

INTRODUCTION TO IPSAS



Financial Instruments

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Introduction



Introduction

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting standards for public sector entities.

Information about financial instruments is important to users, as it provides insight into the risks related to financial assets and financial liabilities including the exposure to risks arising from these to the entity and how they are managed. Such information can influence a user's assessment of the financial position and financial performance, as well as provide insight into the amount, timing, and uncertainty of an entities future cash flows.

The extent and nature of financial instruments held by public sector entities varies significantly from entities that have few financial instruments (e.g., a government department whose only financial instruments are accounts receivable and accounts payable) and those that have many and complex financial instruments (e.g., a financial institution whose assets and liabilities are comprised mostly of financial instruments). The complexity and extent of the requirements for presentation, recognition, measurement and disclosures of financial instruments depends on the extent of the entity's use of financial instruments and of its exposure to risk.

It is common for public sector entities to use derivatives in managing interest rate risk, credit risk and risks associated with fluctuating market prices of commodities. This module addresses the recognition of derivatives acquired to off et these risks and their measurement.

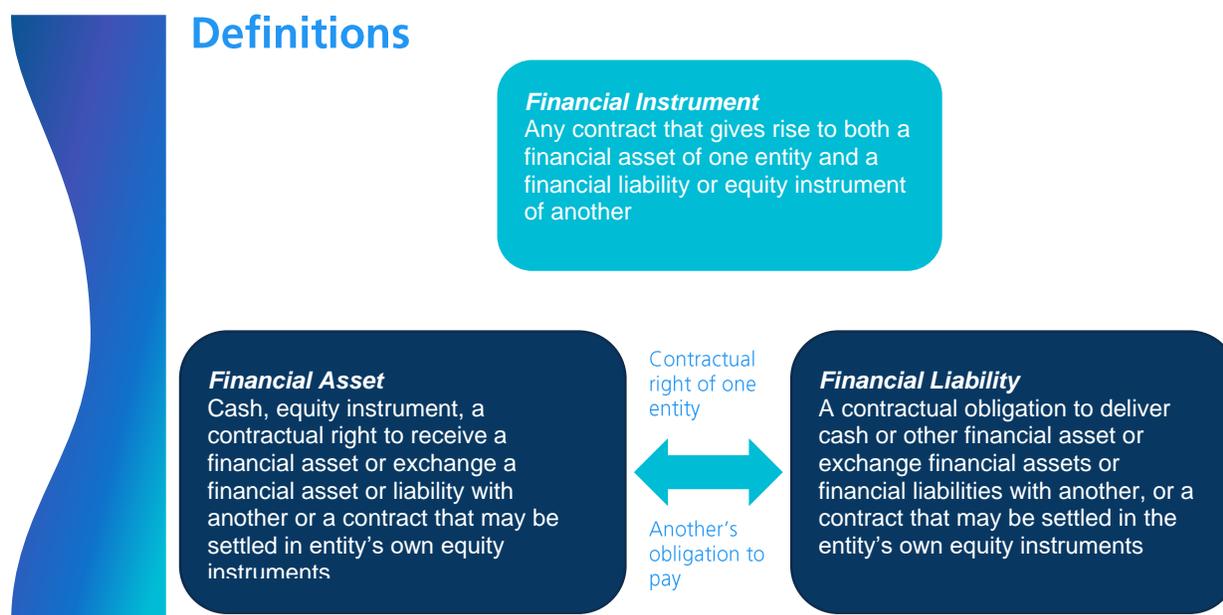
This module focuses on requirements of [IPSAS 28, *Financial Instruments: Presentation*](#), [IPSAS 29, *Financial Instruments: Recognition and Measurement*](#), [IPSAS 30, *Financial Instruments: Disclosures*](#), and [IPSAS 41, *Financial Instruments*](#).

IPSAS 41 was issued in August 2018 and has an effective date of January 1, 2023, with early adoption permitted. IPSAS 41 will supersede IPSAS 29 from the point that an entity adopts IPSAS 41.

This module discusses both IPSAS 29 and IPSAS 41 as some entities may have adopted, or be in the process of adopting, IPSAS 29. Entities that are in the process of adopting accrual basis IPSAS but have yet to consider the financial instruments requirements are strongly encouraged to adopt IPSAS 41 as initially adopting IPSAS 29 would result in the need for significant accounting changes at a later date.

The material will focus on the more common public sector transactions involving financial instruments. For example, since it is not common for entities in the public sector to have contributed capital comprising equity instruments, the guidance will not cover financial assets or financial liabilities that arise from contracts that will be settled by an entity delivering or receiving its own equity instruments.

Definitions



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

Assets and liabilities in the public sector arise out of both contractual and non-contractual arrangements. Assets and liabilities arising out of non-contractual arrangements do not meet the definition of a financial asset or a financial liability. For example, provisions accounted for in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* would generally not be a financial instrument. Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Similarly prepaid assets are not financial assets because they represent economic benefits in the form of future receipt of goods or services.

Constructive obligations do not arise from contracts and are therefore not financial liabilities.

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

Public sector entities may enter into arrangements that have the substance of contracts. Application Guidance explains the factors an entity should consider in assessing whether an arrangement is contractual or non-contractual.

An entity considers the substance rather than the legal form of an arrangement in determining whether it is a contract that meets the definition of a financial instrument. Contracts are generally evidenced by the following (although this may differ from jurisdiction to jurisdiction):

- a) Contracts involve willing parties entering into an arrangement;
- b) The terms of the contract create rights and obligations for the parties to the contract, and those rights and obligations need not result in equal performance by each party; and
- c) The remedy for non-performance is enforceable by law.

An example of a contract would be a sale/purchase agreement of a non-financial asset when consideration is in the form of cash or cash equivalents. The amount of revenue receivable arising on a transaction is usually determined by the agreement between the parties. It is generally measured at the fair value of the consideration receivable. However, the fair value of the consideration may be less than the nominal amount of the receivable when the seller provides interest-free credit to the purchaser or accepts a note receivable bearing a below-market interest rate from the purchaser as consideration for the sale of goods.

When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting the future receipts under the terms of the contract.

An example of a contract where the rights and obligations of the parties do not result in equal performance would be an arrangement that creates an obligation for a donor to transfer resources to the recipient and establishes the right of the recipient to receive those resources. These types of arrangements may be contractual even though the recipient did not provide equal consideration in return. That is, the arrangement does not result in equal performance by the parties. The donor and recipient may have a financial liability and asset respectively.

A financial asset is any asset that is:

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

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

Unissued currency does not meet the definition of a financial instrument. An entity applies IPSAS 12, *Inventories* in accounting for any unissued currency. Currency issued as legal tender from the perspective of the issuer, is not addressed in this Standard.

The material does not cover item (d), a contract that will or may be settled in the entity's own equity instruments.

Common examples of financial assets representing a contractual right to receive cash in the future:

- a) Accounts receivable;
- b) Notes receivable;
- c) Loans receivable;
- d) Equity securities; and
- e) Bonds receivable.

A financial liability is any liability that is:

- a) A contractual obligation:
 - (i) To deliver cash or another financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity.
- b) A contract that will or may be settled in the entity's own equity instruments.

The material does not cover item (b), a contract that will or may be settled in the entity's own equity instruments.

Common examples of financial liabilities representing contractual obligations to deliver cash or another financial asset to another entity in the future are:

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

Again, in each case, one party's obligation to deliver cash or another financial asset is matched by contractual right of another party to receive cash.

One entity's contractual right to receive cash is matched by the other entity's corresponding obligation to pay.

The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognized in the financial statements.

A financial instrument may require an entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument such as a change in an interest or exchange rate. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer and a financial asset of the holder.

For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults.

The contractual right and obligation may exist because of a past transaction or event even though one party's ability to exercise its right and the requirement for the other party to perform under its obligation are both contingent on a future event. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower.



Financial Assets

Examples of financial assets:

- Cash
- Accounts receivable
- Loans receivable
- Investment securities (common shares, fixed income investments)

To better understand what financial assets are, some examples are provided. The list of items is not an exhaustive one, but includes examples of common transactions.

Examples would be as follows:

Cash and cash equivalents are considered to be financial assets. To be considered cash, the cash needs to be on hand or in the bank. Cash equivalents need to be highly liquid investments which are short term (3 months or shorter). Even if the maturity is short term, these items should be readily convertible to cash and subject to insignificant valuation risk. Demand deposits would be considered a cash equivalent, as these are considered to have the same level of liquidity as cash and can usually be withdrawn at any time without penalty.

Accounts receivable are amounts receivable from the provision of goods and services.

Loans receivable are amounts owed from lending of cash and cash equivalents.

Investment securities are securities issued by other entities such as shares, bonds and other investment products that are purchased with intention of obtaining an economic benefit either from capital appreciation of the security product or from interest or dividends paid from the security issuer.



Financial Liabilities

Examples of financial liabilities:

- Account payable
- Loans and notes payable
- Bonds

To better understand what financial assets are, some examples are provided. The list of items is not an exhaustive one, but includes examples of common transactions.

Accounts payable are amounts owed to third parties from purchases of supplies and materials required for operations and activities.

Loans and notes payable are amounts owed from borrowing arrangements.

Bonds are fixed income securities, which allow entities to borrow capital for a fixed period of time, with specified payment terms and interest payment terms. An example is a government bond with either fixed or variable interest coupon payments, used to finance its operations and activities of the government.



Contracts to Buy or Sell Non-Financial Assets

- Contracts for buying or selling non-financial items are not financial instruments unless
 - The contract permits it to be settled net in cash;
 - The entity has a practice of settling similar contracts net in cash;
 - The entity has a practice of taking delivery and selling the nonfinancial item for a profit; or
 - The non-financial item is readily convertible to cash

The financial instrument IPSAS are applied to some contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments. However, the financial instrument IPSAS are not applied to those contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.

Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g., a forward contract on oil) are not financial instruments.

Many commodity contracts are of this type. Some are standardized in form and traded on organized markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity.

The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument.

Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the financial instrument IPSAS as if they were financial instruments.

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

Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts.

For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.

The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability.

Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil.

The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.



Contract

Scenario

A public sector entity that operates a public transit system in a region has entered into a forward contract for the delivery of 50% of its diesel fuel requirements to run its fleet of buses for the next six months to protect itself against projected rising prices.

Is the forward contract a financial instrument? Explain.

Would your answer be different if the entity bought and sold future contracts traded on a commodity exchange? Explain.

Answer:

The forward contract would not be a financial instrument.

The forward contract is entered into for the purpose of the delivery of diesel fuel, a non-financial item, in accordance with an entity's expected purchase and usage requirements. The contract does not meet the definition of a financial instrument because it does not establish a present right or obligation of either party to receive, deliver or exchange a financial asset.

The strategy of the entity to buy and sell futures contracts on the commodity exchange may result in the contracts being financial instruments if the objective is to make a profit. However, the ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity does not necessarily mean the contract is a financial instrument.

Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are financial instruments within the scope of the standard as if they were financial instruments.

Currency Swap

Scenario

A government has issued debt at fixed and variable interest rates and in domestic and foreign currencies. It has entered into cross-currency swap agreements to manage interest and currency risk. The agreements call for the exchange of cash amounts between parties to the agreements calculated with reference to current rates of interest and foreign exchange.

Are the cross-currency swap agreements financial instruments? Explain.

Answer:

The cross-currency swap agreements are financial instruments. Even though the contractual obligations on the parties to the cross-currency swap agreements is contingent on the change in interest rates and foreign exchange rates, the parties have an unconditional contractual right to receive cash or another financial asset or an unconditional contractual obligation to deliver cash or another financial asset.

Leases

Scenario

A hospital has entered into a five-year lease for a Medical Resonance Imaging scanning machine. The estimated useful life of the machine is 10 years. At the end of the lease term the hospital has the option of acquiring the machine for 10% of its current fair value or extending the lease at a substantially reduced lease payment.

Is the lease a financial instrument? Explain..

Answer:

The lease is a contract the substance of which is a finance lease since it transfers the risks and rewards incidental to ownership to the hospital. Under IPSAS 13, *Leases*, the hospital recognizes an asset and the lease obligation as a liability.

Classification of leases is discussed in the Assets module.

A finance lease meets the definition of a financial instrument and an operating lease is not regarded as a financial instrument (except as regards individual payments currently due and payable). However, it should be noted that IPSAS 13 deals with accounting for leases, and that the IPSAS 13 should be followed for accounting for lease transactions; except when considering lease receivables, when the financial instruments recognition and impairment provisions apply. Finance lease payables recognized by the lessee are subject to the recognition provisions of the financial instruments standards and derivatives embedded in leases are subject to the financial instrument embedded derivative requirements.

An operating lease is not regarded as a financial instrument (except as regards individual payments currently due and payable) because the lessor commits to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service.

Questions and Discussion

Visit the IPSASB webpage

<http://www.ipsasb.org>

That concludes our module on the introduction to financial instruments. Participants should refer to the review question to test themselves on their knowledge.

Review Question

Question 1

A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Which of the following would be an example of a financial instrument?

- a) A loan guarantee
- b) Cash and cash equivalents
- c) Prepaid expenses
- d) Accounts receivable
- e) Inventories

Answers to Review Question

Question 1

The answer is (a), (b), and (d).

- a) A financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognized in the financial statements.
- b) Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognized in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a check or similar instrument against the balance in favor of a creditor in payment of a financial liability.
- c) Prepaid expenses are not financial assets because the future economic benefit is the receipt of goods or services. They do not embody a right to receive cash or another financial asset.
- d) Accounts receivable represent a contractual right to receive cash in the future and corresponding financial liability representing a contractual obligation to deliver cash in the future. In each case, one party's contractual right to receive cash is matched by the other party's corresponding obligation to pay.
- e) Physical assets such as inventories, property, plant and equipment, leased assets and intangible assets may generate an inflow of cash but they are not financial assets because they do not embody a right to receive cash or another financial asset.

Core Concepts (IPSAS 29)

Introduction

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting standards for public sector entities.

Recognition and Derecognition

- Recognized when entity becomes a party to the contractual arrangement which is a financial instrument
- Financial asset derecognized when contractual rights expire, are waived or transferred
 - Cumulative gain or loss recognized in surplus or deficit
- Financial liability derecognized when contract is discharged, waived, cancelled or expires
 - Difference between the carrying amount and consideration paid recognized in surplus or deficit

The following are examples of applying the principle:

- a) Receivables and payables are recognized as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash. For example, when goods and services have been shipped, delivered or rendered.
- b) A forward contract is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place.
- c) Debt is recognized when issued or derecognized when exchanged or repaid.

Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

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

- An entity de-recognizes a financial asset when
 - a) The contractual rights to the cash flows from the financial asset expire or are waived; or
 - b) It transfers the contractual rights to receive the cash flows of the financial asset and the transfer qualifies under IPSAS 29 for derecognition.

A transfer qualifies for derecognition if, and only if, an entity:

- Transfers the contractual rights to receive the cash flows of the financial asset; or
- 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.
 - On derecognition of a financial asset in its entirety, the difference between:
 - a) The carrying amount; and
 - b) The sum of:

- (i) the consideration received (including any new asset obtained less any new liability assumed) and
- (ii) any cumulative gain or loss that had been recognized directly in net assets/equity; shall be recognized in surplus or deficit. A cumulative gain or loss that had been recognized in net assets/equity is allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts.

Normally, derecognition of a financial asset should be relatively straight forward. However, if the de-recognition involves the transfer of a financial asset, requirements to determine whether the transfer qualifies for de-recognition are complex and beyond the scope of the training material. If a transfer is involved, direct reference should be made to IPSAS 29, paragraphs 21 - 39.

An entity removes a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished – i.e., when the obligation specified in the contract is discharged, waived, cancelled or expires.

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).

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognized in surplus or deficit. Where an obligation is waived by the lender or assumed by a third party as part of a non-exchange transaction, an entity applies IPSAS 23.

An exchange of debt instruments with substantially different terms or a substantial modification of the terms of an existing financial liability shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

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.



Trade Date/Settlement Date

- Regular way purchases of financial assets can be recognized at trade date or settlement date (accounting policy choice— but must be consistently applied to group of assets); except for derivatives which are always recognized on trade date.
- Trade date is the date on which an entity commits to purchase or sell an asset.
- Settlement date is the date on which the asset is delivered to, or by, the entity.

Regular way purchases or sales (derecognition) of a financial asset is done using either trade date or settlement date accounting. A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Regular way purchases of financial assets can either be recognized using trade or settlement date accounting, while derivatives are always recognized using trade date accounting.

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.

Trade date is the date on which an entity commits to purchase or sell an asset.

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.

Settlement date is the date on which asset is delivered to or by an entity.

On December 29, 20X1, an entity commits itself to purchase a bond for settlement on January 4, 20X2. The fair value of the bond on trade (commitment date) is CU 1,000. On the settlement date the fair value of the asset is CU 1,003. The entity, depending on the classification of the investment, may have a choice between using the trade date value or the settlement date value.

The choice is an accounting policy issue and may have accounting implications. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets. For example, interest generally does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

When settlement date accounting is applied an entity may have to account for any change in the fair value of the asset to be received during the period between the trade date and the settlement date depending upon the financial instrument and its classification. For example, the change in value is not recognized for assets carried at cost or amortized cost; it is recognized in surplus or deficit for assets classified as financial assets at fair value through surplus or deficit; and it is recognized in net assets/equity for assets classified as available for sale.



Classification of Financial Assets

- Four categories
 - Financial assets at fair value through surplus or deficit
 - Held-to-maturity investments
 - Loans and receivables
 - Available-for-sale financial assets
- Categorization determines recognition and measurement requirements

Background:

A financial asset is classified into the following four categories:

- a) Financial assets at fair value through surplus or deficit;
- b) Held-to-maturity investments;
- c) Loans and receivables; and
- d) Available-for-sale financial assets.

The categories are significant as it determines how a particular financial asset is recognized and measured in the financial statements both at initial recognition and subsequent to initial recognition. The categories will also determine how the gains and losses are recognized through surplus or deficit. For example, the classification will determine whether the gains or losses resulting from changes in the value of financial assets on re-measurement after initial recognition are through surplus or deficit in the period, or directly to net assets/equity.



Financial Assets at Fair Value through Surplus or Deficit

- A financial asset held for trading
- All derivatives (except hedging instruments)
- A financial asset so designated on initial recognition when
 - It eliminates or significantly reduces measurement inconsistency
 - A group of financial assets, liabilities or both are managed on a fair value basis

Background:

- A financial asset at fair value through surplus or deficit is a financial asset that meets either of the following conditions.
 - a) It is classified as held for trading.

A financial asset is classified as held for trading if:

- (i) It is acquired for the purpose of selling it in the near term;
- (ii) On initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking; or

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.

For example, a public sector entity may hold share equity investments in public companies traded on a securities exchange with the objective of generating investment returns greater than the returns that would be generated on bonds.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured shall not be designated as at fair value through surplus or deficit.

- (iii) It is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

- b) Upon initial recognition it is designated by the entity as at fair value through surplus or deficit.

An entity may use this designation only when doing so results in more relevant information, because either:

- (i) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as "an accounting mismatch") that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases; or

- (ii) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel, for example the entity's governing body and chief executive officer.

Financial Asset Designation

Scenario:

The functional currency for a government is the Japanese yen. It holds a fixed rate 5 million US dollar bond that matures in five years. The government manages its interest rate and exchange risk on the bond by actively trading in US equity securities. The US dollar bond does not meet the definition of a financial asset held for trading.

Could the US dollar bond be designated as at fair value through surplus or deficit? Why?

Answer:

Under IPSAS 29, measurement of a financial asset or financial liability and recognition of 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, a financial asset would be classified as available for sale (with most changes in fair value recognized directly in net assets/ equity) and a liability the entity considers related would be measured at amortized cost (with changes in fair value not recognized). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through surplus or deficit.

The example shows when this condition could be met.

The entity has financial assets that share interest rate or exchange risk that give rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through surplus or deficit (i.e., only the equities are classified as held for trading). The entity does not qualify for hedge accounting because none of the instruments is a derivative.

In this case designating, at initial recognition, the financial assets as at fair value through surplus or deficit may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information.

Held-to-Maturity

- Non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity intends to hold to maturity other than
 - Those designated as at fair value through surplus or deficit
 - Those designated as available for sale
 - Those that are loans and receivables..

Background:

For example, a government that has long term bonds may intend to hold them to maturity because market interest rates have reduced their fair value well below amortized cost.

For most financial assets, fair value is a more appropriate measure than amortized cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity.

Because this classification is an exception to the rule, IPSAS 29 contains complex rules as to when it can be applied.

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

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

Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights).

With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments.

Loans and Receivables

- Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market other than
 - Those that the entity intends to sell
 - Those designated as at fair value through surplus or deficit
 - Those designated as available for sale
 - Those not recoverable (classified as available for sale)

Background:

Any non-derivative financial asset with fixed or determinable payments (including loan assets, receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables.

An example of loans and receivables is outstanding amounts under a student loan program that provides student loans to support a government's tertiary education policy.

However, a financial asset that is quoted in an active market (such as a quoted debt instrument) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification. On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through surplus or deficit, or available for sale.

A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.



Available-for-Sale

- Non-derivative financial assets that are designated as available for sale or are not classified as
 - Financial assets at fair value through surplus or deficit
 - Held-to-maturity investments
 - Loans and receivables

Background:

Available-for-sale is a catch all category. Financial assets that are not in other categories are by default put into this category. An example might be an unlisted equity instrument.



Classification of Financial Liabilities

Two main classifications

- A financial liability at fair value through surplus or deficit that is
 - Financial liability held for trading
 - Financial liability designated on initial recognition
 - All derivatives
- A financial liability measured at amortized cost using the effective interest method

Background:

- There are two classifications of financial liabilities.
 - a) Financial liabilities measured at amortized cost using the effective interest method.
 - b) Financial liabilities at fair value through surplus or deficit.
- A financial liability at fair value through surplus or deficit is a financial liability that meets either of the following conditions:
 - a) It is financial liability held for trading that is:
 - (i) A financial liability incurred principally for the purpose of repurchasing it in the near term; or
 - (ii) Part of a financial instrument portfolio where there is evidence of short-term profit taking and
 - (iii) All derivatives.

- b) A financial liability designated on initial recognition financial liability at fair value through surplus or deficit when doing so results in more relevant information because:
- (i) it eliminates or significantly reduces a measurement inconsistency from measuring financial assets or liabilities on different bases
 - (ii) a group of financial assets, liabilities or both are managed on a fair value basis.

Similar to designating financial assets as fair value through surplus or deficit, an entity may designate a financial liability fair value through surplus or deficit if it eliminates or significantly reduces a measurement or recognition inconsistency or it is part of a group of financial assets and financial liabilities whose performance is evaluated on a fair value basis. In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through surplus or deficit.

Financial Liability Designation

Scenario

The functional currency for a government is the Japanese yen. The government has issued 5 million US dollar fixed rate debt that matures in two years. Interest payments are due semi-annually. The government has entered into a futures contract to purchase 5 million US dollars that matures in two years. The US dollar debt is not designated as a hedged item.

Could the government designate its US dollar liability as a financial liability at fair value through surplus or deficit? Why?

Answer:

The government has financial assets and a financial liability that share similar risks, such as interest rate risk. Due to the nature of the financial instruments, risks give rise to opposite changes in fair value that tend to offset each other. However, only the futures would be measured at fair value through surplus or deficit (i.e., only the futures are classified as held for trading). The entity does not qualify for hedge accounting because the futures are not derivatives.

In this case to designate, at initial recognition, the debt as at fair value through surplus or deficit rather than amortized cost may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information.

Amortized Cost

- Amount at initial recognition
 - Minus principal repayments
 - Plus or minus the cumulative amortization of any difference between initial amount and maturity amount using effective interest method
 - Minus any reduction for impairment or valuation allowance

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest revenue or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity estimates cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall not consider future credit losses.

The calculation of the effective interest rate includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts.

For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate.

This is in contrast to variable rate financial assets and variable rate financial liabilities. When cash flows are re-estimated for variable rate financial instruments to reflect movements in market rates of interest, the effective interest rate is updated. This is because for variable rate instruments it would be inappropriate to determine at inception a single fixed rate to discount estimated future cash flows as varying interest receipts/payments are a contractual term of a variable rate instrument.

The re-estimation of future cash flows for any reason other than changes in market rates or when financial instruments are not variable rate instruments will normally result in a change in carrying amount, since the revised estimated cash flows are discounted at the instrument's original effective interest rate. The adjustment is recognized in profit or loss as income or expense.



Initial Measurement

- Financial asset or liability measured at fair value plus transaction costs except
- Financial asset or liability categorized as fair value through surplus or deficit
- Fair value normally the transaction price (i.e., the fair value of the consideration given or received)

Background:

When a financial asset or financial liability is recognized initially, an entity shall measure it, with one exception, at its fair value plus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

If a financial asset or financial liability is designated as at fair value through surplus or deficit, reference is made to IPSAS 29, Paragraphs 50–52 which provide commentary and guidance on determining fair value. This is complemented by Application Guidance in paragraphs AG101–AG115.

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

When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortized cost, the asset is recognized initially at its fair value on the trade date.

If an entity recognizes financial assets using settlement date accounting any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognized unless the financial assets have been designated as financial assets at fair value through surplus or deficit. For financial assets at fair value through surplus or deficit, the change in fair value shall be recognized in surplus or deficit or in net assets/equity as appropriate. (See commentary on regular way purchase or sale).

The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received).

However, there may be instances where part of the consideration given or received is for something other than the financial instrument. In these cases, the fair value of the financial instrument is estimated, using a valuation technique. The fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating.

For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. The entity accretes the discount to surplus or deficit using the effective interest rate method.

Loans categorized as loans and receivables at amortized cost, record interest charges using the effective interest method.

Loan Example – Effective Interest Method

Scenario

Government G entity borrows CU 50,000 on January 1 20X1 for 5 years. The annual interest rate on the loan is 10% paid at the end of the year. G pays an up-front fee of CU 1,000 and the net proceeds of the loan are CU 49,000.

- What is the annual effective interest rate of the loan?
- What would the annual effective interest rate of the loan be if there is no 1,000 up front fee?

Date	Interest	Coupon 10%	Amortized Cost
Jan 1 20X1	0	0	49,000
Dec 31 20X1	5,169	5,000	49,162
Dec 31 20X2	5,179	5,000	49,341
Dec 31 20X3	5,198	5,000	49,539
Dec 31 20X4	5,219	5,000	49,758
Dec 31 20X5	5,242	5,000	50,000
Total	26,000	25,000	

The effective annual interest method is 10.53482%

Journal Entries at each date are as follows:

Jan 1 20X1	Dec 31 20X1	Dec 31 20X2	Dec 31 20X3	Dec 31 20X4	Dec 31 20X5
DR Cash 49,000	DR Int Exp 5,162	DR Int Exp 5,179	DR Int Exp 5,198	DR Int Exp 5,219	DR Int Exp 5,242
CR Loan (49,000)	CR Cash (5,000)				
	CR Loan (162)	CR Loan (179)	CR Loan (198)	CR Loan (219)	CR Loan (242)

The final journal entry at the end of the period of the loan would be Dr Loan 50,000, Cr Cash 50,000

If there was no annual upfront fee, the effective interest rate would be 10%.

Concessional Loans

- Concessional loans are granted/ received at below market terms.
- A waiver of debt is not a concessional loan
- At inception a concessional loan is recognized as follows:
 - When loan is being received by entity— difference is recognized in accordance with IPSAS 23
 - When loan is granted by entity— difference is recognized as an expense in surplus or deficit
- Subsequent measurement dependent on the classification of the loan in accordance with IPSAS 29

Concessory loans are those loans granted or received, which are below market terms. A number of governments will have given or received concessory loans as a response to the COVID-19 pandemic.

A waiver of debt is not a concessory loan, as at inception the loan was granted at market terms with expectation of repayment.

For example, an entity's intention at the outset of a concessory loan is to provide resources at below market terms. For example, offering a loan at 3% interest when market terms for such a loan would be 5%.

At inception a concessory loan is recognized as follows:

- When loan is being received by entity – difference is recognized in accordance with IPSAS 23
- When loan is granted by the entity – difference is recognized as an expense in surplus or deficit.

The subsequent measurement of a concessory loan dependent on the classification of the loan in accordance with IPSAS 29 (for example amortized cost or fair value through surplus or deficit). An example to illustrate a concessory loan follows on the next page.

Student Loans

Scenario

The department of education made CU 250,000 in low interest student loans on the following terms.

Capital is repaid as follows:

- Year 1 to 2: no capital repayments
- Year 3: 30% capital to be repaid
- Year 4: 30% capital to be repaid
- Year 5: 40% capital to be repaid

Interest at 6% interest is paid annually in arrears

Market rate for similar loans is 11.5%

1. Are the loans concessory loans? Explain.
2. If yes, how is fair value determined? Explain.

Answer:

The student loans are concessory loans. Concessory loans are granted to or received by an entity at below market terms. In this case, the interest rate is below market rates for similar loans.

The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique.

As concessory loans are granted or received at below market terms, the transaction price on initial recognition of the loan may not be its fair value. An entity must determine the fair value of a concessory loan on initial recognition. An entity determines the fair value of the loan by reference to an active market. If an entity cannot determine the fair value of a concessory loan by reference an active market, it uses a valuation technique.

Valuation techniques include using recent arm's length market transactions, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or some other valuation technique commonly used by market participants to price similar instruments.

In this case, fair value of the concessionary loans using a valuation technique could be determined by discounting all future cash receipts using a market related rate of interest for a similar loan.

Any difference between the fair value of the loan and the transaction price (the loan proceeds) is treated as follows:

- a) Where the loan is received by an entity, the difference is accounted for in accordance with IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.
- b) Where the loan is granted by an entity, the difference is treated as an expense in surplus or deficit at initial recognition.

After initial recognition, an entity subsequently measures concessionary loans using the categories of financial instruments defined in IPSAS 29. In most cases, this will be on the basis of amortized cost.

Accounting for Student Loans

Scenario

Based on the information in the previous slide, the department of education has determined that the fair value of the student loans is CU 207,270 by discounting future cash flows using the market related rate of 11.5%.

What is the journal entry the board of education makes for initial recognition of the student loans? Explain.

		CR
Loans receivable (PV of future cash flows @ discount rate 11.5%)	CU 207,720	
Expense (CU 250,000 – CU 207,270)	CU 42,370	
Bank (Amount of loans advanced)		CU 250,000

Answer:

The journal entry by the department of education to record student loans at initial recognition is shown above.



Subsequent Measurement of Financial Assets

- Financial assets and derivatives are measured at fair value without any deduction for costs of disposal except
 - Loans and receivables and held-to-maturity are measured at amortized cost using the effective interest method
 - Investments in equity instruments that do not have a quoted market price at cost
- Financial assets measured at cost or amortized cost reviewed for impairment

Background:

- After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except:
 - a) Loans and receivables, which shall be measured at amortized cost using the effective interest method;
 - b) Held-to-maturity investments which shall be measured at amortized cost using the effective interest method; and
 - c) Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured which shall be measured at cost.

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements.

All financial assets except those measured at fair value through surplus or deficit are subject to review for impairment.



Subsequent Measurement of Financial Liabilities

- Measured at amortized cost using the effective interest method except
 - Financial liabilities classified as at fair value through surplus or deficit
 - Derivatives that are liabilities which are measured at fair value
 - Financial liabilities designated as hedge items, which are effective, which are subject to hedge accounting requirements

Gains and Losses

- On a financial asset or liability classified as at fair value through surplus or deficit in surplus or deficit
- On an available-for-sale financial asset directly in net assets/equity until the financial asset is derecognized
 - When derecognized cumulative gain or loss previously recognized in net assets/equity recognized in surplus or deficit
- Financial assets and financial liabilities carried at amortized cost recognized through amortization and on derecognition in surplus or deficit

Background:

- A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship shall be recognized, as follows:
 - a) A gain or loss on a financial asset or financial liability classified as at fair value through surplus or deficit shall be recognized in surplus or deficit.
 - b) A gain or loss on an available-for-sale financial asset shall be recognized directly in net assets/equity until derecognized, at which time the cumulative gain or loss previously recognized in net assets/equity shall be recognized in surplus or deficit.
- For financial assets and financial liabilities carried at amortized cost, a gain or loss is recognized in surplus or deficit through the amortization process and when the financial asset or financial liability is derecognized or impaired.

Impairment of Financial Assets

- Financial asset or group of assets assessed each reporting period
- Losses on financial assets that are loans and receivables or held-to-maturity recognized in surplus or deficit
- Losses on available-for-sale financial asset is recognized in surplus or deficit
- Losses may, under certain circumstances, be reversed in a subsequent period for financial instruments, except for equities

Background:

- An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired.

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a “loss event”) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.

- If financial assets that are classified as loans and receivables or held-to-maturity are impaired, the carrying amount is reduced either directly or through use of an allowance account, and the loss is recognized in surplus or deficit.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition).

- A loss on an available-for-sale financial asset that has been recognized directly in net assets/ equity is removed from net assets/equity and recognized in surplus or deficit even though the financial asset has not been derecognized.

When a decline in the fair value of an available-for-sale financial asset has been recognized directly in net assets/ equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized directly in net assets/equity shall be removed from net assets/equity and recognized in surplus or deficit even though the financial asset has not been derecognized.

The amount of the cumulative loss that is removed from net assets/equity and recognized in surplus or deficit shall be the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss on that financial asset previously recognized in surplus or deficit.

- Impairment losses, under certain circumstances, may be reversed in a subsequent period.

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

- Impairment losses on equity instruments are not reversed, but may be reversed on a debt instrument

Impairment losses recognized in surplus or deficit for an investment in an equity instrument classified as available for sale shall not be reversed through surplus or deficit.

If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in surplus or deficit, the impairment loss shall be reversed, with the amount of the reversal recognized in surplus or deficit.

Effective Interest Rate

Scenario

On January 1, 20X0 a debt instrument (par value CU 1,250) with five years remaining to maturity is acquired at CU1,000 (including transaction costs). Fixed rate of interest of 4.7 percent is paid annually.

How is the effective interest rate calculated? Explain.

	Year 1 CU	Year 2 CU	Year 3 CU	Year 5 CU	Year 5 CU
Initial Amount	1,000				
Cash Flows- Interest	59	59	59	59	59
Cash Flows- Maturity					1,250

Answer:

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest revenue or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall not consider future credit losses.

Amortized Cost and Revenue

Scenario

The effective interest rate is 10% based on the present value of the cash flows related to the bond. This is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument.

	20X1 CU	20X2 CU	20X3 CU	20X4 CU	20X5 CU
Open PV of cash flow	1,000	1,041	1,086	1,136	1,190
Cash Receipts - Interest	59	59	59	59	59
Cash Receipts - Principal					1,250
Amortization	100	104	109	113	119

The table above summarizes the transactions. What is the annual interest revenue to be recognized in each year? Why?

Answer:

The amortized cost of the debt instrument is less repayments plus or minus plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount and the maturity amount less any reduction due to impairment. The effective interest rate is 10% based on the present value of the cash flows related to the bond. This is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument. The table below provides information about the amortized cost, interest revenue and cash flows of the debt instrument in each reporting period.

Year	Col A Amortized cost, beginning CU	Col B Amortization A*10% CU	Col C Cash Flow CU	Col D End Amortized Cost A + B - C CU	Col E Revenue A - D CU
1	1,000	100	59	1,041	100
2	1,041	104	59	1,086	104
3	1,086	109	59	1,136	109
4	1,136	113	59	1,190	113
5	1,190	119	1,250 + 59	0	119
Total		545	1,545		545

Debenture Debt

Scenario

A government with a fiscal period end of December 31 issues a 5 year debenture settled on January 1, 20X0 with a face value of CU 1 million and a coupon rate of 6%. A brokerage commission of CU 25,000 was paid. The net proceeds from the debenture was CU 1,050,000. The debenture is not classified as fair value through surplus or deficit.

What is the appropriate valuation technique? Explain..

Answer:

Note: Depending on geographic area, the terms debenture and bond, can have different meanings. Generally a bond is more secure than a debenture, which yields a lower interest rate. Debentures are unsecured, yielding a higher rate of interest. In bankruptcy bond holders are usually paid first. Debentures get periodic interest payments, whereas bond holders generally received accrued interest payments upon completion of the bond term (with the return of principal). Bonds are mostly issued by governments, debentures more commonly issued by corporations.

The debenture has not been designated as fair value through surplus or deficit. Therefore it is classified as a financial liability measured at amortized cost using the effective interest method. When applying the effective interest method, an entity generally amortizes any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument.

Accounting for Debenture Debt

	20X1 CU	20X2 CU	20X3 CU	20X4 CU	20X5 CU
Open balance	1,050,000	1,040,924	1,031,408	1,021,430	1,010,969
Cash disbursements					
Coupon Interest	60,000	60,000	60,000	60,000	60,000
Payment on maturity					1,000,000
Amortization @ 4.85%¹	50,924	50,484	50,022	49,538	49,031

¹This is the rate that that exactly discounts estimated future cash flows through the expected life of the financial instrument.

The effective interest rate has been calculated at 4.85%. This is the rate that that exactly discounts estimated future cash flows through the expected life of the financial instrument. The table summarizes the transactions related to the debenture.

Based on the information in the table, what is the journal entry to record the debenture on initial recognition?

What journal entry is made at the end of the period ended December 31, 20X0?

Answer:

Year	Col A Amortized cost, beginning	Col B Amortization A * 4.85%	Col C Cash Flows	Col D End Amortized Cost A + B - C
20X0	1,050,000	50,924	60,000	1,040,924
20X1	1,040,924	50,484	60,000	1,031,408
20X2	1,031,408	50,022	60,000	1,021,430
20X3	1,021,430	49,538	60,000	1,010,969
20X4	1,010,969	49,031	1,060,000	0

Journal Entry to record proceeds on debenture

	DR	CR
Bank	CU 1,050,000	
Loans payable		CU 1,050,000
(Premium on debenture CU 75,000 less brokers commission CU 25,000)		

Journal Entry to record payments and interest expense in year 1

	DR	CR
Loans payable (Payment CU 60,000 less interest CU 50,924)	CU 9,516	
Interest expense	CU 50,924	
Cash		CU 60,000

Questions and Discussion

Visit the IPSASB webpage <http://www.ipsasb.org>

That concludes our module on the core concepts of financial instrument. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 percent of total portfolio value. The investment manager of the portfolio is authorized to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments.

Is Entity A permitted to classify the instruments as available-for-sale?.

Question 2

When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received). An entity pays a brokerage fee to acquire a portfolio investment.

What is the initial value of the financial asset? Why?

How is the portfolio investment measured after initial recognition? Why?

Question 3

A local authority receives a CU 6 million loan from an international development agency to build a primary healthcare clinic. The agreement stipulates that upon completion of the facility, CU 1 million of the loan will be waived and the balance is to be repaid in equal installments over a period of 5 years. Interest of 5% is paid annually in arrears. The market rate for a similar loan is 10%.

Is the loan a financial liability of the authority? Why?

What is the initial measurement?

Question 4

Entity A owns a small number of shares in Entity B. The shares are classified as available-for sale. On December 20, 20X1 the fair value of the shares is CU 120 and the cumulative gain recognized in net assets/equity is CU 20. The shares are not part of a hedging relationship. On the same day, Entity B is seeking bankruptcy protection. The fair value of the shares is CU 20 at December 31, 20X1, the fiscal period end.

How does Entity A account for the shares at December 31, 20X1?

Answers to Review Questions

Question 1

It depends on Entity A's intentions and past practice.

If the portfolio manager is authorized to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available for sale.

A financial asset is classified as held for trading if it is acquired for the purpose of selling it in the near term; it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking.

If the trading reflects active and frequent buying and selling with the objective of generating a profit from short-term fluctuations in price, the financial instruments in the portfolio are classified as held for trading.

Question 2

Upon initial recognition, determining whether transactions costs are included in the measurement of the financial asset depends upon its classification.

When a financial asset (or financial liability) is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received).

For financial assets, incremental costs that are directly attributable to the acquisition of the asset, for example fees and commissions, are added to the amount originally recognized. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally recognized. For financial instruments that are measured at fair value through surplus or deficit, transaction costs are not added to the fair value measurement at initial recognition.

For available-for-sale financial assets, transaction costs are recognized in other net assets/equity as part of a change in fair value at the next remeasurement. If an available-for-sale financial asset has fixed or determinable payments and does not have an indefinite life, the transaction costs are amortized to surplus or deficit using the effective interest method. If an available-for-sale financial asset does not have fixed or determinable payments and has an indefinite life, the transaction costs are recognized in surplus or deficit when the asset is derecognized or becomes impaired. Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the financial assets that are classified as loans and receivables, held-to-maturity investments or investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured which shall be measured at cost.

These latter financial assets would be measured at amortized cost using the effective interest method.

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) after initial recognition and of allocating the interest revenue or interest expense over the relevant period.

For financial instruments that are carried at amortized cost, such as held-to-maturity investments, loans and receivables, and financial liabilities that are not at fair value through surplus or deficit, transaction costs are included in the calculation of amortized cost using the effective interest method and, in effect, amortized through surplus or deficit over the life of the instrument.

The calculation of the effective interest rate includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts..

Question 3

There are two transactions. The forgiveness of the CU 1 million is a non-exchange transaction and should be accounted for under IPSAS 23, Revenue from Non-Exchange Transactions (Taxes and Transfers). Under IPSAS 23, the entity would record an asset and a liability at the time the proceeds are received due to the condition that it must be used to build the health care facility. When the facility is built, the liability is derecognized.

It is different from a waiver of debt owing by an entity. It would not be treated as a derecognition of a loan under IPSAS 29.

The loan is a financial liability and should be accounted for under IPSAS 29.

The loan portion is a concessionary loan because the interest rate is below market. Concessionary loans are granted to or received by an entity at below market terms.

At initial recognition, an entity therefore analyzes the substance of the loan granted into its component parts. If an entity has determined that the transaction, or part of the transaction, is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition. If an entity cannot determine the fair value of the loan by reference an active market, it uses a valuation technique. Fair value using a valuation technique could be determined by discounting all future cash receipts using a market related rate of interest for a similar loan.

Illustrative Examples are provided in paragraph IG54 of IPSAS 23 as well as paragraphs IE40 to IE41 accompanying IPSAS 29.

After initial recognition, an entity subsequently measures concessionary loans using the categories of financial instruments defined in IPSAS 29. In most cases, this will be on the basis of amortized cost.

Question 4

There is objective evidence that the asset is impaired. When a decline in the fair value of an available-for-sale financial asset has been recognized directly in net assets/equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized directly in net assets/equity shall be removed from net assets/equity and recognized in surplus or deficit even though the financial asset has not been derecognized.

The amount of the cumulative loss that is removed from net assets/equity and recognized in surplus or deficit shall be the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss on that financial asset previously recognized in surplus or deficit.

The difference between the acquisition cost of CU 100 (Fair value before CU 120 less cumulative gain in net asset/equity CU 20) and the fair value at the fiscal period end CU 20 is recognized in surplus or deficit.

Impairment losses recognized in surplus or deficit for an investment in an equity instrument classified as available for sale shall not be reversed through surplus or deficit.

Hedging & Derivatives (IPSAS 29)



Introduction

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting standards for public sector entities.

Hedge Accounting

- Recognizes offsetting effects on surplus or deficit of changes in fair values of hedging instrument and hedged item.
- Hedging instrument is a designated derivative or a non-derivative financial asset or financial liability
- Hedged item is a designated asset, liability, firm commitment or future transaction
- Designated hedging relationships can be
 - Fair value hedge
 - Cash flow hedge.

Background:

Hedge accounting is complicated territory. It allows an entity to link two separate transactions in its accounts to balance risks associated with a financial asset or financial liability or groups of financial assets and financial liabilities.

The requirements for hedge accounting are complex and beyond the scope of this material. The intention here is to only give participants an awareness of hedge accounting.

- Hedge accounting recognizes the offsetting effects on surplus or deficit of changes in the fair values of the hedging instrument and the hedged item.
- A hedging instrument is a designated derivative or a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.
- A hedged item is an asset, liability, firm commitment, highly probable forecast transaction that:
 - exposes the entity to risk of changes in fair value or future cash flows; and
 - is designated as being hedged.

A hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be

- a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation,
- b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics, or
- c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

- Designated hedging relationships in the public sector tend to be of two types:
 - Fair value hedge: a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect surplus or deficit.
 - Cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect surplus or deficit.

A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

There is a third type that is not covered in the course material. That is, a hedge of a net investment in a foreign operation as defined in IPSAS 4.

Cash Flow Hedge

Scenario

On January 1, 20X1 a city enters into a firm commitment contract to purchase a fire truck for delivery on June 30, 20X1 for Foreign Currency (FC) 100,000. On January 1 20X1, it enters into a forward exchange contract to receive FC 100,000 and deliver Local Currency (LC) 109,600 on June 30, 20X1. It designates the forward exchange contract as a hedging instrument in a cash flow hedge of a firm a commitment. Changes in the exchange rates affecting FC and LC are expected to offset each other.

- Why would the entity enter into the forward exchange contract? Explain.
- What is the hedged item? Explain.
- What is the hedging instrument? Explain.

Answer:

This is an illustrative example of a cash flow hedge. That is, it is a hedge of the exposure to variability in cash flows that could result from changes in foreign exchange rates related to the firm commitment contract (a highly probable forecast transaction) for the purchase of the fire truck. The results of fluctuations in the exchange rates will affect surplus or deficit.

The hedged item is the firm commitment contract liability for the purchase of the fire truck.

The hedging instrument is the forward exchange contract. It is a derivative, that is, it is a financial instrument, the value of which is derived from the value of underlying currency exchange rates. It is used to mitigate currency risk to future cash flows of a financial liability that may be caused by fluctuations foreign exchange rates without directly purchasing the underlying instrument. The contractual amounts are notional amounts to which the exchange rate is applied to compute the cash flows to be exchanged between parties.

The value of the derivative has all three of the following characteristics:

- a) Its value changes in response to the change in exchange rate;
- b) It required no initial net investment; and
- c) It is settled at a future date.

Fair Value Hedge

Scenario

An entity has outstanding FC 5 million five-year debt. Principal is repayable at maturity in two years. It has entered into a currency swap contract for the notional value of FC 5 million. Under the contract it makes a payment of LC 5.1 million and receives a payment of FC 5 million on the date of maturity of the debt instrument.

- What type of hedge relationship is it? Explain.

Answer:

It could be either a fair value hedge or a cash flow hedge. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge. If it is considered a fair value hedge, the hedge relationship is a hedge of the exposure to changes in fair value of the recognized liability that is attributable to foreign exchange risk. Fluctuations in the fair value of the debt instrument could affect surplus or deficit.

Derivatives

- A financial instrument when the value is derived from the value of underlying market-based factors
- Essential characteristics
 - Value changes with changes in a specified index (the “underlying”)
 - No or nominal initial net investment required
 - Settled at a future date.

A derivative is a financial instrument, the value of which is derived from the value of underlying assets, indices, interest rates, currency exchange rates or other market-based factors.

Derivatives are generally used to limit or adjust market, credit, interest rate, currency and other financial exposures without directly purchasing or selling the underlying instrument.

Derivatives are used to mitigate the risks to the fair value or future cash flows of a financial asset or financial liability that may be caused by fluctuations in market prices, interest rates, foreign exchange rates and other indices. Derivatives may also be purchased for speculative purposes; however, this is rarer in a public sector setting than in the non-public sector.

Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument.

The contractual amounts of derivatives are notional amounts to which a rate or price is applied for computing the cash flows to be exchanged between the parties to a derivative contract. The notional amounts are used to determine the gains/losses and fair value of the contracts. The notional amounts are not recorded as assets or liabilities on the statement of financial position.

A derivative is a financial instrument or other contract with all three of the following characteristics:

- a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the “underlying”);

- b) It requires either no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- c) It is settled at a future date.

On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favorable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavorable.

However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange.

Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favorable or unfavorable.



Embedded Derivatives

- Is a component of a hybrid instrument, that includes a non- derivative host contract.
- The embedded derivative is not contractually transferrable independent of the host contract.
- The embedded derivative should be separated from the host contract and accounted for as a derivative in accordance with the guidance of IPSAS 29.

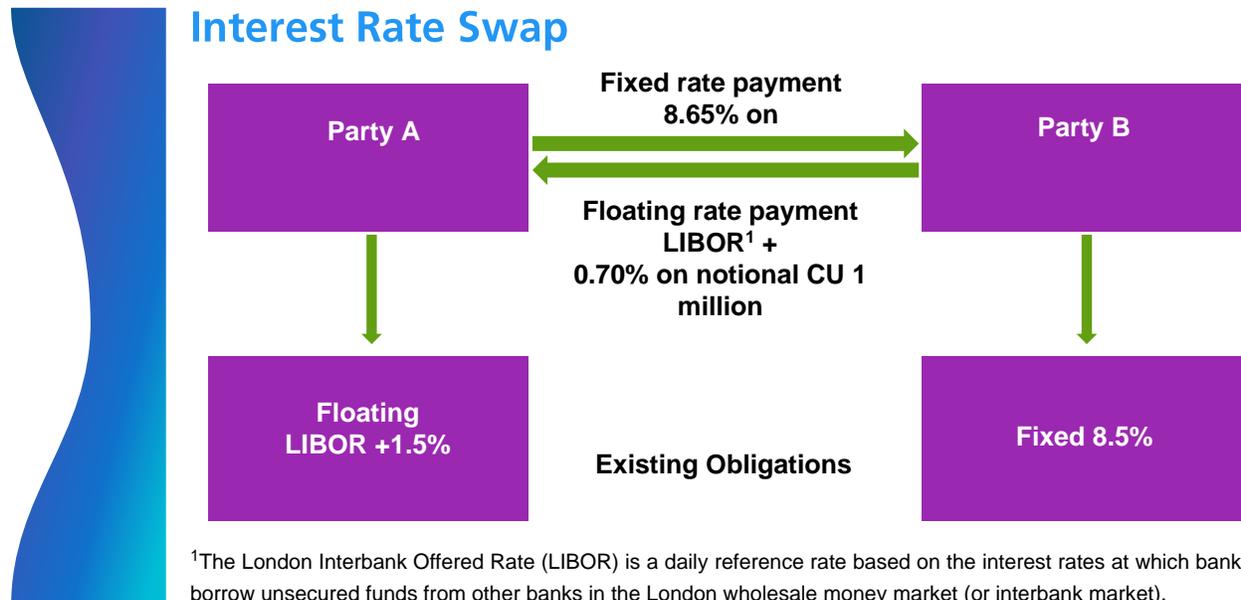
An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

An embedded derivative should be separated from the host contract and accounted for as a derivative under IPSAS 29 if, and only if:

- a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in surplus or deficit (i.e., a derivative that is embedded in a financial asset or financial liability at fair value through surplus or deficit is not separated).

If an embedded derivative is separated, the host contract shall be accounted for under IPSAS 29 if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. IPSAS 29 does not address whether an embedded derivative shall be presented separately in the statement of financial position.

Under some circumstances an entity can elect to account for the entire contract as a derivative if the criteria are met and the entity elects to do so. This is beyond the scope of this course, but is something to be aware of.



A common derivative used in the public sector is an interest rate swap. Interest rate swaps are used by public sector entities to manage the risks of adverse interest-rate movements.

In a typical interest rate swap, one party to the agreement agrees to pay either a fixed or floating rate denominated in a particular currency to another party. The floating rate is usually pegged to a reference rate such as LIBOR. The fixed or floating rate is multiplied by a notional principal amount (say, CU 1 million). This notional principal amount is generally not exchanged between counterparties, but is used only for calculating the size of cash flows to be exchanged.

The example is based on the following facts. Party A agrees to pay Party B periodic fixed interest rate payments of 8.65%, in exchange for periodic variable interest rate payments of LIBOR + 70 bps (0.70%). Note that there is no exchange of the principal amounts and that the interest rates are on a “notional” principal amount. The fixed rate (8.65% in this example) is referred to as the swap rate.

What are the characteristics of the interest rate swap that satisfy definition of a derivative financial instrument? Explain.

Answer:

The example of the interest rate swap demonstrates the following characteristics of derivative financial instruments:

- a) Its value changes in response to the change in a specified interest rate;
- b) It requires no initial net investment (in this example); and
- c) It is settled at a future date in periodic payments between parties.

The notional principal amount upon which the periodic payments are based is not exchanged. Initial value of the financial instrument in this case is zero.

Questions and Discussion

Visit the IPSASB webpage <http://www.ipsasb.org>

That concludes our module on hedging and derivatives. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

Entity X enters into a fixed price forward contract to purchase one million liters of oil in accordance with its expected usage requirements. The contract permits the entity to take physical delivery of the oil at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of oil.

Is the contract accounted for as a derivative? Why?

Question 2

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement.

Is this a derivative? Why?

Question 3

A South African entity, Entity XYZ, whose functional currency is the South African rand, sells electricity to Mozambique denominated in US dollars. XYZ enters into a contract with an investment bank to convert US dollars to rand at a fixed exchange rate. The contract requires XYZ to remit rand based on its sales volume in Mozambique in exchange for US dollars at a fixed exchange rate of 6.00.

Is that contract a derivative?

Answers to Review Questions

Question 1

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of oil, and it is to be settled at a future date.

Contracts that are entered into and that continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with an entity's expected purchase or usage requirements to buy non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g. a forward contract on oil) are not financial instruments. Many commodity contracts are of this type.

However, contracts to buy a non-financial item are evaluated to determine that they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase or usage requirement, and accordingly, whether they are within the scope of this Standard.

Some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are financial instruments within the scope of the standard as if they were financial instruments.

There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments.

When the terms of a contract to buy a non-financial asset permit either party to settle it net in cash or another financial asset or by exchanging financial instruments and it is the practice of the entity to settle similar contracts under those terms, the contract has not been entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements, and, accordingly, it is a financial instrument.

Similarly, when it is an entity's practice to take delivery of the non-financial item and sell it within a short period after delivery for purpose of generating a profit from short term fluctuations in the price or dealer's margin, the contract has not been entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements, and, accordingly, it is a financial instrument.

In this case, if X intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the oil and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under IPSAS 29. Instead, it is accounted for as an executor contract.

Question 2

Yes. This meets the definition of a derivative.

There is an underlying variable. That is the value changes in response to the change in a specified interest rate.

There are no transfers of principal at inception of the two loans, since Entity A and Entity B have a netting agreement. No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement. However, the same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IPSAS 29.10 does not require net settlement.

The contract will be settled at a future date.

The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- a) They are entered into at the same time and in contemplation of one another;
- b) They have the same counterparty;
- c) They relate to the same risk; and
- d) There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favorable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavorable.

However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favorable or unfavorable.

Question 3

Yes. The contract is a derivative.

The contract has two underlying variable; namely, the foreign exchange rate and the volume of sales.

No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision.

It is settled at a future date.

IPSAS 29 does not exclude from its scope derivatives that are based on sales volume.

Disclosures (IPSAS 29)

Introduction

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting standards for public sector entities.

In this module the disclosure requirements in IPSAS 30 are those that apply prior to the adoption of IPSAS 41. For the disclosure requirements in IPSAS 30 that apply after the adoption of IPSAS 41, see the module *Disclosures (IPSAS 41)*.

Disclosure Requirements

Disclosures allow users information to evaluate the financial instruments of the entity and understand the nature and extent of risks from such instruments. Required items to disclose are as follows:

- Carrying amounts of each category of financial instrument
- Fair value measurements and fair value hierarchy level
- Revenue, expense, gains, or losses
 - Net gains or losses by category
 - Interest revenue and expense
 - Impairment losses
- Information about hedges
- Information about concessionary loans
- Nature, types and extent of risks.

Background:

The objective of IPSAS 30 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- a) The significance of financial instruments for the entity's financial position and performance; and
- b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.
 - Carrying amounts of each category

The carrying amounts of each category shall be disclosed either in the statement of financial position or in the notes:

- a) Financial assets at fair value through surplus or deficit, showing separately
 - (i) those designated as such upon initial recognition, and
 - (ii) those classified as held-for-trading in accordance with IPSAS 29;
- b) Held-to-maturity investments;
- c) Loans and receivables;
- d) Available-for-sale financial assets.

The carrying amounts of each category shall be disclosed either in the statement of financial position or in the notes:

- a) Financial liabilities at fair value through surplus or deficit, showing separately
 - (i) those designated as such upon initial recognition, and
 - (ii) those classified as held-for-trading in accordance with IPSAS 29; and
- b) Financial liabilities measured at amortized cost.
 - Fair value measurements and fair value hierarchy level

For fair value measurements recognized an entity discloses the level in the fair value hierarchy into which the fair value measurements are categorized.

The fair value hierarchy has the following levels:

- a) Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- b) Level 2 - Inputs other than quoted prices that are observable for the asset or liability, either directly (i.e., as price) or indirectly (i.e., derived from prices); and
- c) Level 3 - Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The disclosure requirements related to fair value measurements recognized in the statement of financial position an entity are quite extensive. Participants should refer to IPSAS 30, paragraphs 29 – 36.

- Revenue, expense, gains, or losses

An entity shall disclose the following items of revenue, expense, gains, or losses either in the statement of financial performance or in the notes:

- a) Net gains or net losses on each category of financial asset and liability;
- b) Total interest revenue and total interest expense for financial assets or liabilities that are not at fair value through surplus or deficit;
- c) The amount of any impairment loss for each class of financial asset.

For detailed disclosure requirements related to revenues, expenses, gains and losses refer to IPSAS 30, paragraph 24.

- Information about hedges

An entity shall disclose for each type of hedge (i.e., fair value hedges, cash flow hedges, etc.):

- a) A description of each type of hedge;
- b) A description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period; and
- c) The nature of the risks being hedged.

For detailed disclosure requirements related to hedge accounting refer to IPSAS 30, paragraphs 27 - 28.

- Information about concessionary loans

For concessionary loans granted an entity shall disclose:

- a) A reconciliation between the opening and closing carrying amounts of the loans, including:
 - (i) Nominal value of new loans granted during the period;
 - (ii) The fair value adjustment on initial recognition;
 - (iii) Loans repaid during the period;

- (iv) Impairment losses recognized;
 - (v) Any increase during the period in the discounted amount arising from the passage of time; and
 - (vi) Other changes.
- b)** Nominal value of the loans at the end of the period;
 - c)** The purpose and terms of the various types of loans; and
 - d)** Valuation assumptions.
 - Nature, type and extent of risks

An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period. Disclosures will be both qualitative and quantitative for each type of risk.

The types include credit risk, liquidity risk and market risk.

- a)** Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
- b)** Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
- c)** Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.
- d)** Market risk comprises three types of risk:
 - (i) Currency risk - the fair value or future cash flows will fluctuate because of changes in foreign exchange rates.
 - (ii) Interest rate risk - the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
 - (iii) Other price risk the fair value or future cash flows of a financial instrument will fluctuate due to other changes in market prices other than interest or foreign exchange rates.

For each type of risk arising from financial instruments, an entity shall disclose:

- a)** The exposures to risk and how they arise;
- b)** Its objectives, policies, and processes for managing the risk and the methods used to measure the risk; and
- c)** Any changes in (a) or (b) from the previous period.

For each type of risk arising from financial instruments, an entity shall disclose:

- a)** Summary quantitative data about its exposure to that risk at the end of the reporting period.
- b)** Required disclosures credit risk, liquidity risk and market risk to the extent not provided in (a).
- c)** Concentrations of risk if not apparent from (a) and (b).

The disclosures required by IPSAS 30 related to credit, liquidity and market risks are extensive. For detailed disclosure requirements refer to IPSAS 30, paragraphs 43-49.

Accounting Policy Note

- The Commission makes the following classifications of its financial assets and financial liabilities
 - Cash is classified as “assets held for trading through surplus or deficit” and is measured at fair value
 - Accounts receivable are classified as “loans and receivables” and are measured at amortized cost
 - Accounts payable and accrued liabilities, other liabilities and long term financing are classified as “other financial liabilities” and are initially measured at fair value

Background:

The illustrative note is intended to show how an entity might comply with the requirements in IPSAS 30 to disclose information by class of financial instrument. An entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Sample financial instruments accounting policy note.

The Commission has elected the following balance sheet classifications with respect to its financial assets and financial liabilities:

- a) Cash is classified as “assets held for trading through surplus or deficit” and is measured at fair value.
- b) Accounts receivable are classified as “loans and receivables” and are measured at amortized cost which, upon initial recognition, is considered equivalent to fair value.
- c) Accounts payable and accrued liabilities, other liabilities and long term financing are classified as “other financial liabilities” and are initially measured at fair value.

Carrying Amount and Fair Value Disclosure

Background:

This note has been abbreviated for presentation purposes and does not purport to illustrate all the disclosure requirements. Participants should consult IPSAS 30 for detailed guidance.

For each class of financial assets and financial liabilities an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

An entity shall disclose for each class of financial instruments the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. (This note has been abbreviated for presentation purposes and does not purport to illustrate all the disclosure requirements).

Disclosures of fair value are not required when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables.

Carrying Amount and Fair Value Illustrative Note Disclosure

The following table presents the carrying value and the fair value of liabilities and financial assets. Fair values are Government estimates and are generally calculated using market conditions at a specific point in time.

	20X2 Carrying Amount	20X2 Fair Value	20X1 Carrying Amount	20X1 Fair Value
Financial Liabilities				
Pensions	142,843	154,630	139,909	155,877
Debt	559,126	597,531	514,020	561,964
Financial Assets				
Loans and Receivables	101,205	95,627	122,147	121,207
Investments	121,207	121,207	99,926	104,925

Fair Value Hierarchy

The following table shows the fair value hierarchy for fair value measurements of financial assets recognized in the statement of financial position.

Description	20X2 CU	Level 1 CU	Level 2 CU	Level 3 CU
Financial assets at fair value through surplus or deficit				
Trading Securities	15,650	9,325	4,175	2,150
Derivatives	25,420	10,168	7,827	7,425
Available-for-sale financial assets				
Equity Investments	9,575	925	2,875	5,775
Total	50,645	20,418	14,877	15,350

Background:

IPSAS 30 requires disclosures about the level in the fair value hierarchy in which fair value measurements are categorized for assets and liabilities measured in the statement of financial position. A tabular format is required unless another format is more appropriate.

IPSAS 30 requires a reconciliation from beginning to ending balances for those assets and liabilities that are measured in the statement of financial position at fair value based on a valuation technique for which any significant input is not based on observable market data (Level 3). The illustrative example does not include this disclosure.

Credit Risk

Note X - Credit Risk

The use of derivatives introduces the credit risk of a counterparty defaulting on contractual obligations. The Province manages its credit risk by dealing only with high credit quality counterparties and entering into contractual agreements that provide for termination netting. The table below presents the gross credit risk for the derivative financial instrument portfolio.

	March 31 20X2 (000)	March 31 20X1 (000)
Gross Credit Risk Exposure Derivatives	2,919	5,492

Background:

The above is an illustration of a disclosure an entity may make in compliance with IPSAS 30 related to credit risk. The illustrative note is of necessity abbreviated. Participants should consult IPSAS 30 for more the detailed disclosure requirements.

Questions and Discussion

Visit the IPSASB webpage

<http://www.ipsasb.org>

This concludes our module on financial instrument disclosures. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

For fair value measurements recognized, IPSAS 30 requires an entity to disclose the level in the fair value hierarchy into which the fair value measurements are categorized.

The fair value hierarchy uses the following inputs:

- a) **Inputs for the asset or liability that are not based on observable market data (unobservable inputs).**
- b) **Quoted prices (unadjusted) in active markets for identical assets or liabilities.**
- c) **Inputs other than quoted prices that are observable for the asset or liability, either directly (i.e., as price) or indirectly (i.e., derived from prices).**

Which input relates to Level 1, which to Level 2 and which to Level 3?

Question 2

IPSAS 30 requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Information about what types of risk should be disclosed?

Answers to Review Questions

Question 1

The answer is (a) – Level 3; (b) – Level 1; and (c) – Level 2

The fair value hierarchy has the following levels:

- a) Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- b) Level 2 - Inputs other than quoted prices that are observable for the asset or liability, either directly (i.e., as price) or indirectly (i.e., derived from prices); and
- c) Level 3 - Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Level 1 has the least uncertainty and level of judgment required. At each further down the hierarchy, the level of uncertainty and judgment required increases.

Question 2

The types include credit risk, liquidity risk and market risk.

Core Concepts (IPSAS 41)

Introduction

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting principles for public sector entities.

Recognition and Derecognition

- Recognized when entity becomes a party to the contractual provisions of the financial instrument
- Financial asset derecognized when contractual rights expire, are waived or transferred
 - Cumulative gain or loss recognized in surplus or deficit
- Financial liability derecognized when contract is discharged, waived, cancelled or expires
 - Difference between the carrying amount and consideration paid recognized in surplus or deficit

When an entity first recognizes a financial instrument, it applies the classification provisions of IPSAS 41 to that financial instrument.

The following are examples of applying the principle:

- a) Receivables and payables are recognized as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash. For example, when goods and services have been shipped, delivered, or rendered.
- b) A forward contract is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place.
- c) Debt is recognized when issued or derecognized when exchanged or repaid.

Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

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

An entity derecognizes a financial asset when

- a) The contractual rights to the cash flows from the financial asset expire or are waived; or
- b) It transfers the contractual rights to receive the cash flows of the financial asset and the transfer qualifies under IPSAS 41 for derecognition.

A transfer qualifies for derecognition if, and only if, an entity:

- 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.

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

- a) The carrying amount; and
- b) The consideration received (including any new asset obtained less any new liability assumed)

is recognized in surplus or deficit.

Normally, derecognition of a financial asset should be relatively straight forward. However, if the derecognition involves the transfer of a financial asset, requirements to determine whether the transfer qualifies for derecognition are complex and beyond the scope of the training material. If a transfer is involved, direct reference should be made to IPSAS 41, paragraphs 15 - 34.

An entity removes a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished – i.e., when the obligation specified in the contract is discharged, waived, cancelled or expires.

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).

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, is recognized in surplus or deficit. Where an obligation is waived by the lender or assumed by a third party as part of a non-exchange transaction, an entity applies IPSAS 23.

An exchange of debt instruments with substantially different terms or a substantial modification of the terms of an existing financial liability is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

An exchange between an existing borrower and lender of debt instruments with substantially different terms is 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) is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.



Trade Date/Settlement Date Accounting

- Regular way purchases of financial assets can be recognized at trade date or settlement date (accounting policy choice – but must be consistently applied to group of assets); except for derivatives which are always recognized on trade date.
- Trade date is the date on which an entity commits to purchase or sell an asset.
- Settlement date is the date on which the asset is delivered to, or by, the entity.

Regular way purchases or sales (derecognition) of a financial asset is done using either trade date or settlement date accounting. A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Regular way purchases of financial assets can either be recognized using trade or settlement date accounting, while derivatives are always recognized using trade date accounting.

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.

Trade date is the date on which an entity commits to purchase or sell an asset.

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.

Settlement date is the date on which asset is delivered to or by an entity.

As an example, on December 29, 20X1, an entity commits itself to purchase a bond for settlement on January 4, 20X2. The fair value of the bond on trade (commitment date) is CU 1,000. On the settlement date the fair value of the asset is CU 1,003. The entity, depending on the classification of the investment, may have a choice between using the trade date value or the settlement date value.

The choice is an accounting policy issue and may have accounting implications. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets. For example, interest generally does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

When settlement date accounting is applied an entity may have to account for any change in the fair value of the asset to be received during the period between the trade date and the settlement date depending upon the financial instrument and its classification. For example, the change in value is not recognized for assets carried at cost or amortized cost, but is recognized in surplus or deficit for assets classified as financial assets at fair value through surplus or deficit.



Classification of Financial Assets

- Classes of Financial Asset
 - Amortized Cost
 - Fair Value through Nets Assets/Equity
 - Fair Value through Surplus or Deficit
- Classification based on entity's management model and contractual cash flow characteristics of the financial asset
- Classification determines recognition and measurement requirements

The classification of financial assets is significant as it determines how a particular financial asset is recognized and measured in the financial statements both at initial recognition and subsequent to initial recognition.

The classifications will also determine how the gains and losses are recognized through surplus or deficit. For example, the classification will determine whether the gains or losses resulting from changes in the value of financial assets on remeasurement after initial recognition are through surplus or deficit in the period, or directly to net assets/equity.

Management Model

An entity's management model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular objective.

The entity's management 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 management model for its financial instruments. Consequently, 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 realize fair value changes.

Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into sub-portfolios in order to reflect the level at which an entity manages those financial assets.

For example, that may be the case if an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them.



Financial Assets Measured at Amortized Cost

A financial asset is measured at amortized cost if both of the following conditions are met:

- a) The financial asset is held within a management model whose objective is to hold financial assets in order to collect contractual cash flows and
- 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.

Financial assets that are held within a management model whose objective is to hold assets in order to collect contractual cash flows are managed to realize cash flows by collecting contractual payments over the life of the instrument.

That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows (instead of managing the overall return on the portfolio by both holding and selling assets).

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest.



Financial Assets Measured at Fair Value through Net Assets/Equity

A financial asset is measured at fair value through net assets/equity if both of the following conditions are met:

- a) The financial asset is held within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets and
- 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.

An entity may hold financial assets in a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

In this type of management model, the entity's key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the management model.

There are various objectives that may be consistent with this type of management model. For example, the objective of the management model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding.

To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.

Compared to a management model whose objective is to hold financial assets to collect contractual cash flows, this management model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the management model's objective instead of being only incidental to it.

However, there is no threshold for the frequency or value of sales that must occur in this management model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.



Financial Assets Measured at Fair Value through Surplus or Deficit

A financial asset shall be measured at fair value through surplus or deficit unless it is measured at amortized cost or at fair value through net assets/equity.

Entity may:

- Designate a financial asset as measured at fair value through surplus or deficit
- Elect for particular investments in equity instruments that would otherwise be measured at fair value through surplus or deficit to present subsequent changes in fair value in net assets/equity.

Financial assets are measured at fair value through surplus or deficit if they are not held within a management model whose objective is to hold assets to collect contractual cash flows or within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

One management model that results in measurement at fair value through surplus or deficit is one in which an entity manages the financial assets with the objective of realizing cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realize those fair values.

In this case, the entity's objective will typically result in active buying and selling. Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a management model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the management model's objective; instead, it is incidental to it.

In addition, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through surplus or deficit 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 recognizing the gains and losses on them on different bases.

Investment in Equity Instrument

An entity may also make an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through surplus or deficit to present subsequent changes in fair value in net assets/equity.

This election may be made where the investment in an equity instrument is neither held for trading nor contingent consideration recognized by an acquirer in a public sector combination.

If an entity makes this election, it recognizes in surplus or deficit any dividends or similar distributions from that investment.



Financial Asset Designation

The functional currency for a government is the Japanese yen. It holds a fixed rate 5 million US dollar bond that matures in five years. The government manages its interest rate and exchange risk on the bond by actively trading in US equity securities. The management model for the US dollar bond and similar investments is to hold financial assets in order to collect contractual cash flows.

Could the US dollar bond be designated as at fair value through surplus or deficit?

Why?

Answer:

Under IPSAS 41, measurement of a financial asset or financial liability and recognition of 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, a financial asset would be classified as measured at fair value through net assets/equity (with changes in fair value recognized directly in net assets/ equity) and a liability the entity considers related would be measured at amortized cost (with changes in fair value not recognized).

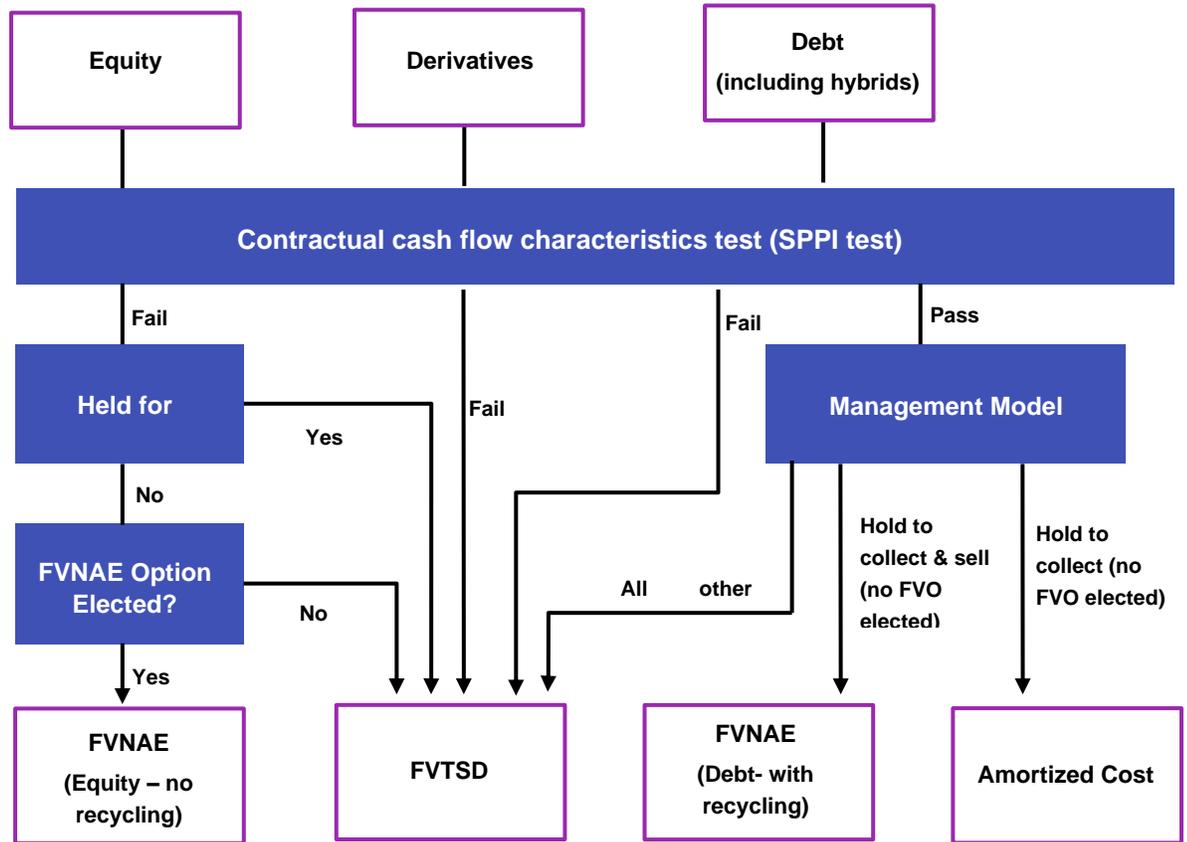
In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through surplus or deficit.

The example shows when this condition could be met.

The entity has financial assets that share interest rate or exchange risk that give rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through surplus or deficit (i.e., only the equities are held under a management model whose objective is realizing cash flows through the sale of the assets).

In this case designating, at initial recognition, the financial assets as at fair value through surplus or deficit may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information.

Financial Asset Classification Summary



The diagram summarizes the process for classifying financial assets. The abbreviations used in the diagram are as follows:

- SPPI Solely Payments of Principal or Interest
- FVNAE Fair Value through Net Assets/Equity
- FVTSD Fair Value through Surplus or Deficit
- FVO Fair Value Option

Recycling refers to subsequent measurement and is addressed later.

Classification of Financial Liabilities

An entity classifies all financial liabilities as subsequently measured at amortized cost, except for:

- a) Financial liabilities at fair value through surplus or deficit
- b) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition
- c) Financial guarantee contracts
- d) Commitments to provide a loan at a below-market interest rate
- e) Contingent consideration recognized by an acquirer in a public sector combination.

An entity classifies all financial liabilities as subsequently measured at amortized cost, except for:

- a) Financial liabilities at fair value through surplus or deficit. Such liabilities, including derivatives that are liabilities, are 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.
- c) Financial guarantee contracts. After initial recognition, an issuer of such a contract subsequently measures it at the higher of:
 - (i) The amount of the loss allowance determined in accordance with paragraphs 73–93 of IPSAS 41; and
 - (ii) The amount initially recognized less, when appropriate, the cumulative amount of amortization recognized in accordance with the principles of IPSAS 9.
- d) Commitments to provide a loan at a below-market interest rate. An issuer of such a commitment subsequently measures it at the higher of:
 - (i) The amount of the loss allowance determined in accordance with paragraphs 73–93 of IPSAS 41; and
 - (ii) The amount initially recognized less, when appropriate, the cumulative amount of amortization recognized in accordance with the principles of IPSAS 9.
- e) Contingent consideration recognized by an acquirer in a public sector combination to which IPSAS 40 applies. Such contingent consideration is subsequently measured at fair value with changes recognized in surplus or deficit.

An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through surplus or deficit 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 recognizing 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.



Financial Liability Designation

The functional currency for a government is the Japanese yen. The government has issued 5 million US dollar fixed rate debt that matures in two years. Interest payments are due semi-annually. The government has entered into a futures contract to purchase 5 million US dollars that matures in two years. The US dollar debt is not designated as a hedged item.

Could the government designate its US dollar liability as a financial liability at fair value through surplus or deficit? Why?

Answer:

The government has financial assets and a financial liability that share similar risks, such as interest rate risk. Due to the nature of the financial instruments, risks give rise to opposite changes in fair value that tend to offset each other. However, only the futures would be measured at fair value through surplus or deficit.

In this case to designate, at initial recognition, the debt as at fair value through surplus or deficit rather than amortized cost may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information.



Amortized Cost

- Amount at initial recognition
 - Minus principal repayments
 - Plus or minus the cumulative amortization of any difference between initial amount and maturity amount using effective interest method
 - Minus any reduction for impairment or valuation allowance

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest revenue or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity estimates cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall not consider future credit losses.

The calculation of the effective interest rate includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts.

For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate.

This is in contrast to variable rate financial assets and variable rate financial liabilities. When cash flows are re-estimated for variable rate financial instruments to reflect movements in market rates of interest, the effective interest rate is updated.

This is because for variable rate instruments it would be inappropriate to determine at inception a single fixed rate to discount estimated future cash flows as varying interest receipts/payments are a contractual term of a variable rate instrument.

The re-estimation of future cash flows for any reason other than changes in market rates or when financial instruments are not variable rate instruments will normally result in a change in carrying amount, since the revised estimated cash flows are discounted at the instrument's original effective interest rate. The adjustment is recognized in profit or loss as income or expense.



Initial Measurement

- Except for short-term receivables and payables, 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 surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability
- Exception if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price
- An entity may measure short-term receivables and payables at the original invoice amount if the effect of discounting is immaterial

When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value, plus or minus the transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability, subject to the following exceptions.

- If a financial asset or financial liability is designated as at fair value through surplus or deficit, reference is made to IPSAS 41, Paragraphs 66–68 which provide commentary and guidance on determining fair value. This is complemented by Application Guidance in paragraphs AG144–AG155.
- The fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.
- When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortized cost, the asset is recognized initially at its fair value on the trade date.
- When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognized for assets measured at amortized cost; it is recognized in surplus or deficit for assets classified as financial assets measured at fair value through surplus or deficit; and it is recognized in net assets/equity for financial assets measured at fair value through net assets/equity in accordance with paragraph 41 and for investments in equity instruments.
- At initial recognition, an entity may measure short-term receivables and payables at the original invoice amount if the effect of discounting is immaterial.

Loan Example – Effective Interest Method

Scenario

Government G entity borrows CU 50,000 on January 1 20X1 for 5 years. The annual interest rate on the loan is 10% paid at the end of the year. G pays an up-front fee of CU 1,000 and the net proceeds of the loan are CU 49,000.

- What is the annual effective interest rate of the loan?
- What would the annual effective interest rate of the loan be if there is no 1,000 up front fee?

The effective annual interest method is 10.53482%.

Date	Interest	Coupon- 10%	Amortized Cost
Jan 1 20X1	0	0	49,000
Dec 31 20X1	5,169	5,000	49,162
Dec 31 20X2	5,179	5,000	49,341
Dec 31 20X3	5,198	5,000	49,539
Dec 31 20X4	5,219	5,000	49,758
Dec 31 20X5	5,242	5,000	50,000
Total	26,000	25,000	

Journal Entries at each date are as follows:

Jan 1 20X1	Dec 31 20X1	Dec 31 20X2	Dec 31 20X3	Dec 31 20X4	Dec 31 20X5
DR Cash 49,000	DR Int Exp 5,162	DR Int Exp 5,179	DR Int Exp 5,198	DR Int Exp 5,219	DR Int Exp 5,242
CR Loan (49,000)	CR Cash (5,000)				
	CR Loan (162)	CR Loan (179)	CR Loan (198)	CR Loan (219)	CR Loan (242)

The final journal entry at the end of the period of the loan would be Dr Loan 50,000, Cr Cash 50,000

If there was no annual upfront fee, the effective interest rate would be 10%.

Concessionary Loans

- Concessionary loans are granted/received at below market terms.
- A waiver of debt is not a concessionary loan
- At inception a concessionary loan is recognized as follows:
 - When loan is being received by entity – difference is recognized in accordance with IPSAS 23
 - When loan is granted by entity – difference is recognized as an expense in surplus or deficit
- Subsequent measurement dependent on the classification of the loan in accordance with IPSAS 41.

Concessionary loans are those loans granted or received, which are below market terms. A number of governments will have given or received concessionary loans in response to the COVID-19 pandemic.

A waiver of debt is not a concessionary loan, as at inception the loan was granted at market terms with expectation of repayment.

For example, an entity's intention at the outset of a concessionary loan is to provide resources at below market terms. For example, offering a loan at 3% interest when market terms for such a loan would be 5%.

At inception a concessionary loan is recognized as follows:

- When loan is being received by entity, the difference between the amount received and the fair value of the loan is recognized in accordance with IPSAS 23
- When loan is granted by the entity, the difference between the amount granted and the fair value of the loan is recognized as an expense in surplus or deficit.

The subsequent measurement of a concessionary loan is dependent on the classification of the loan in accordance with IPSAS 41 (for example amortized cost or fair value through surplus or deficit). An example to illustrate a concessionary loan follows.

Student Loans

Scenario

The department of education made CU 250,000 in low interest student loans on the following terms.

Capital is repaid as follows:

- Year 1 to 2: no capital repayments
- Year 3: 30% capital to be repaid
- Year 4: 30% capital to be repaid
- Year 5: 40% capital to be repaid

Interest at 6% interest is paid annually in arrears

Market rate for similar loans is 11.5%

1. Are the loans concessionary loans? Explain.
2. If yes, how is fair value determined? Explain.

Answer:

The student loans are concessionary loans. Concessionary loans are granted to or received by an entity at below market terms. In this case, the interest rate is below market rates for similar loans.

The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique.

As concessionary loans are granted or received at below market terms, the transaction price on initial recognition of the loan may not be its fair value. An entity determines the fair value of the loan by reference to an active market. If an entity cannot determine the fair value of a concessionary loan by reference to an active market, it uses a valuation technique.

Valuation techniques include using recent arm's length market transactions, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or some other valuation technique commonly used by market participants to price similar instruments.

In this case, fair value of the concessionary loans using a valuation technique could be determined by discounting all future cash receipts using a market related rate of interest for a similar loan.

Any difference between the fair value of the loan and the transaction price (the loan proceeds) is treated as follows:

- a) Where the loan is received by an entity, the difference is accounted for in accordance with IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.
- b) Where the loan is granted by an entity, the difference is treated as an expense in surplus or deficit at initial recognition.

After initial recognition, an entity subsequently measures concessionary loans using the classifications of financial instruments defined in IPSAS 41. In most cases, this will be on the basis of amortized cost.



Accounting for Student Loans

Scenario

Based on the information in the previous slide, the department of education has determined that the fair value of the student loans is CU 207,270 by discounting future cash flows using the market related rate of 11.5%.

What is the journal entry the board of education makes for initial recognition of the student loans? Explain.

DR	DR	CR
Loans receivable (PV of future cash flows @ discount rate 11.5%)	CU 207,720	
Expense (CU 250,000 – CU 207,270)	CU 42,370	
Bank (Amount of loans advanced)		CU 250,000

Answer:

The journal entry by the department of education to record student loans at initial recognition is shown above..

Subsequent Measurement – Financial Assets

- Financial Assets are subsequently measured according to their classification:
 - Amortized Cost
 - Fair Value through Net Assets/Equity
 - Fair Value through Surplus or Deficit
- Financial assets measured at amortized cost or fair value through net assets/equity are reviewed for impairment.

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements.

All financial assets except those measured at fair value through surplus or deficit are subject to review for impairment.

Subsequent Measurement of Financial Liabilities

Financial liabilities are subsequently measured at amortized cost, except for:

- a) Financial liabilities at fair value through surplus or deficit
- b) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition
- c) Financial guarantee contracts
- d) Commitments to provide a loan at a below-market interest rate
- e) Contingent consideration recognized by an acquirer in a public sector combination

Financial liabilities are subsequently measured in accordance with their classification. Financial liabilities as subsequently measured at amortized cost, except for:

- a) Financial liabilities at fair value through surplus or deficit. Such liabilities, including derivatives that are liabilities, are 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.
- c) Financial guarantee contracts. After initial recognition, an issuer of such a contract subsequently measures it at the higher of:
 - (i) The amount of the loss allowance determined in accordance with paragraphs 73–93 of IPSAS 41; and
 - (ii) The amount initially recognized less, when appropriate, the cumulative amount of amortization recognized in accordance with the principles of IPSAS 9.

- d) Commitments to provide a loan at a below-market interest rate. An issuer of such a commitment subsequently measures it at the higher of:
 - (i) The amount of the loss allowance determined in accordance with paragraphs 73–93 of IPSAS 41; and
 - (ii) The amount initially recognized less, when appropriate, the cumulative amount of amortization recognized in accordance with the principles of IPSAS 9.
- e) Contingent consideration recognized by an acquirer in a public sector combination to which IPSAS 40 applies. Such contingent consideration is subsequently measured at fair value with changes recognized in surplus or deficit.

Gains and Losses

- A gain or loss on a financial asset or financial liability measured at fair value is recognized in surplus or deficit unless it is:
 - Part of a hedging relationship
 - Investment in an equity instrument (net assets/equity election)
 - Financial liability designated as at fair value through surplus or deficit; changes in liability's credit risk presented in net assets/equity
 - Financial asset measured at fair value through net assets/equity
- A gain or loss on a financial asset measured at amortized cost is recognized in surplus or deficit when the financial asset is derecognized, reclassified, through the amortization process, or in order to recognize impairment gains or losses.

Hedging Relationship

If a financial instrument is part of a hedging relationship, gains and losses are accounted for using the hedging provisions in IPSAS 41.

Investment in Equity Instrument

An entity may elect to present subsequent changes in the fair value of an investment in an equity instrument in net assets/equity. The investment cannot be held for trading nor contingent consideration recognized by an acquirer in a public sector combination

For these investments, amounts presented in net assets/ equity shall not be subsequently transferred to surplus or deficit. However, the entity may transfer the cumulative gain or loss within net assets/equity. In other words, the gains or losses are not “recycled” through surplus or deficit.

Financial Liability Designated as at Fair Value through Surplus or Deficit

The gain or loss on a financial liability that is designated as at fair value through surplus or deficit is presented 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 (i.e., “own credit risk”) shall be presented in net assets/equity; and
- b) The remaining amount of change in the fair value of the liability shall be presented in surplus or deficit.

IPSAS 41 includes additional guidance on the accounting in cases where the treatment of own credit risk outlined above would create or enlarge an accounting mismatch.

Financial Asset Measured at Fair Value through Net Assets/Equity

A gain or loss on a financial asset measured at fair value through net assets/equity is recognized in net assets/equity, except for impairment gains or losses and foreign exchange gains and losses, until the financial asset is derecognized or reclassified.

When the financial asset is derecognized the cumulative gain or loss previously recognized in net assets/equity is reclassified from net assets/equity to surplus or deficit as a reclassification adjustment (sometimes referred to as “recycling”).

Amortized Cost

Gains or losses on financial assets measured at amortized cost are recognized through the amortization process until the asset is derecognized, reclassified, or impaired.

Reclassification of financial instruments is beyond the scope of this training material; participants should refer directly to IPSAS 41 for further information..

Impairment of Financial Assets

- An entity shall recognize a loss allowance for expected credit losses on a financial asset that is measured at amortized cost or at fair value through net assets/equity
- Loss allowance:
 - 12-month expected credit losses if the credit risk has not increased significantly since initial recognition
 - Lifetime expected credit losses if the credit risk has increased significantly since initial recognition
- Only recognize the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance for purchased or originated credit-impaired financial assets.

For financial assets that are measured at fair value through net assets/equity the loss allowance is recognized in net assets/equity and does not reduce the carrying amount of the financial asset in the statement of financial position.

Under IPSAS 41, impairment losses are assessed using an expected credit loss model. Loss allowances are recognized at inception for all financial assets measured at amortized cost or at fair value through net assets/equity, regardless of whether a default event for an asset has occurred.

A **credit loss** is the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original effective interest rate.

Cash flows are estimated by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument.

An **expected credit loss** is the weighted average of credit losses with the respective risks of a default occurring as the weights.

Lifetime expected credit losses are the expected credit losses that result from all possible default events over the expected life of a financial instrument.

12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Expected Credit Loss Model

Stage	Performance	Loss Allowance	Interest Revenue
1	Initial recognition, no significant increase in credit risk	12-month expected credit loss	Effective interest on gross carrying amount
2	Significant increase in credit risk since initial recognition	Lifetime expected credit loss	Effective interest on gross carrying amount
3	Credit-impaired assets	Lifetime expected credit loss	Effective interest on net carrying amount

The expected credit loss model applied under IPSAS 41 has three stages

Stage 1

In stage 1, financial assets can be considered to be performing. For these assets, there has been no significant increase in the credit risk since inception.

The loss allowance for financial assets in stage 1 is calculated as the 12-month expected credit loss.

Interest for financial assets in stage 1 is calculated by applying the effective interest rate to the gross carrying amount of the financial assets, i.e., the amount before deducting the loss allowance for the asset.

Stage 2

In stage 2, financial assets can be considered to be under-performing. For these assets, there has been a significant increase in the credit risk since inception.

The loss allowance for financial assets in stage 2 is calculated as the lifetime expected credit loss.

Interest for financial assets in stage 2 continues to be calculated by applying the effective interest rate to the gross carrying amount of the financial assets, i.e., the amount before deducting the loss allowance for the asset.

Stage 3

Financial assets in stage 3 are credit-impaired. A credit-impaired financial asset is a financial asset that is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.

Evidence that a financial asset is credit-impaired include observable data about the following events:

- a) Significant financial difficulty of the issuer or the borrower;
- b) A breach of contract, such as a default or past due event;
- c) The lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
- d) It is becoming probable that the borrower will enter bankruptcy or other financial reorganization;
- e) The disappearance of an active market for that financial asset because of financial difficulties; or
- f) The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event—instead, the combined effect of several events may have caused financial assets to become credit-impaired.

The loss allowance for financial assets in stage 3 is calculated as the lifetime expected credit loss.

Interest for financial assets in stage 3 is calculated by applying the effective interest rate to the net carrying amount of the financial assets, i.e., after deducting the loss allowance for the asset.

Purchased or Originated Credit-Impaired Financial Assets

An entity may purchase or originate credit-impaired financial assets. An entity only recognizes the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance for purchased or originated credit-impaired financial assets.

Interest revenue for purchased or originated credit-impaired financial assets is calculated by applying the credit-adjusted effective interest rate to the amortized cost of the financial asset from initial recognition.

The **credit-adjusted effective interest** rate is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortized cost of a financial asset that is a purchased or originated credit-impaired financial asset.



Simplified Approach for Receivables

- An entity always measures the loss allowance at an amount equal to lifetime expected credit losses for receivables that result from exchange transactions that are within the scope of IPSAS 9 and non-exchange transactions within the scope of IPSAS 23
- An entity may apply the same approach to lease receivables (accounting policy choice).

The approach for receivables is simplified in that an entity does not need to distinguish between lifetime expected credit losses and 12-month expected credit losses. However, expected credit losses still need to be determined.



Effective Interest Rate

Scenario

On January 1, 20X0 a debt instrument (par value CU 1,250) with five years remaining to maturity is acquired at CU1,000 (including transaction costs). Fixed rate of interest of 4.7 percent is paid annually.

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Initial Amount	1,000				
Cash	59	59	59	59	59
Flows- Interest					
Cash					1,250
Flows- Maturity					

How is the effective interest rate calculated? Explain.

Answer:

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest revenue or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall not consider future credit losses.

Amortized Cost and Revenue

	20X1 CU	20X2 CU	20X3 CU	20X4 CU	20X5 CU
Open PV of cash flow	1,000	1,041	1,086	1,136	1,190
Cash Receipts - Interest	59	59	59	59	59
Cash Receipts - Principle					1,250
Amortization	100	104	109	113	119

Scenario

The effective interest rate is 10% based on the present value of the cash flows related to the bond. This is the rate that that exactly discounts estimated future cash receipts through the expected life of the financial instrument.

The table above summarizes the transactions. What is the annual interest revenue to be recognized in each year? Why?

Answer:

The amortized cost of the debt instrument is less repayments plus or minus plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount and the maturity amount less any reduction due to impairment. The effective interest rate is 10% based on the present value of the cash flows related to the bond. This is the rate that that exactly discounts estimated future cash receipts through the expected life of the financial instrument. The table below provides information about the amortized cost, interest revenue and cash flows of the debt instrument in each reporting period.

Year	Col A Amortized cost, beginning CU	Col B Amortization A*10% CU	Col C Cash Flow CU	Col D End Amortized Cost A + B - C CU	Col E Revenue A - D CU
1	1,000	100	59	1,041	100
2	1,041	104	59	1,086	104
3	1,086	109	59	1,136	109
4	1,136	113	59	1,190	113
5	1,190	119	1,250 + 59	0	119
Total		545	1,545		545

Debenture Debt

Scenario

A government with a fiscal period end of December 31 issues a 5 year debenture settled on January 1, 20X0 with a face value of CU 1 million and a coupon rate of 6%. A brokerage commission of CU 25,000 was paid. The net proceeds from the debenture was CU 1,050,000. The debenture is not classified as fair value through surplus or deficit.

What is the appropriate valuation technique? Explain.

Answer:

Note: Depending on geographic area, the terms debenture and bond, can have different meanings. Generally a bond is more secure than a debenture, which yields a lower interest rate. Debentures are unsecured, yielding a higher rate of interest. In bankruptcy bond holders are usually paid first. Debentures get periodic interest payments, whereas bond holders generally received accrued interest payments upon completion of the bond term (with the return of principal). Bonds are mostly issued by governments, debentures more commonly issued by corporations.

The debenture has not been designated as fair value through surplus or deficit. Therefore it is classified as a financial liability measured at amortized cost using the effective interest method. When applying the effective interest method, an entity generally amortizes any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument.

Accounting for Debenture Debt

	20X1 CU	20X2 CU	20X3 CU	20X4 CU	20X5 CU
Open balance	1,050,000	1,040,924	1,031,408	1,021,430	1,010,969
Cash disbursements					
Coupon Interest	60,000	60,000	60,000	60,000	60,000
Payment on maturity					1,000,000
Amortization @ 4.85% ¹	50,924	50,484	50,022	49,538	49,031

¹ This is the rate that exactly discounts estimated future cash flows through the expected life of the financial instrument.

The effective interest rate has been calculated at 4.85%. This is the rate that exactly discounts estimated future cash flows through the expected life of the financial instrument. The table summarizes the transactions related to the debenture.

Based on the information in the table, what is the journal entry to record the debenture on initial recognition?

What journal entry is made at the end of the period ended December 31, 20X0?

Answer:

Year	Col A Amortized cost, beginning	Col B Amortization A * 4.85%	Col C Cash Flows	Col D End Amortized Cost A + B - C
20X0	1,050,000	50,924	60,000	1,040,924
20X1	1,040,924	50,484	60,000	1,031,408
20X2	1,031,408	50,022	60,000	1,021,430
20X3	1,021,430	49,538	60,000	1,010,969
20X4	1,010,969	49,031	1,060,000	0

Journal entry to record proceeds on debenture

	DR	CR
Bank	CU 1,050,000	
Loans payable		CU 1,050,000
(Premium on debenture CU 75,000 less brokers' commission CU 25,000)		

Journal Entry to record payments and interest expense in year 1.

	DR	CR
Loans payable (Payment CU 60,000 less interest CU 50,924)	CU 9,516	
Interest expense	CU 50,924	
Cash		CU 60,000

Questions and Discussion

Visit the IPSASB webpage

<http://www.ipsasb.org>

This concludes our module on financial instrument disclosures. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

A government department has a management model with the objective of originating student loans and subsequently selling those loans to a securitization vehicle. The securitization vehicle issues instruments to investors.

The government that controls the department also controls the securitization vehicle and thus consolidates both.

The securitization vehicle collects the contractual cash flows from the loans and passes them on to its investors.

It is assumed for the purposes of this example that the loans continue to be recognized in the consolidated statement of financial position because they are not derecognized by the securitization vehicle

How should the loans be accounted for in:

- a) the department's financial statements; and**
- b) the government's consolidated financial statements?**

Question 2

When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received). An entity pays a brokerage fee to acquire a portfolio investment.

What is the initial value of the financial asset? Why?

How is the portfolio investment measured after initial recognition? Why?

Question 3

A local authority receives a CU 6 million loan from an international development agency to build a primary healthcare clinic. The agreement stipulates that upon completion of the facility, CU 1 million of the loan will be waived and the balance is to be repaid in equal installments over a period of 5 years. Interest of 5% is paid annually in arrears. The market rate for a similar loan is 10%.

Is the loan a financial liability of the authority? Why?

What is the initial measurement?

Question 4

Entity A has a portfolio of financial assets, including a loan to Entity B. Entity A holds the financial assets under a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets. Entity A has not designated the investments as at fair value through surplus or deficit.

Entity A has previously determined that there has been no significant increase in credit risk in the loan to Entity B, and the loss allowance is measured at the 12-month expected credit loss. On December 30, 20X1 Entity B indicates that it is seeking bankruptcy protection.

How does Entity A account for the loan to Entity B at December 31, 20X1?

Answers to Review Questions

Question 1

(a) Government Department

The government department has an objective of realizing cash flows on the loan portfolio by selling the loans to the securitization 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. Consequently, the loans would be classified as at fair value through surplus or deficit for the purposes of the department's separate financial statements.

(b) Government's Consolidated Financial Statements

The consolidated economic entity originated the loans with the objective of holding them to collect the contractual cash flows. Consequently, the loans would be classified as at amortized cost in the consolidated financial statements (unless the government has designated the loans at fair value through surplus or deficit).

Question 2

Upon initial recognition, determining whether transactions costs are included in the measurement of the financial asset depends upon its classification.

When a financial asset (or financial liability) is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received).

For financial assets, incremental costs that are directly attributable to the acquisition of the asset, for example fees and commissions, are added to the amount originally recognized. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally recognized. For financial instruments that are measured at fair value through surplus or deficit, transaction costs are not added to the fair value measurement at initial recognition.

After initial recognition, measurement of a financial asset (or financial liability) also depends on its classification.

The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) after initial recognition and of allocating the interest revenue or interest expense over the relevant period.

For financial instruments subsequently measured at amortized cost transaction costs are included in the calculation of the effective interest rate. The costs are, in effect, amortized through surplus or deficit over the life of the instrument.

The calculation of the effective interest rate includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts.

Financial assets (and financial liabilities) that are not subsequently measured at amortized cost are subsequently measured at their fair values, without any deduction for transaction costs. Changes in fair value are recognized in surplus or deficit for assets classified as at fair value through surplus or deficit, and in net assets/equity for assets classified as at fair value through net assets/equity.

Question 3

There are two transactions. The forgiveness of the CU 1 million is a non-exchange transaction and should be accounted for under IPSAS 23, Revenue from Non-Exchange Transactions (Taxes and Transfers). Under IPSAS 23, the entity would record an asset and a liability at the time the proceeds are received due to the condition that it must be used to build the health care facility. When the facility is built, the liability is derecognized.

It is different from a waiver of debt owing by an entity, as the entity does not intent to collect the CU 1 million. It would not be treated as a derecognition of a loan under IPSAS 41.

The loan is a financial liability and should be accounted for under IPSAS 41.

The loan portion is a concessionary loan because the interest rate is below market. Concessionary loans are granted to or received by an entity at below market terms.

At initial recognition, an entity therefore analyzes the substance of the loan granted into its component parts. If an entity has determined that the transaction, or part of the transaction, is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition. If an entity cannot determine the fair value of the loan by reference an active market, it uses a valuation technique. Fair value using a valuation technique could be determined by discounting all future cash receipts using a market related rate of interest for a similar loan.

Illustrative Examples are provided in paragraph IG54 of IPSAS 23 as well as paragraphs IE153 to IE172 accompanying IPSAS 41.

After initial recognition, an entity subsequently measures concessionary loans using the categories of financial instruments defined in IPSAS 41. In most cases, this will be on the basis of amortized cost.

Question 4

The loan to Entity B is held under a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets. Entity A has not designated the investments as at fair value through surplus or deficit. Consequently, the loan is classified as at fair value through net assets/equity.

The fact that Entity B is seeking bankruptcy protection is evidence of a significant increase in credit risk since initial recognition. Consequently, Entity A would measure the loss allowance in respect of the investment at the lifetime expected credit loss. Impairment losses on financial assets classified as at fair value through net assets/equity are recognized in surplus or deficit.

The fact that Entity B is seeking bankruptcy protection is also evidence that the loan is credit impaired. Consequently, Entity A will calculate future interest revenue on the loan by applying the effective interest rate to the net carrying amount (i.e., after deducting the loss allowance).

Hedging and Derivatives (IPSAS 41)



Introduction

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting principles for public sector entities.

Objective of Hedge Accounting

To represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect surplus or deficit (or net assets/equity, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in net assets/equity).

This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect.

Hedge accounting is a complicated issue. It allows an entity to offset transactions in its accounts to reflect its risk management activities associated with a financial asset or financial liability or groups of financial assets and financial liabilities.

The requirements for hedge accounting are complex and beyond the scope of this material. The intention here is to only give participants an awareness of hedge accounting.

Hedge Accounting

- Hedging instrument (fair value through surplus or deficit):
 - A derivative measured
 - A non-derivative financial asset or a non-derivative financial liability
 - Contract with an external party
- Hedged item:
 - A recognized asset or liability, an unrecognized firm commitment, a forecast transaction or a net investment in a foreign operation
 - Single item or group of items
- Designated hedging relationships can be
 - Fair value hedge
 - Cash flow hedge
 - Hedge of a net investment in a foreign operation.

A hedging instrument is the financial instrument that is used as part of an entity's risk management activities to manage risks associated with a hedged item.

Hedging instruments are as follows:

- a) A derivative measured at fair value through surplus or deficit may be designated as a hedging instrument.

- b) A non-derivative financial asset or a non-derivative financial liability measured at fair value through surplus or deficit may be designated as a hedging instrument (unless it is a financial liability designated as at fair value through surplus or deficit for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in net assets/equity).
- c) For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in net assets/equity.
- d) For hedge accounting purposes, only contracts with a party external to the reporting entity (i.e., external to the economic entity or individual entity that is being reported on) can be designated as hedging instruments.

With some exceptions relating to option or futures contracts, a qualifying instrument must be designated in its entirety as a hedging instrument.

A hedged item can be a recognized asset or liability, an unrecognized firm commitment, a forecast transaction or a net investment in a foreign operation. The hedged item can be:

- a) A single item; or
- b) A group of items.

The hedged item must be reliably measurable. If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

- a) The hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- b) At the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
- c) The hedging relationship meets all of hedge effectiveness requirements.

There are three types of hedging relationships:

- a) Fair value hedge: a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect surplus or deficit.
- b) Cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognized asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect surplus or deficit.
- c) Hedge of a net investment in a foreign operation as defined in IPSAS 4.

Cash Flow Hedge

Scenario

On January 1, 20X1 a city enters into a firm commitment contract to purchase a fire truck for delivery on June 30, 20X1 for Foreign Currency (FC)100,000. On January 1 20X1, it enters into a forward exchange contract to receive FC 100,000 and deliver Local Currency (LC) 109,600 on June 30, 20X1. Changes in the exchange rates affecting FC and LC are expected to offset each other.

- Why would the entity enter into the forward exchange contract? Explain.
- What is the hedged item? Explain.
- What is the hedging instrument? Explain.

Answer:

This is an illustrative example of a cash flow hedge. That is, it is a hedge of the exposure to variability in cash flows that could result from changes in foreign exchange rates related to the firm commitment contract (a highly probable forecast transaction) for the purchase of the fire truck. The results of fluctuations in the exchange rates will affect surplus or deficit.

The hedged item is the firm commitment contract liability for the purchase of the fire truck.

The hedging instrument is the forward exchange contract. It is a derivative, that is, it is a financial instrument, the value of which is derived from the value of underlying currency exchange rates.

It is used to mitigate currency risk to future cash flows of a financial liability that may be caused by fluctuations foreign exchange rates without directly purchasing the underlying instrument. The contractual amounts are notional amounts to which the exchange rate is applied to compute the cash flows to be exchanged between parties.

The value of the derivative has all three of the following characteristics:

- a) Its value changes in response to the change in exchange rate;
- b) It required no initial net investment; and
- c) It is settled at a future date.

Fair Value Hedge

Scenario

An entity has outstanding FC 5 million five-year debt. Principal is repayable at maturity in two years. It has entered into a currency swap contract for the notional value of FC 5 million. Under the contract it makes a payment of LC 5.1 million and receives a payment of FC 5 million on the date of maturity of the debt instrument.

What type of hedge relationship is it? Explain.

Answer:

It could be either a fair value hedge or a cash flow hedge. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge. If it is considered a fair value hedge, the hedge relationship is a hedge of the exposure to changes in fair value of the recognized

liability that is attributable to foreign exchange risk. Fluctuations in the fair value of the debt instrument could affect surplus or deficit.



Derivatives

- A financial instrument when the value is derived from the value of underlying market-based factors
- Essential characteristics:
 - Value changes with changes in a specified index (the “underlying”)
 - No or nominal initial net investment required
 - Settled at a future date

A derivative is a financial instrument, the value of which is derived from the value of underlying assets, indices, interest rates, currency exchange rates or other market-based factors.

Derivatives are generally used to limit or adjust market, credit, interest rate, currency and other financial exposures without directly purchasing or selling the underlying instrument.

Derivatives are used to mitigate the risks to the fair value or future cash flows of a financial asset or financial liability that may be caused by fluctuations in market prices, interest rates, foreign exchange rates and other indices. Derivatives may also be purchased for speculative purposes; however, this is rarer in a public sector setting than in the non-public sector.

Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument.

The contractual amounts of derivatives are notional amounts to which a rate or price is applied for computing the cash flows to be exchanged between the parties to a derivative contract. The notional amounts are used to determine the gains/losses and fair value of the contracts. The notional amounts are not recorded as assets or liabilities on the statement of financial position.

A derivative is a financial instrument or other contract with all three of the following characteristics:

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

On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favorable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavorable.

However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange.

Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favorable or unfavorable.

Embedded Derivatives

- An embedded derivative is a component of a hybrid contract that also includes a non-derivative host
- Effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative
- Not contractually transferable independently of financial instrument to which it is attached
- Only separated where:
 - Economic characteristics and risks not closely related to those of the host
 - Separate instrument meets definition of a derivative
 - Hybrid instrument not measured at fair value through surplus or deficit

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.

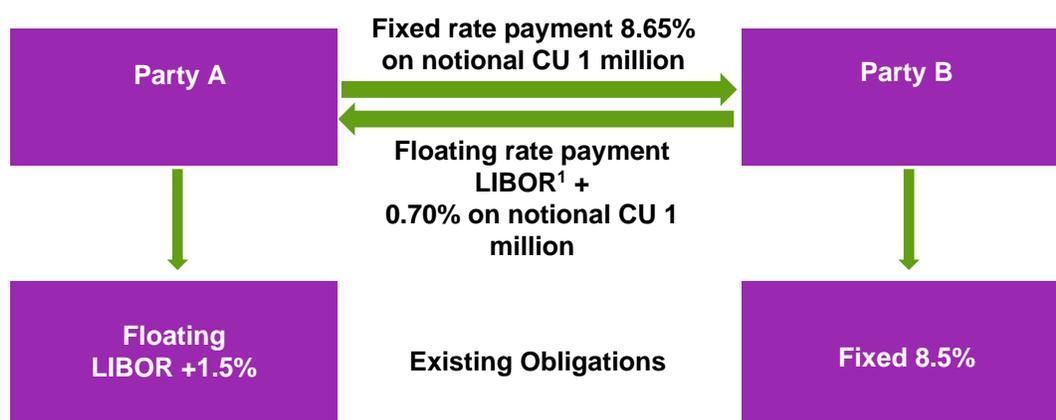
If a hybrid contract contains a host that is an asset within the scope of IPSAS 41, an entity applies the requirements for classifying financial assets to the entire hybrid contract. This may mean that the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding; in such circumstances the financial asset would be classified as at fair value through surplus or deficit.

If a hybrid contract contains a host that is not an asset within the scope of IPSAS 41, an embedded derivative shall be separated from the host and accounted for as a derivative under IPSAS 41 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;
- 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 recognized in surplus or deficit (i.e., a derivative that is embedded in a financial liability at fair value through surplus or deficit is not separated).

If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards.

Interest Swap



¹ The London Interbank Offered Rate (LIBOR) is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the London wholesale money market (or interbank market).

A common derivative used in the public sector is an interest rate swap. Interest rate swaps are used by public sector entities to manage the risks of adverse interest-rate movements.

In a typical interest rate swap, one party to the agreement agrees to pay either a fixed or floating rate denominated in a particular currency to another party. The floating rate is usually pegged to a reference rate such as LIBOR. The fixed or floating rate is multiplied by a notional principal amount (say, CU 1 million). This notional principal amount is generally not exchanged between counterparties, but is used only for calculating the size of cash flows to be exchanged.

The example is based on the following facts. Party A agrees to pay Party B periodic fixed interest rate payments of 8.65%, in exchange for periodic variable interest rate payments of LIBOR + 70 bps (0.70%). Note that there is no exchange of the principal amounts and that the interest rates are on a “notional” principal amount. The fixed rate (8.65% in this example) is referred to as the swap rate.

What are the characteristics of the interest rate swap that satisfy definition of a derivative financial instrument? Explain.

Answer:

The example of the interest rate swap demonstrates the following characteristics of derivative financial instruments:

- a) Its value changes in response to the change in a specified interest rate;
- b) It requires no initial net investment (in this example); and
- c) It is settled at a future date in periodic payments between parties.

The notional principal amount upon which the periodic payments are based is not exchanged. Initial value of the financial instrument in this case is zero.

Questions and Discussion

Visit the IPSASB webpage

<http://www.ipsasb.org>

That concludes our module on the hedging and derivatives requirements of IPSAS 41. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

Entity X enters into a fixed price forward contract to purchase one million liters of oil in accordance with its expected usage requirements. The contract permits the entity to take physical delivery of the oil at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of oil.

Is the contract accounted for as a derivative? Why?

Question 2

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement.

Is this a derivative? Why?

Question 3

A South African entity, Entity XYZ, whose functional currency is the South African rand, sells electricity to Mozambique denominated in US dollars. XYZ enters into a contract with an investment bank to convert US dollars to rand at a fixed exchange rate. The contract requires XYZ to remit rand based on its sales volume in Mozambique in exchange for US dollars at a fixed exchange rate of 6.00.

Is that contract a derivative?

Answers to Review Questions

Question 1

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of oil, and it is to be settled at a future date.

Contracts that are entered into and that continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with an entity's expected purchase or usage requirements to buy non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g. a forward contract on oil) are not financial instruments. Many commodity contracts are of this type.

However, contracts to buy a non-financial item are evaluated to determine that they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase or usage requirement, and accordingly, whether they are within the scope of IPSAS 41.

Some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are financial instruments within the scope of the standard as if they were financial instruments.

There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments.

When the terms of a contract to buy a non-financial asset permit either party to settle it net in cash or another financial asset or by exchanging financial instruments and it is the practice of the entity to settle similar contracts under those terms, the contract has not been entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements, and, accordingly, it is a financial instrument.

Similarly, when it is an entity's practice to take delivery of the non-financial item and sell it within a short period after delivery for purpose of generating a profit from short term fluctuations in the price or dealer's margin, the contract has not been entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements, and, accordingly, it is a financial instrument.

In this case, if X intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the oil and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under IPSAS 41. Instead, it is accounted for as an executory contract.

Question 2

Yes. This meets the definition of a derivative.

There is an underlying variable. That is the value changes in response to the change in a specified interest rate.

There are no transfers of principal at inception of the two loans, since Entity A and Entity B have a netting agreement. No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement. However, the same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IPSAS 41 does not require net settlement.

The contract will be settled at a future date.

The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- a) They are entered into at the same time and in contemplation of one another;
- b) They have the same counterparty;
- c) They relate to the same risk; and
- d) There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favorable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavorable.

However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favorable or unfavorable.

Question 3

Yes. The contract is a derivative.

The contract has two underlying variables; namely, the foreign exchange rate and the volume of sales.

No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision.

It is settled at a future date.

IPSAS 41 does not exclude from its scope derivatives that are based on sales volume..

Disclosures (IPSAS 41)

Introduction

The Handbook of International Public Sector Accounting Pronouncements is the primary authoritative source of international generally accepted accounting principles for public sector entities.

In this module the disclosure requirements in IPSAS 30 are those that apply following the adoption of IPSAS 41. For the disclosure requirements in IPSAS 30 that apply prior to the adoption of IPSAS 41, see the module Disclosures (IPSAS 29).

Disclosure Objective

Enable users to evaluate:

- The significance of financial instruments for the entity's financial position and performance; and
- The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

This objective informs all the disclosures required by IPSAS 30. The disclosure requirements are extensive. This training material highlights the key areas for disclosure, but does not cover all the detailed requirements.

Disclosure Requirements

- Categories of financial assets and financial liabilities
- Items of revenue, expense, gains or losses
- Accounting policies
- Hedge accounting
- Fair value
- Concessionary loans
- Nature and extent of risks arising from financial instruments

The above list summarizes the key areas for which disclosures are required. The following paragraphs discuss these items in more detail.

Categories of Financial Assets and Financial Liabilities

The carrying amounts of each of the following categories, as defined in IPSAS 41, should be disclosed either in the statement of financial position or in the notes:

- a) Financial assets measured at fair value through surplus or deficit, showing separately
 - (i) those designated as such upon initial recognition or subsequently, and
 - (ii) those mandatorily measured at fair value through surplus or deficit;

- b) Financial liabilities at fair value through surplus or deficit, showing separately
 - (i) those designated as such upon initial recognition or subsequently, and
 - (ii) those that meet the definition of held for trading;
- c) Financial assets measured at amortized cost;
- d) Financial liabilities measured at amortized cost; and
- e) Financial assets measured at fair value through net assets/equity, showing separately
 - (i) financial assets that are measured at fair value through net assets/equity; and
 - (ii) investments in equity instruments designated as such upon initial recognition.

If an entity has designated financial assets as measured at fair value through surplus or deficit, the entity discloses additional information about those financial assets. This includes information about the entity's maximum exposure to credit risk and changes in fair value.

If an entity has designated financial liabilities as measured at fair value through surplus or deficit, the entity discloses additional information about those financial liabilities. This includes information about changes in fair value.

If an entity has designated investments in equity instruments to be measured at fair value through net assets/equity, the entity discloses additional information, including details of which instruments have been so designated, the reasons for using this presentation, and the fair value of each instrument at the end of the reporting period.

The carrying amount of financial assets measured at fair value through net assets/equity is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the statement of financial position as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

Items of Revenue, Expense, Gains, or Losses

An entity discloses the following items of revenue, expense, gains, or losses either in the statement of financial performance or in the notes:

- a) Net gains or net losses on:
 - (i) Financial assets or financial liabilities measured at fair value through surplus or deficit, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently, and those on financial assets or financial liabilities that are mandatorily measured at fair value through surplus or deficit (e.g., financial liabilities that meet the definition of held for trading). For financial liabilities designated as at fair value through surplus or deficit, an entity shall show separately the amount of gain or loss recognized in net assets/equity and the amount recognized in surplus or deficit;
 - (ii) Financial liabilities measured at amortized cost;
 - (iii) Financial assets measured at amortized cost;
 - (iv) Investments in equity instruments designated at fair value through net assets/equity; and
 - (v) Financial assets measured at fair value through net assets/equity, showing separately the amount of gain or loss recognized in net assets/ equity during the period and the amount reclassified upon derecognition from accumulated net assets/equity to surplus or deficit for the period.

- b) Total interest revenue and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are measured at amortized cost or that are measured at fair value through net assets/equity (showing these amounts separately); or financial liabilities that are not measured at fair value through surplus or deficit;
- c) Fee revenue and expense (other than amounts included in determining the effective interest rate) arising from:
 - (i) Financial assets or financial liabilities that are not at fair value through surplus or deficit; and
 - (ii) Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

Accounting Policies

An entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge Accounting

Hedge accounting disclosures provide information about:

- a) An entity's risk management strategy and how it is applied to manage risk;
- b) How the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- c) The effect that hedge accounting has had on the entity's statement of financial position, statement of financial performance and statement of changes in net assets/equity.

The detailed disclosure requirements are extensive and are not covered in this training material.

Fair Value

For each class of financial assets and financial liabilities, an entity discloses the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount. Disclosures of fair value are not required:

- a) When the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables; and
- b) For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.

An entity shall disclose for each class of financial instruments the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities.

An entity classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

- a) Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);
- b) Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as price) or indirectly (i.e., derived from prices) (Level 2); and
- c) Inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

For fair value measurements recognized in the statement of financial position an entity shall disclose (for each class of financial instruments the level in the fair value hierarchy into which the fair value measurements are categorized in their entirety, segregating fair value measurements in accordance with the levels. An entity also discloses information about transfers between levels, and further information about financial instruments measured using level 3 inputs.

Concessionary Loans

Concessionary loans are granted by entities on below market terms. Examples of concessionary loans that commonly have below market terms include loans to developing countries, small farms, student loans granted to qualifying students for university or college education, and housing loans granted to low income families. For concessionary loans, an entity discloses:

- a) A reconciliation between the opening and closing carrying amounts of the loans, including:
 - (i) Nominal value of new loans granted during the period;
 - (ii) The fair value adjustment on initial recognition;
 - (iii) Loans repaid during the period;
 - (iv) Impairment losses recognized (loans measured at amortized cost only);
 - (v) Any increase during the period in the discounted amount arising from the passage of time (loans measured at amortized cost only);
 - (vi) The fair value adjustment during the period (separate from initial recognition) (loans measured at fair value only); and
 - (vii) Other changes.
- b) Nominal value of the loans at the end of the period;
- c) The purpose and terms of the various types of loans; and
- d) Valuation assumptions.

Nature and Extent of Risks Arising from Financial Instruments

An entity discloses information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

These risks typically include, but are not limited to, credit risk, liquidity risk, and market risk.

For each type of risk arising from financial instruments, an entity shall disclose the following qualitative information:

- a) The exposures to risk and how they arise;
- b) Its objectives, policies, and processes for managing the risk and the methods used to measure the risk; and
- c) Any changes in (a) or (b) from the previous period.

For each type of risk arising from financial instruments, an entity also discloses summary quantitative data about its exposure to that risk at the end of the reporting period.

The detailed quantitative disclosures are extensive, and IPSAS 30 should be referred to if more detailed information is required. Examples of the disclosure requirements in IPSAS 30 include:

Credit Risk. An entity shall explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses.

Liability Risk. A maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities; and a similar analysis for derivative financial liabilities.

Market Risk. A sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how surplus or deficit and net assets/equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date..

Accounting Policy Note

The Commission has adopted following classifications of its financial assets and financial liabilities

- Cash is classified as "assets held for trading through surplus or deficit" and is measured at fair value.
- Accounts receivable are classified as "financial assets measured at amortized cost" and accounts payable are classified as "financial liabilities measured at amortized cost" They are initially measured at the initial invoice amount and subsequently measured at amortized cost using the effective interest rate.
- Long-term loans are classified as "financial liabilities measured at amortized cost." They are initially measured at fair value, and subsequently measured at amortized cost using the effective interest rate.

The illustrative note is intended to show how an entity might comply with the requirements in IPSAS 30 to disclose information by class of financial instrument. An entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Carrying Amount and Fair Value Disclosure

This note has been abbreviated for presentation purposes and does not purport to illustrate all the disclosure requirements. Participants should consult IPSAS 30 for detailed guidance.

For each class of financial assets and financial liabilities an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

An entity shall disclose for each class of financial instruments the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities.

Disclosures of fair value are not required when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables.

Carrying Amount and Fair Value Illustrative Note Disclosure

Fair values liabilities and financial assets are estimates and are generally calculated using market conditions at a specific point in time. The following table presents the carrying amounts and fair values.

	20X2 Carrying Amount	20X2 Fair Value	20X1 Carrying Amount	20X1 Fair Value
Financial Liabilities				
Pensions	142,843	154,630	139,909	155,877
Debt	559,126	597,531	514,020	561,964
Financial Assets				
Receivables	101,205	95,627	122,147	121,207
Investments	121,207	121,207	99,926	104,925

Fair Value Hierarchy

The following table shows the fair value hierarchy for fair value measurements of financial assets recognized in the statement of financial position.

Description	20X2 CU	Level 1 CU	Level 2 CU	Level 3 CU
Financial assets at fair value through surplus or deficit				
Trading Securities	15,650	9,325	4,175	2,150
Derivatives	25,420	10,168	7,827	7,425
Investments in equity instruments at fair value through net assets/equity				
Equity Investments	9,575	925	2,875	5,775
Total	50,645	20,418	14,877	15,350

IPSAS 30 requires disclosures about the level in the fair value hierarchy in which fair value measurements are categorized for assets and liabilities measured in the statement of financial position. A tabular format is required unless another format is more appropriate.

IPSAS 30 requires a reconciliation from beginning to ending balances for those assets and liabilities that are measured in the statement of financial position at fair value based on a valuation technique for which any significant input is not based on observable market data (Level 3). The illustrative example does not include this disclosure.

Credit Risk

Note X - Credit Risk

The use of derivatives introduces the credit risk of a counterparty defaulting on contractual obligations. The Province manages its credit risk by dealing only with high credit quality counterparties and entering into contractual agreements that provide for termination netting. The table below presents the gross credit risk for the derivative financial instrument portfolio.

	March 31 20X2 (000)	March 21 20X1 (000)
Gross Credit Risk Exposure Derivatives	2,919	5,492

The above is an illustration of a disclosure an entity may make in compliance with IPSAS 30 related to credit risk. The illustrative note is of necessity abbreviated.

Participants should consult IPSAS 30 for more the detailed disclosure requirements.

Questions and Discussion

Visit the IPSASB webpage

<http://www.ipsasb.org>

That concludes our module on the financial instrument disclosures. Participants should refer to the review questions to test themselves on their knowledge.

Review Questions

Question 1

For fair value measurements recognized, IPSAS 30 requires an entity to disclose the level in the fair value hierarchy into which the fair value measurements are categorized.

The fair value hierarchy uses the following inputs:

- a) **Inputs for the asset or liability that are not based on observable market data (unobservable inputs).**
- b) **Quoted prices (unadjusted) in active markets for identical assets or liabilities.**
- c) **Inputs other than quoted prices that are observable for the asset or liability, either directly (i.e., as price) or indirectly (i.e., derived from prices).**

Which input relates to Level 1, which to Level 2 and which to Level 3?

Question 2

IPSAS 30 requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Information about what types of risk should be disclosed?

Answers to Review Questions

Question 1

The Answer is (a) – Level 3; (b) – Level 1; and (c) – Level 2

The fair value hierarchy has the following levels:

- a) Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- b) Level 2 - Inputs other than quoted prices that are observable for the asset or liability, either directly (i.e., as price) or indirectly (i.e., derived from prices); and
- c) Level 3 - Inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Level 1 has the least uncertainty and level of judgment required. At each further down the hierarchy, the level of uncertainty and judgment required increases.

Question 2

The types include credit risk, liquidity risk and market risk.

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