satisfy the condition in paragraph 4.1.2(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

- B4.1.17 However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraph 4.1.2(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraph 4.1.2(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.
- B4.1.18 If a contractual cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.
- B4.1.19 In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

Contractually linked instruments

- B4.1.20 In some types of transactions, an entity may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest

on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches.

- B4.1.21 In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:
- (a) the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (eg the interest rate on the tranche is not linked to a commodity index);
 - (b) the underlying pool of financial instruments has the cash flow characteristics set out in paragraphs B4.1.23 and B4.1.24; and
 - (c) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, this condition would be met if the underlying pool of instruments were to lose 50 per cent as a result of credit losses and under all circumstances the tranche would lose 50 per cent or less).
- B4.1.22 An entity must look through until it can identify the underlying pool of instruments that are creating (rather than passing through) the cash flows. This is the underlying pool of financial instruments.
- B4.1.23 The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.
- B4.1.24 The underlying pool of instruments may also include instruments that:
- (a) reduce the cash flow variability of the instruments in paragraph B4.1.23 and, when combined with the instruments in paragraph B4.1.23, result in cash flows that are solely payments of principal and interest on the principal amount outstanding (eg an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in paragraph B4.1.23); or

- (b) align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph B4.1.23 to address differences in and only in:
 - (i) whether the interest rate is fixed or floating;
 - (ii) the currency in which the cash flows are denominated, including inflation in that currency; or
 - (iii) the timing of the cash flows.
- B4.1.25 If any instrument in the pool does not meet the conditions in either paragraph B4.1.23 or paragraph B4.1.24, the condition in paragraph B4.1.21(b) is not met.
- B4.1.26 If the holder cannot assess the conditions in paragraph B4.1.21 at initial recognition, the tranche must be measured at fair value. If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the conditions in paragraphs B4.1.23 and B4.1.24, the tranche does not meet the conditions in paragraph B4.1.21 and must be measured at fair value.

Option to designate a financial asset or financial liability as at fair value through profit or loss (sections 4.1 and 4.2)

- B4.1.27 Subject to the conditions in paragraphs 4.1.5 and 4.2.2, this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.
- B4.1.28 The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of AASB 108 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of designation of a financial liability as at fair value through profit or loss, paragraph 4.2.2 sets out the two circumstances when the requirement for more relevant information will be met.

Accordingly, to choose such designation in accordance with paragraph 4.2.2, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Designation eliminates or significantly reduces an accounting mismatch

- B4.1.29 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as subsequently measured at fair value and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss.
- B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a).
- (a) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by AASB 4 *Insurance Contracts*, paragraph 24), and financial assets it considers related that would otherwise be measured at amortised cost.
 - (b) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 of AASB 139 are not met.
 - (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each

other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

- B4.1.31 In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.
- B4.1.32 It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100 and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must

designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

A group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis

- B4.1.33 An entity may manage and evaluate the performance of a group of financial liabilities or financial assets and financial liabilities in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.
- B4.1.34 For example, an entity may use this condition to designate financial liabilities as at fair value through profit or loss if it meets the principle in paragraph 4.2.2(b) and the entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments.
- B4.1.35 As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial liabilities as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial liabilities that are managed and evaluated together.
- B4.1.36 Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 4.2.2(b). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department – as approved by the entity's key management personnel – clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 4.2.2(b).

Embedded derivatives (section 4.3)

- B4.3.1 When an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard, paragraph 4.3.3 requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently.
- B4.3.2 If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.
- B4.3.3 An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.
- B4.3.4 Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see AASB 132) are accounted for separately from those classified as assets or liabilities. In addition, if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.
- B4.3.5 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 4.3.3(a)) in the following examples. In these examples, assuming the conditions in paragraph 4.3.3(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.
- (b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.
- (c) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the value of equity instruments – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (d) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the price of a commodity (such as gold) – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:
 - (i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or
 - (ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is

the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with AASB 132.

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

B4.3.6 An example of a hybrid contract is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (ie the indexed principal payment) under paragraph 4.3.3 because the host contract is a debt instrument under paragraph B4.3.2 and the indexed principal payment is not closely related to a host debt instrument under paragraph B4.3.5(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

B4.3.7 In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

- B4.3.8 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.
- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.
 - (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.
 - (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (eg a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because AASB 121 *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in profit or loss.
 - (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option

feature, and requires payments denominated in one of the following currencies:

- (i) the functional currency of any substantial party to that contract;
 - (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
 - (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).
- (e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.
- (f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.
- (g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.
- (h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded

derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

Instruments containing embedded derivatives

- B4.3.9 As noted in paragraph B4.3.1, when an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard and with one or more embedded derivatives, paragraph 4.3.3 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire hybrid contract to be designated as at fair value through profit or loss.
- B4.3.10 Such designation may be used whether paragraph 4.3.3 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 4.3.5 would not justify designating the hybrid contract as at fair value through profit or loss in the cases set out in paragraph 4.3.5(a) and (b) because doing so would not reduce complexity or increase reliability.

Reassessment of embedded derivatives

- B4.3.11 In accordance with paragraph 4.3.3, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.
- B4.3.12 Paragraph B4.3.11 does not apply to embedded derivatives in contracts acquired in:

- (a) a business combination (as defined in AASB 3 *Business Combinations*);
- (b) a combination of entities or businesses under common control as described in paragraphs B1-B4 of AASB 3; or
- (c) the formation of a joint venture as defined in AASB 11 *Joint Arrangements*

or their possible reassessment at the date of acquisition.¹

Reclassification of financial assets (section 4.4)

B4.4.1 Paragraph 4.4.1 requires an entity to reclassify financial assets if the objective of the entity's business model for managing those financial assets changes. Such changes are expected to be very infrequent. Such changes must be determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Examples of a change in business model include the following:

- (a) An entity has a portfolio of commercial loans that it holds to sell in the short-term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

B4.4.2 A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.

¹ AASB 3 addresses the acquisition of contracts with embedded derivatives in a business combination.

- B4.4.3 The following are not changes in business model:
- (a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).
 - (b) The temporary disappearance of a particular market for financial assets.
 - (c) A transfer of financial assets between parts of the entity with different business models.

Measurement (chapter 5)

Initial measurement (section 5.1)

- B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and AASB 13). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.
- B5.1.2 If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives.
- B5.1.2A The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also AASB 13). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:
- (a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market

for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

- (b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

Subsequent measurement of financial assets (section 5.2)

- B5.2.1 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value decreases below zero, it is a financial liability measured in accordance with paragraph 4.2.1. However, hybrid contracts with hosts that are assets within the scope of this Standard are always measured in accordance with paragraph 4.3.2.
- B5.2.2 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income in accordance with paragraph 5.7.5. An entity acquires an asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income.
- B5.2.2A The subsequent measurement of a financial asset or financial liability and the subsequent recognition of gains and losses described in paragraph B5.1.2A shall be consistent with the requirements of this Standard.
- B5.4.1-B5.4.13 [Deleted by the IASB]

Investments in equity instruments and contracts on those investments

- B5.4.14 All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.
- B5.4.15 Indicators that cost might not be representative of fair value include:
- (a) a significant change in the performance of the investee compared with budgets, plans or milestones.
 - (b) changes in expectation that the investee's technical product milestones will be achieved.
 - (c) a significant change in the market for the investee's equity or its products or potential products.
 - (d) a significant change in the global economy or the economic environment in which the investee operates.
 - (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.
 - (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.
 - (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.
- B5.4.16 The list in paragraph B5.4.15 is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.
- B5.4.17 Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Gains and losses (section 5.7)

- B5.7.1 Paragraph 5.7.5 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. This election is made on an instrument-by-instrument (ie share-by-share) basis. Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity. Dividends on such investments are recognised in profit or loss in accordance with AASB 118 unless the dividend clearly represents a recovery of part of the cost of the investment.
- B5.7.2 An entity applies AASB 121 to financial assets and financial liabilities that are monetary items in accordance with AASB 121 and denominated in a foreign currency. AASB 121 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 95-101 of AASB 139) or a hedge of a net investment (see paragraph 102 of AASB 139).
- B5.7.3 Paragraph 5.7.5 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. Such an investment is not a monetary item. Accordingly, the gain or loss that is presented in other comprehensive income in accordance with paragraph 5.7.5 includes any related foreign exchange component.
- B5.7.4 If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in profit or loss.

Liabilities designated as at fair value through profit or loss

- B5.7.5 When an entity designates a financial liability as at fair value through profit or loss, it must determine whether presenting in other comprehensive income the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss. An accounting mismatch would be created or enlarged if presenting the effects of changes in the liability's credit risk in other comprehensive income would

result in a greater mismatch in profit or loss than if those amounts were presented in profit or loss.

- B5.7.6 To make that determination, an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument measured at fair value through profit or loss. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument.
- B5.7.7 That determination is made at initial recognition and is not reassessed. For practical purposes the entity need not enter into all of the assets and liabilities giving rise to an accounting mismatch at exactly the same time. A reasonable delay is permitted provided that any remaining transactions are expected to occur. An entity must apply consistently its methodology for determining whether presenting in other comprehensive income the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss. However, an entity may use different methodologies when there are different economic relationships between the characteristics of the liabilities designated as at fair value through profit or loss and the characteristics of the other financial instruments. AASB 7 requires an entity to provide qualitative disclosures in the notes to the financial statements about its methodology for making that determination.
- B5.7.8 If such a mismatch would be created or enlarged, the entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in profit or loss. If such a mismatch would not be created or enlarged, the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income.
- B5.7.9 Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity.
- B5.7.10 The following example describes a situation in which an accounting mismatch would be created in profit or loss if the effects of changes in the credit risk of the liability were presented in other comprehensive income. A mortgage bank provides loans to customers and funds those loans by selling bonds with matching characteristics (eg amount outstanding, repayment profile, term and currency) in the market. The contractual terms of the loan permit the mortgage customer to

prepay its loan (ie satisfy its obligation to the bank) by buying the corresponding bond at fair value in the market and delivering that bond to the mortgage bank. As a result of that contractual prepayment right, if the credit quality of the bond worsens (and, thus, the fair value of the mortgage bank's liability decreases), the fair value of the mortgage bank's loan asset also decreases. The change in the fair value of the asset reflects the mortgage customer's contractual right to prepay the mortgage loan by buying the underlying bond at fair value (which, in this example, has decreased) and delivering the bond to the mortgage bank. Therefore, the effects of changes in the credit risk of the liability (the bond) will be offset in profit or loss by a corresponding change in the fair value of a financial asset (the loan). If the effects of changes in the liability's credit risk were presented in other comprehensive income there would be an accounting mismatch in profit or loss. Therefore, the mortgage bank is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in profit or loss.

- B5.7.11 In the example in paragraph B5.7.10, there is a contractual linkage between the effects of changes in the credit risk of the liability and changes in the fair value of the financial asset (ie as a result of the mortgage customer's contractual right to prepay the loan by buying the bond at fair value and delivering the bond to the mortgage bank). However, an accounting mismatch may also occur in the absence of a contractual linkage.
- B5.7.12 For the purposes of applying the requirements in paragraphs 5.7.7 and 5.7.8, an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk. An accounting mismatch in profit or loss would arise only when the effects of changes in the liability's credit risk (as defined in AASB 7) are expected to be offset by changes in the fair value of another financial instrument. A mismatch that arises solely as a result of the measurement method (ie because an entity does not isolate changes in a liability's credit risk from some other changes in its fair value) does not affect the determination required by paragraphs 5.7.7 and 5.7.8. For example, an entity may not isolate changes in a liability's credit risk from changes in liquidity risk. If the entity presents the combined effect of both factors in other comprehensive income, a mismatch may occur because changes in liquidity risk may be included in the fair value measurement of the entity's financial assets and the entire fair value change of those assets is presented in profit or loss. However, such a mismatch is caused by measurement

imprecision, not the offsetting relationship described in paragraph B5.7.6 and, therefore, does not affect the determination required by paragraphs 5.7.7 and 5.7.8.

The meaning of ‘credit risk’

- B5.7.13 AASB 7 defines credit risk as ‘the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation’. The requirement in paragraph 5.7.7(a) relates to the risk that the issuer will fail to perform on that particular liability. It does not necessarily relate to the creditworthiness of the issuer. For example, if an entity issues a collateralised liability and a non-collateralised liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero.
- B5.7.14 For the purposes of applying the requirement in paragraph 5.7.7(a), credit risk is different from asset-specific performance risk. Asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but rather it is related to the risk that a single asset or a group of assets will perform poorly (or not at all).
- B5.7.15 The following are examples of asset-specific performance risk:
- (a) A liability with a unit-linking feature whereby the amount due to investors is contractually determined on the basis of the performance of specified assets. The effect of that unit-linking feature on the fair value of the liability is asset-specific performance risk, not credit risk.
 - (b) A liability issued by a structured entity with the following characteristics. The entity is legally isolated so the assets in the entity are ring-fenced solely for the benefit of its investors, even in the event of bankruptcy. The entity enters into no other transactions and the assets in the entity cannot be hypothecated. Amounts are due to the entity’s investors only if the ring-fenced assets generate cash flows. Thus, changes in the fair value of the liability primarily reflect changes in the fair value of the assets. The effect of the performance of the assets on the fair value of the liability is asset-specific performance risk, not credit risk.

Determining the effects of changes in credit risk

- B5.7.16 For the purposes of applying the requirement in paragraph 5.7.7(a), an entity shall determine the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability either:
- (a) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see paragraphs B5.7.17 and B5.7.18); or
 - (b) using an alternative method the entity believes more faithfully represents the amount of change in the liability's fair value that is attributable to changes in its credit risk.
- B5.7.17 Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates.
- B5.7.18 If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount in paragraph B5.7.16(a) can be estimated as follows:
- (a) First, the entity computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.
 - (b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).
 - (c) The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).

- B5.7.19 The example in paragraph B5.7.18 assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in observed (benchmark) interest rates are not significant. This method would not be appropriate if changes in fair value arising from other factors are significant. In those cases, an entity is required to use an alternative method that more faithfully measures the effects of changes in the liability's credit risk (see paragraph B5.7.16(b)). For example, if the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).
- B5.7.20 As with all fair value measurements, an entity's measurement method for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk must make maximum use of relevant observable inputs and minimum use of unobservable inputs.

Effective date and transition (chapter 7)

Transition (section 7.2)

Financial assets held for trading

- B7.2.1 At the date of initial application of this Standard, an entity must determine whether the objective of the entity's business model for managing any of its financial assets meets the condition in paragraph 4.1.2(a) or if a financial asset is eligible for the election in paragraph 5.7.5. For that purpose, an entity shall determine whether financial assets meet the definition of held for trading as if the entity had acquired the assets at the date of initial application.

Definitions (Appendix A)

Derivatives

- BA.1 Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can

change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000 if six-month LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

- BA.2 The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (eg a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (eg a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 5-7 of AASB 139).
- BA.3 One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.
- BA.4 A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 3.1.2 and B3.1.3-B3.1.6).
- BA.5 The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable)

but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Financial assets and liabilities held for trading

- BA.6 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.
- BA.7 Financial liabilities held for trading include:
- (a) derivative liabilities that are not accounted for as hedging instruments;
 - (b) obligations to deliver financial assets borrowed by a short seller (ie an entity that sells financial assets it has borrowed and does not yet own);
 - (c) financial liabilities that are incurred with an intention to repurchase them in the near term (eg a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
 - (d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.
- BA.8 The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

DELETED IFRS 9 TEXT

Deleted IFRS 9 text is not part of AASB 9.

Paragraph 7.1.1

An entity shall apply this IFRS for annual periods beginning on or after 1 January 2015. Earlier application is permitted. However, if an entity elects to apply this IFRS early and has not already applied IFRS 9 issued in 2009, it must apply all of the requirements in this IFRS at the same time (but see also paragraph 7.3.2). If an entity applies this IFRS in its financial statements for a period beginning before 1 January 2015, it shall disclose that fact and at the same time apply the amendments in Appendix C.

Paragraph 7.3.1

This IFRS supersedes IFRIC 9 *Reassessment of Embedded Derivatives*. The requirements added to IFRS 9 in October 2010 incorporated the requirements previously set out in paragraphs 5 and 7 of IFRIC 9. As a consequential amendment, IFRS 1 *First-time Adoption of International Financial Reporting Standards* incorporated the requirements previously set out in paragraph 8 of IFRIC 9.

Paragraph 7.3.2

This IFRS supersedes IFRS 9 issued in 2009. However, for annual periods beginning before 1 January 2015, an entity may elect to apply IFRS 9 issued in 2009 instead of applying this IFRS.