Final Pronouncement

January 2022

IPSAS®

International Public Sector Accounting Standard®

IPSAS 29, *Financial Instruments: Recognition and Measurement* (as applicable prior to the adoption of IPSAS 41, *Financial Instruments*)

This document was developed and approved by the International Public Sector Accounting Standards Board® (IPSASB®).

The objective of the IPSASB is to serve the public interest by setting high-quality public sector accounting standards and by facilitating the adoption and implementation of these, thereby enhancing the quality and consistency of practice throughout the world and strengthening the transparency and accountability of public sector finances.

In meeting this objective, the IPSASB sets International Public Sector Accounting Standards™ (IPSAS™) and Recommended Practice Guidelines (RPGs) for use by public sector entities, including national, regional, and local governments, and related governmental agencies.

IPSAS relate to the general-purpose financial statements (financial statements) and are authoritative. RPGs are pronouncements that provide guidance on good practice in preparing general purpose financial reports (GPFRs) that are not financial statements. Unlike IPSAS RPGs do not establish requirements. Currently all pronouncements relating to GPFRs that are not financial statements are RPGs. RPGs do not provide guidance on the level of assurance (if any) to which information should be subjected.

The structures and processes that support the operations of the IPSASB® are facilitated by the International Federation of Accountants® (IFAC®).

IPSAS 29 as Applicable Prior to the Adoption of IPSAS 41, *Financial Instruments*

The IPSASB Handbook includes all IPSAS that have been published by the IPSASB until January 31 of the publication year. It omits standards that are being withdrawn or are being replaced by an approved standard and reflects amendments as a result of any approved Standard.

In December 2021, the IPSASB approved changes to guidance in IPSAS 29, *Financial Instruments: Recognition and Measurement* that is no longer published since the 2018 IPSASB Handbook. While the recognition and measurement guidance in IPSAS 29 continues to be effective until January 1, 2023, it is excluded from the 2021 IPSASB Handbook because it is superseded by IPSAS 41, *Financial Instruments*.

To provide visibility into the impact of these changes, these amendments below reflect the revisions to IPSAS 29 for users that have yet to adopt IPSAS 41.

IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, International Financial Reporting Interpretations Committee (IFRIC) Interpretation 9, *Reassessment of Embedded Derivatives*, (IFRIC 9) and Interpretation 16 (IFRIC 16) of the IFRIC, *Hedges of a Net Investment in a Foreign Operation* published by the International Accounting Standards Board (IASB). Extracts from IAS 39, IFRIC 9, and IFRIC 16 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2022.

IPSAS 29, *Financial Instruments: Recognition and Measurement* was issued in January 2010.

Since then, IPSAS 29 has been amended by the following IPSASs:

- *Improvements to IPSAS, 2021* (issued January 2022)
- IPSAS 40, *Public Sector Combinations* (issued January 2017)
- IPSAS 39, *Employee Benefits* (issued July 2016)
- *The Applicability of IPSASs* (issued April 2016)
- *Improvements to IPSASs 2015* (issued April 2016)
- IPSAS 37, *Joint Arrangements* (issued January 2015)
- IPSAS 35, *Consolidated Financial Statements* (issued January 2015)
- IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* (issued January 2015)
- IPSAS 32, *Service Concession Arrangements: Grantor* (issued October 2011)
- *Improvements to IPSASs 2011* (issued October 2011)

Table of Amended Paragraphs in IPSAS 29

Paragraph Affected	How Affected	Affected By
Introduction section	Deleted	Improvements to IP-SASs October 2011
2	Amended	IPSAS 40 January

Paragraph Affected	How Affected	Affected By
		2017 IPSAS 39 July 2016 IPSAS 37 January 2015 IPSAS 35 January 2015 IPSAS 32 October 2011
7	Deleted	The Applicability of IPSASs April 2016
8	Deleted	The Applicability of IPSASs April 2016
17	Amended	IPSAS 35 January 2015
89	Amended	IPSAS 35 January 2015
113A–113ZC	New	Improvements to IP-SAS, 2021 January 2022
114	Deleted	IPSAS 33 January 2015
115	Deleted	IPSAS 33 January 2015
116	Deleted	IPSAS 33 January 2015
117	Deleted	IPSAS 33 January

Paragraph Affected	How Affected	Affected By
		2015
118	Deleted	IPSAS 33 January 2015
119	Deleted	IPSAS 33 January 2015
120	Deleted	IPSAS 33 January 2015
121	Deleted	IPSAS 33 January 2015
122	Deleted	IPSAS 33 January 2015
123	Deleted	IPSAS 33 January 2015
125A	New	IPSAS 32 October 2011
125B	New	IPSAS 33 January 2015
125C	New	IPSAS 37 January 2015 IPSAS 35 January 2015
125D	New	Improvements to IP-SASs April 2016
125E	New	The Applicability of IPSASs April 2016

Paragraph Affected	How Affected	Affected By
125F	New	IPSAS 39 July 2016
125G	New	IPSAS 40 January 2017
125I	New	Improvements to IP-SAS, 2021 January 2022
125J	New	Improvements to IP-SAS, 2021 January 2022
125K	New	Improvements to IP-SAS, 2021 January 2022
125L	New	Improvements to IP-SAS, 2021 January 2022
125M	New	Improvements to IP-SAS, 2021 January 2022
126	Amended	IPSAS 33 January 2015
AG20A–AG20E	New	Improvements to IP-SAS, 2021 January 2022
AG35	Amended	IPSAS 40 January 2017
AG51	Amended	IPSAS 35 January 2015

Paragraph Affected	How Affected	Affected By
AG52	Amended	IPSAS 35 January 2015
AG53	Amended	IPSAS 35 January 2015
AG131	Amended	IPSAS 40 January 2017
B4	Amended	IPSAS 40 January 2017
C2	Amended	IPSAS 37 January 2015

IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

CONTENTS

International Public Sector Accounting Standard 29, *Financial Instruments: Recognition and Measurement*, is set out in paragraphs 1–126. All the paragraphs have equal authority. IPSAS 29 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards,* and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to establish principles for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in IPSAS 28, *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in IPSAS 30, *Financial Instruments: Disclosures*.

Scope

2. **This Standard shall be applied by all entities to all types of financial instruments, except:**

   (a) **Those interests in controlled entities, associates and joint ventures that are accounted for in accordance with IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements* IPSAS 36, *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 34, IPSAS 35 or IPSAS 36 require or permit an entity to account for an interest in a controlled entity, associate, or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a controlled entity, associate, or joint venture unless the derivative meets the definition of an equity instrument of the entity in IPSAS 28.**

   (b) **Rights and obligations under leases to which IPSAS 13, *Leases* applies. However:**

      (i) **Lease receivables recognized by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 17–39, 67, 68, 72, and Appendix A paragraphs AG51–AG67 and AG117–AG126);**

      (ii) **Finance lease payables recognized by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 41–44 and Appendix A paragraphs AG72–AG80); and**

      (iii) **Derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 11–15 and Appendix A paragraphs AG40–AG46).**

(c) **Employers' rights and obligations under employee benefit plans, to which IPSAS 39, *Employee Benefits* applies.**

(d) **Financial instruments issued by the entity that meet the definition of an equity instrument in IPSAS 28 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 15 and 16 or 17 and 18 of IPSAS 28. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.**

(e) **Rights and obligations arising under:**

(i) **An insurance contract, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 10; or**

(ii) **A contract that is within the scope of the relevant international or national accounting standard dealing with insurance contracts because it contains a discretionary participation feature.**

This Standard applies to a derivative that is embedded in an insurance contract if the derivative is not itself an insurance contract (see paragraphs 11–15 and Appendix A paragraphs AG40–AG46 of this Standard). An entity applies this Standard to financial guarantee contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them. Notwithstanding (i) above, an entity may apply this Standard to other insurance contracts which involve the transfer of financial risk.

(f) **Any forward contracts between an acquirer and seller to buy or sell an acquired operation that will result in a public sector combination at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.**

(g) **Loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments**

are subject to the derecognition provisions of this Standard (see paragraphs 17–44 and Appendix A paragraphs AG51–AG80).

(h) **Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share based payment applies, except for contracts within the scope of paragraphs 4–6 of this Standard, to which this Standard applies.**

(i) **Rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognizes as a provision in accordance with IPSAS 19, or for which, in an earlier period, it recognized a provision in accordance with IPSAS 19.**

(j) **The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions, to which IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* applies.**

(k) **Rights and obligations under service concession arrangements to which IPSAS 32, *Service Concession Assets: Grantor* applies. However, financial liabilities recognized by a grantor under the financial liability model are subject to the derecognition provisions of this Standard (see paragraphs 41–44 and Appendix A paragraphs AG72–AG80).**

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

(a) **Loan commitments that the entity designates as financial liabilities at fair value through surplus or deficit. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.**

(b) **Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in installments (e.g., a mortgage construction loan that is paid out in installments in line with the progress of construction).**

(c) **Commitments to provide a loan at a below-market interest rate. Paragraph 49(d) specifies the subsequent measurement**

of liabilities arising from these loan commitments.

4. **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.**

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

   (a) When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

   (b) When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

   (c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

   (d) When the non-financial item that is the subject of the contract is readily convertible to cash.

   A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements and, accordingly, whether they are within the scope of this Standard.

6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial

instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

7. [Deleted]

8. [Deleted]

Definitions

9. The terms defined in IPSAS 28 are used in this Standard with the meanings specified in paragraph 9 of IPSAS 28. IPSAS 28 defines the following terms:

- Financial instrument;
- Financial asset;
- Financial liability;
- Equity instrument;

and provides guidance on applying those definitions.

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

Definition of a derivative

A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–6) with all three of the following characteristics:

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

(b) **It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and**

(c) **It is settled at a future date.**

Definitions of four categories of financial instruments

A financial asset or financial liability at fair value through surplus or deficit is a financial asset or financial liability that meets either of the following conditions.

(a) **It is classified as held for trading. A financial asset or financial liability is classified as held for trading if:**

  (i) **It is acquired or incurred principally for the purpose of selling or repurchasing 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**

  (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 permitted by paragraph 13 or when doing so results in more relevant information, because either:**

  (i) **It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as "an accounting mismatch") that would otherwise arise from measuring assets or liabilities or 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 (as defined in IPSAS 20, *Related Party Disclosures*), for example the entity's governing body and chief executive officer.**

In IPSAS 30, paragraphs 11–13 and AG4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through surplus or deficit, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through surplus or

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

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably[1] measured (see paragraph 48(c) and Appendix A paragraphs AG113 and AG114), shall not be designated as at fair value through surplus or deficit.

It should be noted that paragraphs 50, 51, 52, and Appendix A paragraphs AG101–AG115, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG29–AG38) other than:

(a) **Those that the entity upon initial recognition designates as at fair value through surplus or deficit;**

(b) **Those that the entity designates as available for sale; and**

(c) **Those that meet the definition of loans and receivables.**

An entity shall not classify any financial assets as held to maturity if the entity has, during the current 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**

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[1] Information that is reliable is free from material error and bias, and can be depended on by users to faithfully represent that which it purports to represent or could reasonably be expected to represent. Paragraph BC16 of IPSAS 1 discusses the transitional approach to the explanation of reliability.

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.**

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

(a) **Those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through surplus or deficit;**

(b) **Those that the entity upon initial recognition designates as available for sale; or**

(c) **Those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.**

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

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

Definition of a financial guarantee contract

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

Definitions relating to recognition and measurement

The amortized cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any

difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

The effective interest method is a method of calculating the 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 shall estimate cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IPSAS 9, *Revenue from Exchange Transactions*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

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

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

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG26). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Definitions relating to hedge accounting

A firm commitment is a binding agreement for the exchange of a

specified quantity of resources at a specified price on a specified future date or dates.

A forecast transaction is an uncommitted but anticipated future transaction.

A hedging instrument is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 81–86 and Appendix A paragraphs AG127–AG130 elaborate on the definition of a hedging instrument).

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 87–94 and Appendix A paragraphs AG131–AG141 elaborate on the definition of hedged items).

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG145–AG156).

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately.

Embedded Derivatives

11. An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, 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.

12. **An embedded derivative shall be separated from the host contract and accounted for as a derivative under this Standard if, and only if:**

    (a) **The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG43 and AG46);**

    (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 this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative shall be presented separately in the statement of financial position.

13. **Notwithstanding paragraph 12, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through surplus or deficit unless:**

    (a) **The embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or**

    (b) **It is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortized cost.**

14. **If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through surplus or deficit. Similarly, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of fair value**

through surplus or deficit category, that reclassification is prohibited. In such circumstances the hybrid (combined) contract remains classified as at fair value through surplus or deficit in its entirety.

15. If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (e.g., because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 14 applies and the hybrid (combined) instrument is designated as at fair value through surplus or deficit.

Recognition and Derecognition

Initial Recognition

16. **An entity shall recognize a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 40 with respect to regular way purchases of financial assets).**

Derecognition of a Financial Asset

17. In consolidated financial statements, paragraphs 18–25 and Appendix A paragraphs AG49–AG67 are applied at a consolidated level. Hence, an entity first consolidates all controlled entities in accordance with IPSAS 35 and then applies paragraphs 18–25 and Appendix A paragraphs AG49–AG67 to the resulting economic entity.

18. **Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 19–25, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.**

    (a) **Paragraphs 19–25 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.**

        (i) **The part comprises only specifically identified cash flows from a financial asset (or a group of similar**

financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 19–25 are applied to the interest cash flows.

(ii) **The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of all cash flows of a debt instrument, paragraphs 19–25 are applied to 90 percent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.**

(iii) **The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of interest cash flows from a financial asset, paragraphs 19–25 are applied to 90 percent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.**

(b) **In all other cases, paragraphs 19–25 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 percent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 percent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 percent of the principal amount of the receivables, paragraphs 19–25 are applied to the financial asset (or a group of similar financial assets) in its entirety.**

In paragraphs 19–28, the term "financial asset" refers to either a part of a financial asset (or a part of a group of similar financial

assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

19. **An entity shall derecognize a financial asset when, and only when:**

    (a) **The contractual rights to the cash flows from the financial asset expire or are waived; or**

    (b) **It transfers the financial asset as set out in paragraphs 20 and 21 and the transfer qualifies for derecognition in accordance with paragraph 22.**

    (See paragraph 40 for regular way sales of financial assets).

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

    (a) **Transfers the contractual rights to receive the cash flows of the financial asset; or**

    (b) **Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 21.**

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

    (a) **The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.**

    (b) **The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.**

    (c) **The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IPSAS 2, *Cash Flow Statements*) during the short settlement period from the collection date to the date of required**

remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

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

    (a) **If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.**

    (b) **If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognize the financial asset.**

    (c) **If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:**

        (i) **If the entity has not retained control, it shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.**

        (ii) **If the entity has retained control, it shall continue to recognize the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 32).**

23. The transfer of risks and rewards (see paragraph 22) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g., because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (e.g., because the entity has sold a financial asset subject only to an option to buy it back at its fair

value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 21).

24. Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison is made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.

25. Whether the entity has retained control (see paragraph 22(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

Transfers that Qualify for Derecognition (see paragraph 22(a) and (c)(i))

26. **If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognize either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognized at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognized for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 29.**

27. **If, as a result of a transfer, a financial asset is derecognized in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognize the new financial asset, financial liability or servicing liability at fair value.**

28. **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 (see paragraph 64(b));**

shall be recognized in surplus or deficit.

29. **If the transferred asset is part of a larger financial asset (e.g., when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 18(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognized. The difference between:**

(a) **The carrying amount allocated to the part derecognized; and**

(b) **The sum of (i) the consideration received for the part derecognized (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognized directly in net assets/equity (see paragraph 64(b));**

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.

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

Transfers that do not Qualify for Derecognition (see paragraph 22(b))

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

Continuing Involvement in Transferred Assets (see paragraph 22(c)(ii))

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

    (a) **When the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ("the guarantee amount").**

    (b) **When the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG63).**

    (c) **When the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.**

33. **When an entity continues to recognize an asset to the extent of its continuing involvement, the entity also recognizes an associated liability. Despite the other measurement requirements in this**

Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

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

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

34. **The entity shall continue to recognize any revenue arising on the transferred asset to the extent of its continuing involvement and shall recognize any expense incurred on the associated liability.**

35. **For the purpose of subsequent measurement, recognized changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 64, and shall not be offset.**

36. **If an entity's continuing involvement is in only a part of a financial asset (e.g., when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognize under continuing involvement, and the part it no longer recognizes on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 30 apply. The difference between:**

(a) **The carrying amount allocated to the part that is no longer recognized; and**

(b) **The sum of (i) the consideration received for the part no longer recognized and (ii) any cumulative gain or loss allocated to it that had been recognized directly in net assets/equity (see paragraph 64(b));**

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 no longer recognized on the basis of the relative fair values of those parts.

37. If the transferred asset is measured at amortized cost, the option in this Standard to designate a financial liability as at fair value through surplus or deficit is not applicable to the associated liability.

All Transfers

38. **If a transferred asset continues to be recognized, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any revenue arising from the transferred asset with any expense incurred on the associated liability (see IPSAS 28 paragraph 47).**

39. **If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:**

    (a) **If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.**

    (b) **If the transferee sells collateral pledged to it, it shall recognize the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.**

    (c) **If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the transferee shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.**

    (d) **Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognize the collateral as an asset.**

Regular Way Purchase or Sale of a Financial Asset

40. **A regular way purchase or sale of financial assets shall be recognized and derecognized, as applicable, using trade date accounting or settlement date accounting (see Appendix A paragraphs AG68–AG71).**

Derecognition of a Financial Liability

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

42. **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.**

43. **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.**

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

Measurement

Initial Measurement of Financial Assets and Financial Liabilities

45. **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.**

46. 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 (see Appendix A

paragraphs AG68–AG71).

Subsequent Measurement of Financial Assets

47. For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 10:

(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.

These categories apply to measurement and surplus or deficit recognition under this Standard. The entity may use other descriptors for these categories or other categorizations when presenting information in the financial statements. The entity shall disclose in the notes the information required by IPSAS 30.

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

(a) **Loans and receivables as defined in paragraph 10, which shall be measured at amortized cost using the effective interest method;**

(b) **Held-to-maturity investments as defined in paragraph 10, 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 and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG113 and AG114).**

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 99–113. All financial assets except those measured at fair value through surplus or deficit are subject to review for impairment in accordance with paragraphs 67–79 and Appendix A paragraphs AG117–AG126.

Subsequent Measurement of Financial Liabilities

49. **After initial recognition, an entity shall measure all financial liabilities at amortized cost using the effective interest method, except for:**

    (a) **Financial liabilities at fair value through surplus or deficit. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.**

    (b) **Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 31 and 33 apply to the measurement of such financial liabilities.**

    (c) **Financial guarantee contracts as defined in paragraph 10. After initial recognition, an issuer of such a contract shall (unless paragraph 49(a) or (b) applies) measure it at the higher of:**

        (i) **The amount determined in accordance with IPSAS 19; and**

        (ii) **The amount initially recognized (see paragraph 45) less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.**

    (d) **Commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 49(a) applies) measure it at the higher of:**

        (i) **The amount determined in accordance with IPSAS 19; and**

        (ii) **The amount initially recognized (see paragraph 45) less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.**

    Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 99–113.

Fair Value Measurement Considerations

50. **In determining the fair value of a financial asset or a financial**

liability for the purpose of applying this Standard, IPSAS 28 or IPSAS 30, an entity shall apply paragraphs AG101–AG115 of Appendix A.

51. The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data.

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

Reclassifications

53. **An entity:**

    (a) **Shall not reclassify a derivative out of the fair value through surplus or deficit category while it is held or issued;**

    (b) **Shall not reclassify any financial instrument out of the fair value through surplus or deficit category if upon initial recognition it was designated by the entity as at fair value through surplus or deficit; and**

    (c) **May, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term (notwithstanding that the financial asset may have been acquired or incurred**

principally for the purpose of selling or repurchasing it in the near term), reclassify that financial asset out of the fair value through surplus or deficit category if the requirements in paragraph 55 or 57 are met.

An entity shall not reclassify any financial instrument into the fair value through surplus or deficit category after initial recognition.

54. The following changes in circumstances are not reclassifications for the purposes of paragraph 53:

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

    (b) A derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.

55. A financial asset to which paragraph 53(c) applies (except a financial asset of the type described in paragraph 57) may be reclassified out of the fair value through surplus or deficit category only in rare circumstances.

56. If an entity reclassifies a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 55, the financial asset shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognized in surplus or deficit shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable.

57. A financial asset to which paragraph 53(c) applies that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the fair value through surplus or deficit category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

58. A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available-for-sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

59. If an entity reclassifies a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 57 or out of the available-for-sale category in accordance with paragraph 58, it shall

reclassify the financial asset at its fair value on the date of reclassification. For a financial asset reclassified in accordance with paragraph 57, any gain or loss already recognized in surplus or deficit shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable. For a financial asset reclassified out of the available-for-sale category in accordance with paragraph 58, any previous gain or loss on that asset that has been recognized directly in net assets/equity in accordance with paragraph 64(b) shall be accounted for in accordance with paragraph 63.

60. **If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 64(b).**

61. **Whenever sales or reclassification of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in paragraph 10, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 64(b).**

62. **If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 48(c) and 49), the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 64.**

63. **If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 48(c) and 49) or because the "two preceding financial years" referred to in paragraph 10 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortized cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortized cost, as applicable. Any previous gain or loss on that asset that has been recognized directly in net assets/equity in accordance with paragraph 64(b) shall be accounted for as follows:**

(a) **In the case of a financial asset with a fixed maturity, the gain**

or loss shall be amortized to surplus or deficit over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortized cost and maturity amount shall also be amortized over the remaining life of the financial asset using the effective interest method, similar to the amortization of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognized directly in net assets/equity is recognized in surplus or deficit in accordance with paragraph 76.

(b) **In the case of a financial asset that does not have a fixed maturity, the gain or loss shall remain in net assets/equity until the financial asset is sold or otherwise disposed of, when it shall be recognized in surplus or deficit. If the financial asset is subsequently impaired any previous gain or loss that has been recognized directly in net assets/equity is recognized in surplus or deficit in accordance with paragraph 76.**

Gains and Losses

64. **A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 99–113), 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 through the statement of changes in net assets/equity (see IPSAS 1, except for impairment losses (see paragraphs 76–79) and foreign exchange gains and losses (see Appendix A paragraph AG116), until the financial asset is derecognized, at which time the cumulative gain or loss previously recognized in net assets/equity shall be recognized in surplus or deficit. However, interest calculated using the effective interest method (see paragraph 10) is recognized in surplus or deficit (see IPSAS 9). Dividends or similar distributions on an available-for-sale equity instrument are recognized in surplus or deficit when the entity's right to receive payment is established (see IPSAS 9).**

65. **For financial assets and financial liabilities carried at amortized cost (see paragraphs 48 and 49), a gain or loss is recognized in surplus or deficit when the financial asset or financial liability is derecognized or impaired, and through the amortization process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 87–94 and Appendix A paragraphs AG131–AG141) the accounting for the gain or loss shall follow paragraphs 99–113.**

66. **If an entity recognizes financial assets using settlement date accounting (see paragraph 40 and Appendix A paragraphs AG68 and AG71), 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 for assets carried at cost or amortized cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognized in surplus or deficit or in net assets/equity, as appropriate under paragraph 64.**

Impairment and Uncollectibility of Financial Assets

67. **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. If any such evidence exists, the entity shall apply paragraph 72 (for financial assets carried at amortized cost), paragraph 75 (for financial assets carried at cost) or paragraph 76 (for available-for-sale financial assets) to determine the amount of any impairment loss.**

68. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognized. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

    (a) Significant financial difficulty of the issuer or obligor;

    (b) A breach of contract, such as a default or delinquency in interest or principal payments;

(c) The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

(d) It becoming probable that the borrower will enter bankruptcy or other financial reorganization;

(e) The disappearance of an active market for that financial asset because of financial difficulties; or

(f) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

(i) Adverse changes in the payment status of borrowers in the group (e.g., an increased number of delayed payments); or

(ii) National or local economic conditions that correlate with defaults on the assets in the group (e.g., an increase in the unemployment rate in the geographical area of the borrowers, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

69. The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortized cost is not necessarily evidence of impairment (e.g., a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

70. In addition to the types of events in paragraph 68, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

71. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case

when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgment to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgment to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG122). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability[2].

Financial Assets Carried at Amortized Cost

72. **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). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognized in surplus or deficit.**

73. An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 68). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.

74. **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**

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[2] Information that is reliable is free from material error and bias, and can be depended on by users to faithfully represent that which it purports to represent or could reasonably be expected to represent. Paragraph BC16 of IPSAS 1 discusses the transitional approach to the explanation of reliability.

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.

Financial Assets Carried at Cost

75. **If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 48(c) and Appendix A paragraphs AG113 and AG114). Such impairment losses shall not be reversed.**

Available-For-Sale Financial Assets

76. **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 (see paragraph 68), 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.**

77. **The amount of the cumulative loss that is removed from net assets/equity and recognized in surplus or deficit under paragraph 76 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.**

78. **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.**

79. **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.

Hedging

80. **If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 95–98 and Appendix A paragraphs AG142–AG144, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 99–113.**

Hedging Instruments

Qualifying Instruments

81. This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 98 are met, except for some written options (see Appendix A paragraph AG127). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.

82. For hedge accounting purposes, only instruments that involve 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. Although individual entities within an economic entity or divisions within an entity may enter into hedging transactions with other entities within the economic entity or divisions within the entity, any such transactions within the economic entity are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the economic entity. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the economic entity provided that they are external to the individual entity that is being reported on.

Designation of Hedging Instruments

83. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:

    (a) Separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value;

and

(b) Separating the interest element and the spot price of a forward contract.

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

84. A proportion of the entire hedging instrument, such as 50 percent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.

85. A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

86. Two or more derivatives, or proportions of them (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

Hedged Items

Qualifying Items

87. 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.

88. Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

89. For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities in the same economic entity only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the economic entity except for the consolidated financial statements of an investment entity, as defined in IPSAS 35, where transactions between an investment entity and its controlled entities measured at fair value through surplus or deficit will not be eliminated in the consolidated financial statements. As an exception, the foreign currency risk of monetary item within an economic entity (e.g., a payable/receivable between two controlled entities) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IPSAS 4, *The Effects of Changes in Foreign Exchange Rates*. In accordance with IPSAS 4, foreign exchange rate gains and losses on monetary items within an economic entity are not fully eliminated on consolidation when the monetary item is transacted between two entities within the economic entity that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated surplus or deficit.

Designation of Financial Items as Hedged Items

90. If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its

cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).

91. In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Designation of Non-Financial Items as Hedged Items

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

Designation of Groups of Items as Hedged Items

93. Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged.

Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.

94. Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (e.g., the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

Hedge Accounting

95. Hedge accounting recognizes the offsetting effects on surplus or deficit of changes in the fair values of the hedging instrument and the hedged item.

96. **Hedging relationships are of three types:**

    (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 an identified portion of such an asset, liability or firm commitment, 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 (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.**

    (c) **Hedge of a net investment in a foreign operation as defined in IPSAS 4.**

97. 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.

98. **A hedging relationship qualifies for hedge accounting under paragraphs 99–113 if, and only if, all of the following conditions are met.**

    (a) **At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the**

hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

(b) **The hedge is expected to be highly effective (see Appendix A paragraphs AG145–AG156) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.**

(c) **For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect surplus or deficit.**

(d) **The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 48 and 49 and Appendix A paragraphs AG113 and AG114 for guidance on determining fair value).**

(e) **The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.**

Fair Value Hedges

99. **If a fair value hedge meets the conditions in paragraph 98 during the period, it shall be accounted for as follows:**

(a) **The gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with IPSAS 4 (for a non-derivative hedging instrument) shall be recognized in surplus or deficit; and**

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

100. For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 99(b) may be met by presenting the gain or loss attributable to the hedged item either:

(a) In a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or

(b) In a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

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

101. If only particular risks attributable to a hedged item are hedged, recognized changes in the fair value of the hedged item unrelated to the hedged risk are recognized as set out in paragraph 64.

102. **An entity shall discontinue prospectively the hedge accounting specified in paragraph 99 if:**

(a) **The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy);**

(b) **The hedge no longer meets the criteria for hedge accounting in paragraph 98; or**

(c) **The entity revokes the designation.**

103. **Any adjustment arising from paragraph 99(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used (or, in the case of a portfolio hedge of interest rate risk, to the separate line item in the statement of financial position described in paragraph 100) shall be amortized to surplus or deficit. Amortization may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortization begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such**

a hedge), amortizing using a recalculated effective interest rate is not practicable, the adjustment shall be amortized using a straight-line method. The adjustment shall be amortized fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

104. When an unrecognized firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognized as an asset or liability with a corresponding gain or loss recognized in surplus or deficit (see paragraph 99(b)). The changes in the fair value of the hedging instrument are also recognized in surplus or deficit.

105. When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognized in the statement of financial position.

Cash Flow Hedges

106. **If a cash flow hedge meets the conditions in paragraph 98 during the period, it shall be accounted for as follows:**

    (a) **The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) shall be recognized directly in net assets/equity through the statement of changes in net assets/equity; and**

    (b) **The ineffective portion of the gain or loss on the hedging instrument shall be recognized in surplus or deficit.**

107. More specifically, a cash flow hedge is accounted for as follows:

    (a) The separate component of net assets/equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):

        (i) The cumulative gain or loss on the hedging instrument from inception of the hedge; and

        (ii) The cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;

    (b) Any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is

recognized in surplus or deficit; and

(c) If an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 83, 84, and 98(a)), that excluded component of gain or loss is recognized in accordance with paragraph 64.

108. **If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognized directly in net assets/equity in accordance with paragraph 106 shall be reclassified into surplus or deficit in the same period or periods during which the hedged forecast cash flows affects surplus or deficit (such as in the periods that interest revenue or interest expense is recognized). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify into surplus or deficit the amount that is not expected to be recovered.**

109. **If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:**

(a) **It reclassifies the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106 into surplus or deficit in the same period or periods during which the asset acquired or liability assumed affects surplus or deficit (such as in the periods that depreciation or inventories are recognized as an expense). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify from net assets/equity into surplus or deficit the amount that is not expected to be recovered.**

(b) **It removes the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106, and includes them in the initial cost or other carrying amount of the asset or liability.**

110. **An entity shall adopt either (a) or (b) in paragraph 109 as its accounting policy and shall apply it consistently to all hedges to**

which paragraph 109 relates.

111. **For cash flow hedges other than those covered by paragraphs 108 and 109, amounts that had been recognized directly in net assets/equity shall be recognized in surplus or deficit in the same period or periods during which the hedged forecast cash flows affects surplus or deficit (e.g., when a forecast sale occurs).**

112. **In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 106–111:**

(a) **The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109, or 111 applies.**

(b) **The hedge no longer meets the criteria for hedge accounting in paragraph 98. In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109, or 111 applies.**

(c) **The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that has been recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall be recognized in surplus or deficit. A forecast transaction that is no longer highly probable (see paragraph 98(c)) may still be expected to occur.**

(d) **The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs or is no**

longer expected to occur. When the transaction occurs, paragraph 108, 109, or 111 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized directly in net assets/equity shall be recognized in surplus or deficit.

Hedges of a Net Investment

113. **Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IPSAS 4), shall be accounted for similarly to cash flow hedges:**

(a) **The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) shall be recognized directly in net assets/equity through the statement of changes in net assets/equity (see IPSAS 1); and**

(b) **The ineffective portion shall be recognized in surplus or deficit.**

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognized directly in net assets/equity shall be recognized in surplus or deficit in accordance with paragraphs 56–57 of IPSAS 4 on disposal of the foreign operation.

Temporary Exceptions from Applying Specific Hedge Accounting Requirements

113A. An entity shall apply paragraphs 113D–113N and 125I to all hedging relationships directly affected by interest rate benchmark reform. These paragraphs apply only to such hedging relationships. A hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about:

(a) The interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk; and/or

(b) The timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

113B. For the purpose of applying paragraphs 113D–113N, the term ‘interest rate benchmark reform’ refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the Financial Stability Board’s July 2014

report ‘Reforming Major Interest Rate Benchmarks’.[3]

113C. Paragraphs 113D–113N provide exceptions only to the requirements specified in these paragraphs. An entity shall continue to apply all other hedge accounting requirements to hedging relationships directly affected by interest rate benchmark reform.

Highly Probable Requirement for Cash Flow Hedges

113D. For the purpose of applying the requirement in paragraph 98(c) that a forecast transaction must be highly probable, an entity shall assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

Reclassifying the Cumulative Gain or Loss Recognized Directly in Net Assets/Equity

113E. For the purpose of applying the requirement in paragraph 112(c) in order to determine whether the forecast transaction is no longer expected to occur, an entity shall assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

Effectiveness Assessment

113F. For the purpose of applying the requirements in paragraphs 98(b) and AG145(a), an entity shall assume that the interest rate benchmark on which the hedged cash flows and/or the hedged risk (contractually or non-contractually specified) are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, is not altered as a result of interest rate benchmark reform.

113G. For the purpose of applying the requirement in paragraph 98(e), an entity is not required to discontinue a hedging relationship because the actual results of the hedge do not meet the requirements in paragraph AG145(b). For the avoidance of doubt, an entity shall apply the other conditions in paragraph 98, including the prospective assessment in paragraph 98(b), to assess whether the hedging relationship must be discontinued.

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[3] The report, 'Reforming Major Interest Rate Benchmarks',is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

Designating Financial Items as Hedged Items

113H. Unless paragraph 113I applies, for a hedge of a non-contractually specified benchmark portion of interest rate risk, an entity shall apply the requirement in paragraphs 90 and AG139—that the designated portion shall be separately identifiable—only at the inception of the hedging relationship.

113I. When an entity, consistent with its hedge documentation, frequently resets (i.e., discontinues and restarts) a hedging relationship because both the hedging instrument and the hedged item frequently change (i.e., the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long), the entity shall apply the requirement in paragraphs 90 and AG139—that the designated portion is separately identifiable—only when it initially designates a hedged item in that hedging relationship. A hedged item that has been assessed at the time of its initial designation in the hedging relationship, whether it was at the time of the hedge inception or subsequently, is not reassessed at any subsequent redesignation in the same hedging relationship.

End of Application

113J. An entity shall prospectively cease applying paragraph 113D to a hedged item at the earlier of:

(a) When the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) When the hedging relationship that the hedged item is part of is discontinued.

113K. An entity shall prospectively cease applying paragraph 113E at the earlier of:

(a) When the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based future cash flows of the hedged item; and

(b) When the entire cumulative gain or loss recognized in net assets/equity with respect to that discontinued hedging relationship has been reclassified to surplus or deficit.

113L. An entity shall prospectively cease applying paragraph 113F:

(a) To a hedged item, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk or the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) To a hedging instrument, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedging instrument.

If the hedging relationship that the hedged item and the hedging instrument are part of is discontinued earlier than the date specified in paragraph 113L(a) or the date specified in paragraph 113L(b), the entity shall prospectively cease applying paragraph 113F to that hedging relationship at the date of discontinuation.

113M. An entity shall prospectively cease applying paragraph 113G to a hedging relationship at the earlier of:

(a) When the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and the timing and the amount of the interest rate benchmark-based cash flows of the hedged item and of the hedging instrument; and

(b) When the hedging relationship to which the exception is applied is discontinued.

113N. When designating a group of items as the hedged item, or a combination of financial instruments as the hedging instrument, an entity shall prospectively cease applying paragraphs 113D–113G to an individual item or financial instrument in accordance with paragraphs 113J, 113K, 113L, or 113M, as relevant, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of the interest rate benchmark-based cash flows of that item or financial instrument.

113O. An entity shall prospectively cease applying paragraphs 113H and 113I at the earlier of:

(a) When changes required by interest rate benchmark reform are made to the non-contractually specified risk portion applying paragraph 113P; or

(b) When the hedging relationship in which the non-contractually specified risk portion is designated is discontinued.

Additional Temporary Exceptions Arising from Interest Rate Benchmark

Reform

Hedge Accounting

113P. As and when the requirements in paragraphs 113D–113I cease to apply to a hedging relationship (see paragraphs 113J–113O), an entity shall amend the formal designation of that hedging relationship as previously documented to reflect the changes required by interest rate benchmark reform, i.e., the changes are consistent with the requirements in paragraphs AG20B–AG20D. In this context, the hedge designation shall be amended only to make one or more of these changes:

(a) Designating an alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

(b) Amending the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged;

(c) Amending the description of the hedging instrument; or

(d) Amending the description of how the entity will assess hedge effectiveness.

113Q. An entity also shall apply the requirement in paragraph 113P(c) if these three conditions are met:

(a) The entity makes a change required by interest rate benchmark reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument (as described in paragraph AG20B);

(b) The original hedging instrument is not derecognized; and

(c) The chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument (as described in paragraphs AG20C and AG20D).

113R. The requirements in paragraphs 113D–113I may cease to apply at different times. Therefore, applying paragraph 113P, an entity may be required to amend the formal designation of its hedging relationships at different times, or may be required to amend the formal designation of a hedging relationship more than once. When, and only when, such a change is made to the hedge designation, an entity shall apply paragraphs 113V–113ZB as applicable. An entity also shall apply paragraph 99 (for a fair value hedge) or paragraph 107 (for a cash flow hedge) to account for any changes in the fair value of the hedged item or

the hedging instrument.

113S. An entity shall amend a hedging relationship as required in paragraph 113P by the end of the reporting period during which a change required by interest rate benchmark reform is made to the hedged risk, hedged item or hedging instrument. For the avoidance of doubt, such an amendment to the formal designation of a hedging relationship constitutes neither the discontinuation of the hedging relationship nor the designation of a new hedging relationship.

113T. If changes are made in addition to those changes required by interest rate benchmark reform to the financial asset or financial liability designated in a hedging relationship (as described in paragraphs AG20B–AG20D) or to the designation of the hedging relationship (as required by paragraph 113P), an entity shall first apply the applicable requirements in this Standard to determine if those additional changes result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, an entity shall amend the formal designation of the hedging relationship as specified in paragraph 113P.

113U. Paragraphs 113V–113ZC provide exceptions to the requirements specified in those paragraphs only. An entity shall apply all other hedge accounting requirements in this Standard, including the qualifying criteria in paragraph 98, to hedging relationships that were directly affected by interest rate benchmark reform.

Accounting for Qualifying Hedging Relationships

Retrospective Effectiveness Assessment

113V. For the purpose of assessing the retrospective effectiveness of a hedging relationship on a cumulative basis applying paragraph 98(e) and only for this purpose, an entity may elect to reset to zero the cumulative fair value changes of the hedged item and hedging instrument when ceasing to apply paragraph 113G as required by paragraph 113M. This election is made separately for each hedging relationship (i.e., on an individual hedging relationship basis).

Cash Flow Hedges

113W. For the purpose of applying paragraph 108, at the point when an entity amends the description of a hedged item as required in paragraph 113P(b), the cumulative gain or loss in net assets/equity shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

113X. For a discontinued hedging relationship, when the interest rate benchmark on which the hedged future cash flows had been based is changed as required by interest rate benchmark reform, for the purpose of applying paragraph 112(c) in order to determine whether the hedged future cash flows are expected to occur, the amount accumulated in other comprehensive income for that hedging relationship shall be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

Groups of Items

113Y. When an entity applies paragraph 113P to groups of items designated as hedged items in a fair value or cash flow hedge, the entity shall allocate the hedged items to subgroups based on the benchmark rate being hedged and designate the benchmark rate as the hedged risk for each subgroup. For example, in a hedging relationship in which a group of items is hedged for changes in an interest rate benchmark subject to interest rate benchmark reform, the hedged cash flows or fair value of some items in the group could be changed to reference an alternative benchmark rate before other items in the group are changed. In this example, in applying paragraph 113P, the entity would designate the alternative benchmark rate as the hedged risk for that relevant subgroup of hedged items. The entity would continue to designate the existing interest rate benchmark as the hedged risk for the other subgroup of hedged items until the hedged cash flows or fair value of those items are changed to reference the alternative benchmark rate or the items expire and are replaced with hedged items that reference the alternative benchmark rate.

113Z. An entity shall assess separately whether each subgroup meets the requirements in paragraphs 87 and 93 to be an eligible hedged item. If any subgroup fails to meet the requirements in paragraphs 87 and 93, the entity shall discontinue hedge accounting prospectively for the hedging relationship in its entirety. An entity also shall apply the requirements in paragraphs 99 or 107 to account for ineffectiveness related to the hedging relationship in its entirety.

Designating Financial Items as Hedged Items

113ZA. An alternative benchmark rate designated as a non-contractually specified risk portion that is not separately identifiable (see paragraphs 90 and AG139) at the date it is designated shall be deemed to have met that requirement at that date, if, and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within 24 months. The 24-month period applies to each

alternative benchmark rate separately and starts from the date the entity designates the alternative benchmark rate as a non-contractually specified risk portion for the first time (i.e., the 24-month period applies on a rate-by-rate basis).

113ZB. If subsequently an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months from the date the entity designated it as a non-contractually specified risk portion for the first time, the entity shall cease applying the requirement in paragraph 113ZA to that alternative benchmark rate and discontinue hedge accounting prospectively from the date of that reassessment for all hedging relationships in which the alternative benchmark rate was designated as a non-contractually specified risk portion.

113ZC. In addition to those hedging relationships specified in paragraph 113P, an entity shall apply the requirements in paragraphs 113ZA and 113ZB to new hedging relationships in which an alternative benchmark rate is designated as a non-contractually specified risk portion (see paragraphs 90 and AG139) when, because of interest rate benchmark reform, that risk portion is not separately identifiable at the date it is designated.

Transition

114. [Deleted]

115. [Deleted]

116. [Deleted]

117. [Deleted]

118. [Deleted]

119. [Deleted]

120. [Deleted]

121. [Deleted]

122. [Deleted]

123. [Deleted]

Effective Date and Transition

124. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2013. Earlier application is encouraged. If an entity applies this Standard for a**

period beginning before January 1, 2013, it shall disclose that fact.

125. **An entity shall not apply this Standard before January 1, 2013, unless it also applies IPSAS 28 and IPSAS 30.**

125A. **Paragraph 2 was amended by IPSAS 32, *Service Concession Arrange-ments: Grantor* issued in October 2011. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2014. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2014, it shall disclose that fact and at the same time apply IPSAS 32, the amendments to paragraphs 6 and 42A of IPSAS 5, the amendments to paragraphs 25–27 and 85B of IPSAS 13, the amendments to paragraphs 5, 7 and 107C of IPSAS 17 and the amendments to paragraphs 6 and 132A of IPSAS 31.**

125B. **Paragraphs 114, 115, 116, 117, 118, 119, 120, 121, 122, 124 and 126 were amended by IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* issued in January 2015. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is permitted. If an entity applies IPSAS 33 for a period beginning before January 1, 2017, the amendments shall also be applied for that earlier period.**

125C. **IPSAS 35, *Consolidated Financial Statements* and IPSAS 37, *Joint Arrangements*, issued in January 2015, amended paragraphs 2(a), 17, 89, AG2, AG14, AG51–53 and C2. An entity shall apply those amendments when it applies IPSAS 35 and IPSAS 37.**

125D. **Paragraph AG8 was amended by *Improvements to IPSASs 2015* issued in April 2016. An entity shall apply this amendment for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2017 it shall disclose that fact.**

125E. **Paragraphs 7 and 8 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.**

125F. **Paragraph 2 was amended by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply that amendment for annual**

financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.

125G. **Paragraphs 2, AG35, AG131 and B4 were amended by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2019. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2019, it shall disclose that fact and apply IPSAS 40 at the same time.**

125I. **Paragraphs 113A–113N were added by *Improvements to IPSAS, 2021*, issued in January 2022. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2022. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact. An entity shall apply these amendments retrospectively to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies these amendments or were designated thereafter, and to the gain or loss recognized in net assets/equity that existed at the beginning of the reporting period in which an entity first applies these amendments.**

125J. **Paragraphs 113O–113ZC, 125K–125M and AG20A-AG20E were added by *Improvements to IPSAS, 2021*, issued in January 2022. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2022. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact. An entity shall apply these amendments retrospectively in accordance with IPSAS 3, except as specified in paragraphs 125K–125M and AG20A-AG20E.**

125K. An entity shall designate a new hedging relationship (for example, as described in paragraph 113ZC) only prospectively (i.e., an entity is prohibited from designating a new hedge accounting relationship in prior periods). However, an entity shall reinstate a discontinued hedging relationship if, and only if, these conditions are met:

(a) The entity had discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and the entity would not have been required to discontinue that hedging

relationship if these amendments had been applied at that time; and

(b) At the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments), that discontinued hedging relationship meets the qualifying criteria for hedge accounting (after taking into account these amendments).

125L. If, in applying paragraph 125K, an entity reinstates a discontinued hedging relationship, the entity shall read references in paragraphs 113ZA and 113ZB to the date the alternative benchmark rate is designated as a non-contractually specified risk portion for the first time as referring to the date of initial application of these amendments (i.e., the 24-month period for that alternative benchmark rate designated as a non-contractually specified risk portion begins from the date of initial application of these amendments).

125M. An entity is not required to restate prior periods to reflect the application of these amendments. The entity may restate prior periods if, and only if, it is possible without the use of hindsight. If an entity does not restate prior periods, the entity shall recognize any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application of these amendments in the opening net assets/equity (or other component of net assets/equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.

126. When an entity adopts the accrual basis IPSASs of accounting as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 29.

Scope (paragraphs 2–8)

AG1. This Standard does not change the requirements relating to employee benefit plans that comply with the relevant international or national accounting standard on accounting and reporting by retirement benefit plans and royalty agreements based on the volume of sales or service revenues that are accounted for under IPSAS 9.

Investments in Controlled Entities, Associates, and Joint Ventures

AG2. Sometimes, an entity makes what it views as a "strategic investment" in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor or joint venture entity uses IPSAS 36 to determine whether the equity method of accounting is appropriate for such an investment. If the equity method is not appropriate, the entity applies this Standard to that strategic investment.

Insurance Contracts

AG3. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise from insurance contracts. An entity does however apply this Standard to:

- Financial guarantee contracts, except those where the issuer elects to treat such contracts as insurance contracts in accordance with IPSAS 28; and
- Embedded derivatives included in insurance contracts.

An entity may, but is not required to, apply this Standard to other insurance contracts that involve the transfer of financial risk.

AG4. Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an

insurance contract if the risk transferred is significant, the issuer applies this Standard. Nevertheless, an entity may elect, under certain circumstances, to treat financial guarantee contracts as insurance contracts of financial instruments using IPSAS 28 if the issuer has previously adopted an accounting policy that treated financial guarantee contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or the relevant international or national accounting standard on insurance contracts to such financial guarantee contracts. If this Standard applies paragraph 45 requires the issuer to recognize a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through surplus or deficit or unless paragraphs 31–39 and AG62–67 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) The amount determined in accordance with IPSAS 19; and

(ii) The amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9 (see paragraph 49(c)).

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies IPSAS 9 in determining when it recognizes the revenue from the guarantee and from the sale of goods.

AG5. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as "weather derivatives"). If those contracts are not insurance

contracts, they are within the scope of this Standard.

Rights and Obligations Arising from Non-Exchange Revenue Transactions

AG6. Rights and obligations (assets and liabilities) may arise from non-exchange revenue transactions, for example, an entity may receive cash from a multi-lateral agency to perform certain activities. Where the performance of those activities is subject to conditions, an asset and a liability is recognized simultaneously. Where the asset is a financial asset, it is recognized in accordance with IPSAS 23, and initially measured in accordance with IPSAS 23 and this Standard. A liability that is initially recognized as a result of conditions imposed on the use of an asset is outside the scope of this Standard and is dealt with in IPSAS 23. After initial recognition, if circumstances indicate that recognition of a liability in accordance with IPSAS 23 is no longer appropriate, an entity considers whether a financial liability should be recognized in accordance with this Standard. Other liabilities that may arise from non-exchange revenue transactions are recognized and measured in accordance with this Standard if they meet the definition of a financial liability in IPSAS 28.

Definitions (paragraphs 9 and 10)

Designation as at Fair Value through Surplus or Deficit

AG7. Paragraph 10 of this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through surplus or deficit provided that doing so results in more relevant information.

AG8. The decision of an entity to designate a financial asset or financial liability as at fair value through surplus or deficit is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 17(b) of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors* requires the chosen policy to result in the financial statements providing faithfully representative and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. In the case of designation as at fair value through surplus or deficit, paragraph 10 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 10, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Paragraph 10(b)(i): Designation Eliminates or Significantly Reduces a Measurement or Recognition Inconsistency that Would Otherwise Arise

AG9. Under IPSAS 29, measurement of a financial asset or financial liability and classification of recognized changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an "accounting mismatch") when, for example, in the absence of designation as at fair value through surplus or deficit, 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.

AG10. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through surplus or deficit only if it meets the principle in paragraph 10(b)(i).

(a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realized and/or unrealized investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through surplus or deficit means that changes in the fair value of the financial assets are recognized in surplus or deficit in the same period as related changes in the value of the liabilities.

(b) An entity has liabilities under insurance contracts whose measurement incorporates current information, and financial assets it considers related that would otherwise be classified as available for sale or measured at amortized cost.

(c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through surplus or deficit (i.e., are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting

are not met, for example because the requirements for effectiveness in paragraph 98 are not met.

(d) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:

(i) The entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale with fixed rate debentures whose changes in fair value tend to offset each other. Reporting both the assets and the debentures at fair value through surplus or deficit corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes reported in net assets/equity and the debentures at amortized cost.

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

AG11. In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through surplus or deficit may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through surplus or deficit at its initial recognition and, at that time, any remaining transactions are expected to occur.

AG12. It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through surplus or deficit if to do so would not eliminate or significantly

reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100[4] and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (e.g., individual liabilities with a combined total of CU45) as at fair value through surplus or deficit. However, because designation as at fair value through surplus or deficit can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (e.g., changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e., percentage) of a liability.

Paragraph 10(b)(ii): A Group of Financial Assets, Financial Liabilities or Both is Managed and its Performance is Evaluated on a Fair Value basis, in accordance with a Documented Risk Management or Investment Strategy

AG13. An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through surplus or deficit results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

AG14. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through surplus or deficit only if it meets the principle in paragraph 10(b)(ii).

(a) The entity is a venture capital organization, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest, dividends or similar distributions and changes in fair value. IPSAS 36 allows such investments to be measured at fair value through surplus or deficit in accordance with this Standard. An entity may apply the same accounting policy to other investments managed

[4] In this Standard, monetary amounts are denominated in “currency units” (CU).

on a total return basis but over which its influence is insufficient for them to be within the scope of IPSAS 36.

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

(c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximize its total return (i.e., interest, dividends or similar distributions and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, net assets/equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 10(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 10(b)(ii) may be met when the insurer's objective is to maximize total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realized in a shorter period (e.g., a year) or are subject to the insurer's discretion.

AG15. As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through surplus or deficit on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.

AG16. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 10(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system within an entity as approved by the entity's key management personnel – clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 10(b)(ii).

Effective Interest Rate

AG17. In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

AG18. 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. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortization period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortized to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e., interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortized over the expected life of the instrument.

AG19. 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.

AG20. If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 103. The adjustment is recognized in surplus or deficit as revenue or expense. If a financial asset is reclassified in accordance with paragraph 55, 57, or 58,

and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognized as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

Changes in the Basis for Determining the Contractual Cash Flows as a Result of Interest Rate Benchmark Reform

AG20A. An entity shall apply paragraphs AG20B–AG20E to a financial asset or financial liability if, and only if, the basis for determining the contractual cash flows of that financial asset or financial liability changes as a result of interest rate benchmark reform. For this purpose, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark as described in paragraph 113B.

AG20B. The basis for determining the contractual cash flows of a financial asset or financial liability can change:

(a) By amending the contractual terms specified at the initial recognition of the financial instrument (for example, the contractual terms are amended to replace the referenced interest rate benchmark with an alternative benchmark rate);

(b) In a way that was not considered by—or contemplated in—the contractual terms at the initial recognition of the financial instrument, without amending the contractual terms (for example, the method for calculating the interest rate benchmark is altered without amending the contractual terms); and/or

(c) Because of the activation of an existing contractual term (for example, an existing fallback clause is triggered).

AG20C. As a practical expedient, an entity shall apply paragraph AG19 to account for a change in the basis for determining the contractual cash flows of a financial asset or financial liability that is required by interest rate benchmark reform. This practical expedient applies only to such changes and only to the extent the change is required by interest rate benchmark reform (see also paragraph AG20E). For this purpose, a change in the basis for determining the contractual cash flows is required by interest rate benchmark reform if, and only if, both these conditions are met:

(a) The change is necessary as a direct consequence of interest rate benchmark reform; and

(b) The new basis for determining the contractual cash flows is economically equivalent to the previous basis (i.e., the basis immediately preceding the change).

AG20D. Examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis (i.e., the basis immediately preceding the change) are:

(a) The replacement of an existing interest rate benchmark used to determine the contractual cash flows of a financial asset or financial liability with an alternative benchmark rate—or the implementation of such a reform of an interest rate benchmark by altering the method used to calculate the interest rate benchmark—with the addition of a fixed spread necessary to compensate for the basis difference between the existing interest rate benchmark and the alternative benchmark rate;

(b) Changes to the reset period, reset dates or the number of days between coupon payment dates in order to implement the reform of an interest rate benchmark; and

(c) The addition of a fallback provision to the contractual terms of a financial asset or financial liability to enable any change described in (a) and (b) above to be implemented.

AG20E. If changes are made to a financial asset or financial liability in addition to changes to the basis for determining the contractual cash flows required by interest rate benchmark reform, an entity shall first apply the practical expedient in paragraph AG20C to the changes required by interest rate benchmark reform. The entity shall then apply the applicable requirements in this Standard to any additional changes to which the practical expedient does not apply. If the additional change does not result in the derecognition of the financial asset or financial liability, the entity shall apply paragraph AG20, as applicable, to account for that additional change. If the additional change results in the derecognition of the financial asset or financial liability, the entity shall apply the derecognition requirements.

Derivatives

AG21. Typical examples of derivatives are futures and forward, swap and option

contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000[5] if the six-month interbank offered rate increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

AG22. The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g., a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g., a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 4–6).

AG23. One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

AG24. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognized as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 40 and AG68–AG71).

AG25. The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake

[5] In this Standard, monetary amounts are denominated in "currency units" (CU).

losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Transaction Costs

AG26. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers, and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs, or internal administrative or holding costs.

Financial Assets and Financial Liabilities Held for Trading

AG27. 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.

AG28. Financial liabilities held for trading include:

(a) Derivative liabilities that are not accounted for as hedging instruments;

(b) Obligations to deliver financial assets borrowed by a short seller (i.e., an entity that sells financial assets it has borrowed and does not yet own);

(c) Financial liabilities that are incurred with an intention to repurchase them in the near term (e.g., a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and

(d) Financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

The fact that a liability is used to fund trading activities does not in itself

make that liability one that is held for trading.

Held-to-Maturity Investments

AG29. An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:

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

(b) The entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources, and terms or changes in foreign currency risk; or

(c) The issuer has a right to settle the financial asset at an amount significantly below its amortized cost.

AG30. A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.

AG31. The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalized transaction costs in determining whether the carrying amount would be substantially

recovered.

AG32. A financial asset that is puttable (i.e., the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

AG33. 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. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 10 precludes the use of the exception for a reasonable period of time.

AG34. A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.

AG35. Sales before maturity could satisfy the condition in paragraph 10 – and therefore not raise a question about the entity's intention to hold other investments to maturity – if they are attributable to any of the following:

(a) A significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 67 and 68), the deterioration in creditworthiness is often regarded as significant.

(b) A change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest revenue).

(c) A major public sector combination or major disposition (such as a

sale of a segment) that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the public sector combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).

(d) A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment.

(e) A significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.

(f) A significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.

AG36. An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

(a) It does not have the financial resources available to continue to finance the investment until maturity; or

(b) It is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity—see paragraph AG31).

AG37. Circumstances other than those described in paragraphs AG29–AG36 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

AG38. An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognized, but also at the end of each subsequent reporting period.

Loans and Receivables

AG39. 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. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph AG103) does not qualify for classification as a loan or receivable. Financial assets that do

not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 10 and AG29–AG38). 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.

Embedded Derivatives (paragraphs 11–13)

AG40. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess characteristics of the net assets/equity related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

AG41. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor, or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

AG42. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity instruments (see IPSAS 28) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

AG43. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 12(a)) in the following examples. In these examples, assuming the conditions in paragraph 12(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an

equity or commodity price or index is not closely related to a host debt instrument.

(b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under IPSAS 28, in which case it is excluded from the scope of this Standard).

(c) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

(d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the value of equity instruments – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(e) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the price of a commodity (such as oil – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under IPSAS 28).

(g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument or

the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the element of net assets/equity under IPSAS 28.

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

AG44. An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a "puttable instrument"). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through surplus or deficit, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 12 because the host contract is a debt instrument under paragraph AG40 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG43(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

AG45. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

AG46. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that

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

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g., a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

(c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g., a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because IPSAS 4 requires foreign currency gains and losses on monetary items to be recognized in surplus or deficit.

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

    (i) The functional currency of any substantial party to that contract;

    (ii) The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

    (iii) A currency that is commonly used in contracts to purchase

or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local transactions or external trade).

(e) An embedded prepayment option in an interest – only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.

(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales, or (iii) contingent rentals based on variable interest rates.

(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract).

Instruments Containing Embedded Derivatives

AG47. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 12 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through surplus or deficit. For that reason this Standard permits the entire instrument to be designated as at fair value

through surplus or deficit.

AG48. Such designation may be used whether paragraph 12 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 13 would not justify designating the hybrid (combined) instrument as at fair value through surplus or deficit in the cases set out in paragraph 12(a) and (b) because doing so would not reduce complexity or increase reliability.

Recognition and Derecognition (paragraphs 16–44)

Initial Recognition (paragraph 16)

AG49. As a consequence of the principle in paragraph 16, an entity recognizes all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG64). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset (see paragraph AG65).

AG50. The following are examples of applying the principle in paragraph 16:

(a) Unconditional 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.

(b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognized until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognize an asset (and the entity that places the order does not recognize a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 4–6, its net fair value is recognized as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognized firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognized as an asset or liability after the inception of the hedge (see paragraphs 104 and 105).

(c) A forward contract that is within the scope of this Standard (see

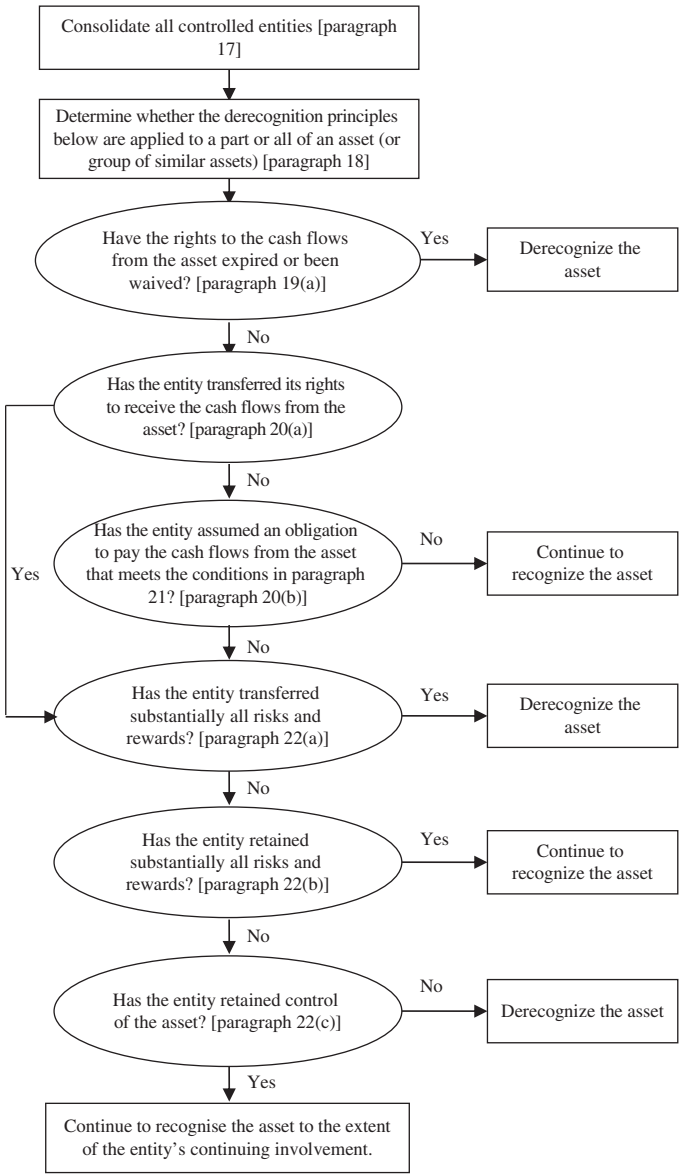
paragraphs 2–6) is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognized as an asset or liability.

(d) Option contracts that are within the scope of this Standard (see paragraphs 2–6) are recognized as assets or liabilities when the holder or writer becomes a party to the contract.

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

Derecognition of a Financial Asset (paragraphs 17–39)

AG51. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognized.



Arrangements under Which an Entity Retains the Contractual Rights to Receive the Cash Flows of a Financial Asset, but Assumes a Contractual Obligation to Pay the Cash Flows to One or More Recipients (paragraph 20(b))

AG52. The situation described in paragraph 20(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 21 and 22 are met.

AG53. In applying paragraph 21, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a controlled entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the Transfer of Risks and Rewards of Ownership (paragraph 22)

AG54. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

(a) An unconditional sale of a financial asset;

(b) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

(c) A sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).

AG55. Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) A securities lending agreement;

(c) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) A sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

AG56. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred

asset, it does not recognize the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the Transfer of Control

AG57. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

AG58. The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

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

(b) An ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:

(i) The transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e., it must be a unilateral ability); and

(ii) The transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or "strings" to the transfer (e.g., conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

AG59. That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred

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

Transfers that Qualify for Derecognition

AG60. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 29, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognized and the part that continues to be recognized. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognized at fair value.

AG61. In estimating the fair values of the part that continues to be recognized and the part that is derecognized for the purposes of applying paragraph 29, an entity applies the fair value measurement requirements in paragraphs 50–52 and AG101–AG115 in addition to paragraph 30.

Transfers that do not Qualify for Derecognition

AG62. The following is an application of the principle outlined in paragraph 31. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognized because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognized in its entirety and the consideration received is recognized as a liability.

Continuing Involvement in Transferred Assets

AG63. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 32.

All assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognized to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ("the guarantee amount"). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognized in surplus or deficit on a time proportion basis (see IPSAS 9) and the carrying value of the asset is reduced by any impairment losses.

Assets measured at amortized cost

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

Assets measured at fair value

(c) If a call option right retained by an entity prevents a transferred asset from being derecognized and the entity measures the transferred asset at fair value, the asset continues to be measured

at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (CU80 – CU5) and the carrying amount of the transferred asset is CU80 (i.e., its fair value).

(d) If a put option written by an entity prevents a transferred asset from being derecognized and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price).

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

respectively. In this case, the entity recognizes an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) – CU5]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

All Transfers

AG64. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognizing both the derivative and either the transferred asset or the liability arising from the transfer would result in recognizing the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognized as a derivative asset.

AG65. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset. The transferee derecognizes the cash or other consideration paid and recognizes a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

Examples

AG66. The following examples illustrate the application of the derecognition principles of this Standard.

(a) Repurchase agreements and securities lending. If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its statement of financial position, for example, as a loaned asset or repurchase receivable.

(b) Repurchase agreements and securities lending—assets that are substantially the same. If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return

the same or substantially the same asset to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership.

(c) Repurchase agreements and securities lending—right of substitution. If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognized because the transferor retains substantially all the risks and rewards of ownership.

(d) Repurchase right of first refusal at fair value. If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognizes the asset because it has transferred substantially all the risks and rewards of ownership.

(e) Wash sale transaction. The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognized.

(f) Put options and call options that are deeply in the money. If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.

(g) Put options and call options that are deeply out of the money. A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognized. This is because the transferor has transferred substantially all the risks and rewards of ownership.

(h) Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money. If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognized. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.

(i) A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money. If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognized to the extent of the transferor's continuing involvement (see paragraph AG64). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognized.

(j) Assets subject to a fair value put or call option or a forward repurchase agreement. A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.

(k) Cash settled call or put options. An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG59 and (g), (h) and (i)

above).

(l) Removal of accounts provision. A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.

(m) Clean-up calls. An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.

(n) Subordinated retained interests and credit guarantees. An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.

(o) Total return swaps. An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a

case, derecognition of all of the asset is prohibited.

(p) Interest rate swaps. An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.

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

AG67. This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

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

estimated fair value of the excess spread of 0.5 percent is CU40.

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

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

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

The entity calculates the gain or loss on the sale of the 90 percent share of cash flows. Assuming that separate fair values of the 90 percent part transferred and the 10 percent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 30 as follows:

	Estimated fair value	*Percentage*	*Allocated carrying amount*
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	**10,100**		**10,000**

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

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

the subordination of CU65). The entity uses all of the above information to account for the transaction as follows:

	Debit		*Credit*
Original asset	–		9,000
Asset recognized for subordination or the residual interest	1,000		–
Asset for the consideration received in the form of excess spread	40		–
Surplus or deficit (gain on transfer)	–		90
Liability	–		1,065
Cash received	9,115		–
Total	**10,155**		**10,155**

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

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

Regular Way Purchase or Sale of a Financial Asset (paragraph 40)

AG68. A regular way purchase or sale of financial assets is recognized using either trade date accounting or settlement date accounting as described in paragraphs AG70 and AG71. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraph 10. For this purpose assets that are held for trading form a separate category from assets designated at fair value through surplus or deficit.

AG69. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

AG70. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

AG71. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not 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.

Derecognition of a Financial Liability (paragraphs 41–44)

AG72. 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).

AG73. If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.

AG74. Payment to a third party, including a trust (sometimes called "in-substance defeasance"), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

AG75. If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognize the debt obligation unless the condition in paragraph AG72(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognizes a new debt obligation to the third party.

AG76. If a third party assumes an obligation of an entity, and the entity provides either no or only nominal consideration to that third party in return, an entity applies the derecognition requirements of this Standard as well as paragraphs 84 to 87 of IPSAS 23.

AG77. Lenders will sometimes waive their right to collect debt owed by a public sector entity, for example, a national government may cancel a loan owed by a local government. This waiver of debt would constitute a legal release of the debt owing by the borrower to the lender. Where an entity's obligations have been waived as part of a non-exchange transaction it applies the derecognition requirements of this Standard as well as paragraphs 84 to 87 of IPSAS 23.

AG78. Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognize a new liability if the derecognition criteria in paragraphs 17–39 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognized, and the entity recognizes a new liability relating to the transferred assets.

AG79. For the purpose of paragraph 42, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 percent different from the discounted present value of the remaining cash flows of the original

financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognized as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.

AG80. In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:

(a) Recognizes a new financial liability based on the fair value of its obligation for the guarantee; and

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

Measurement (paragraphs 45–86)

Non-Exchange Revenue Transactions

AG81. The initial recognition and measurement of assets and liabilities resulting from non-exchange revenue transactions is dealt with in IPSAS 23. Assets resulting from non-exchange revenue transactions can arise out of both contractual and non-contractual arrangements (see IPSAS 28 paragraphs AG20 and AG21). Where these assets arise out of contractual arrangements and otherwise meet the definition of a financial instrument, they are:

(a) Initially recognized in accordance with IPSAS 23;

(b) Initially measured:

(i) At fair value using the principles in IPSAS 23; and

(ii) Taking account of transaction costs that are directly attributable to the acquisition of the financial asset in accordance with paragraph 45 of this Standard, where the asset is subsequently measured other than at fair value through surplus or deficit.

(See paragraphs IE46 to IE50 accompanying this Standard).

Initial Measurement of Financial Assets and Financial Liabilities (paragraph 45)

AG82. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or

received, see also paragraph AG108). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG106–AG112). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of revenue unless it qualifies for recognition as some other type of asset.

AG83. If an entity originates a loan that bears an off-market interest rate (e.g., 5 percent when the market rate for similar loans is 8 percent), and receives an up-front fee as compensation, the entity recognizes the loan at its fair value, i.e., net of the fee it receives. The entity accretes the discount to surplus or deficit using the effective interest rate method.

Concessionary Loans

AG84. Concessionary loans are granted to or received by an entity at below market terms. Examples of concessionary loans granted by entities 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. Entities may receive concessionary loans, for example, from development agencies and other government entities.

AG85. The granting or receiving of a concessionary loan is distinguished from the waiver of debt owing to or by an entity. This distinction is important because it affects whether the below market conditions are considered in the initial recognition or measurement of the loan rather than as part of the subsequent measurement or derecognition.

AG86. The intention of a concessionary loan at the outset is to provide or receive resources at below market terms. A waiver of debt results from loans initially granted or received at market related terms where the intention of either party to the loan has changed subsequent to its initial issue or receipt. For example, a government may lend money to a not-for-profit entity with the intention that the loan be repaid in full on market terms. However, the government may subsequently write-off part of the loan. This is not a concessionary loan as the intention of the loan at the outset was to provide credit to an entity at market related rates. An entity would treat the subsequent write-off of the loan as a waiver of debt and apply the derecognition requirements of IPSAS 29.

AG87. 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. At initial recognition, an entity therefore analyzes the substance of the loan granted or received into its component parts, and accounts for those components using the principles in paragraphs AG88 and AG89 below.

AG88. An entity firstly assesses whether the substance of the concessionary loan is in fact a loan, a grant, a contribution from owners or a combination thereof, by applying the principles in IPSAS 28 and paragraphs 42–58 of IPSAS 23. 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. An entity determines the fair value of the loan by using the principles in AG101–AG115. Where an entity cannot determine fair value by reference to 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 (see AG82).

AG89. 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.

(b) Where the loan is granted by an entity, the difference is treated as an expense in surplus or deficit at initial recognition, except where the loan is a transaction with owners, in their capacity as owners. Where the loan is a transaction with owners in their capacity as owners, for example, where a controlling entity provides a concessionary loan to a controlled entity, the difference may represent a capital contribution, i.e., an investment in an entity, rather than an expense.

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

AG90. After initial recognition, an entity subsequently measures concessionary loans using the categories of financial instruments defined in paragraph 10.

Non-Exchange Revenue Transactions

AG91. [Deleted]

Valuing Financial Guarantees Issued Through a Non-Exchange Transaction

AG92. Only contractual financial guarantees (or guarantees that are in substance, contractual) are within the scope of this Standard (See AG3 and AG4 of IPSAS 28). Non-contractual guarantees are not within the scope of this Standard as they do not meet the definition of a financial instrument. This Standard prescribes recognition and measurement requirements only for the issuer of financial guarantee contracts.

AG93. In paragraph 10 a "financial guarantee contract" is defined as "a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument." Under the requirements of this Standard, financial guarantee contracts, like other financial assets and financial liabilities, are required to be initially recognized at fair value. Paragraphs 50–52 of this Standard provide commentary and guidance on determining fair value and this is complemented by Application Guidance in paragraphs AG101–AG115. Subsequent measurement for financial guarantee contracts is at the higher of the amount determined in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognized less, when appropriate, cumulative amortization in accordance with IPSAS 9, *Revenue from Exchange Transactions*.

AG94. In the public sector, guarantees are frequently provided by way of non-exchange transactions, i.e., at no or nominal consideration. This type of guarantee is provided generally to further the entity's economic and social objectives. Such purposes include supporting infrastructure projects, supporting corporate entities at times of economic distress, guaranteeing the bond issues of entities in other tiers of governments and the loans of employees to finance motor vehicles that are to be used for performance of their duties as employees. Where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an exchange transaction and whether the consideration represents a fair value. If the consideration does represent a fair value, entities should recognize the financial guarantee at the amount of the consideration. Subsequent measurement should be at the higher of the amount determined in accordance with IPSAS 19 and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9. Where the entity concludes that the consideration is not a fair value, an entity determines the carrying value at initial recognition in the same way as if no consideration had been paid.

AG95. At initial recognition, where no fee is charged or where the consideration is not fair value, an entity firstly considers whether there are quoted prices available in an active market for financial guarantee contracts directly equivalent to that entered into. Evidence of an active market includes recent arm's length market transactions between knowledgeable willing parties, and reference to the current fair value of another financial guarantee contract that is substantially the same as that provided at nil or nominal consideration by the issuer. The fact that a financial guarantee contract has been entered into at no consideration by the debtor to the issuer is not, of itself, conclusive evidence of the absence of an active market. Guarantees may be available from commercial issuers, but a public sector entity may agree to enter into a financial guarantee contract for a number of non-commercial reasons. For example, if a debtor is unable to afford a commercial fee, and initiation of a project in fulfillment of one of the entity's social or policy objectives would be put at risk unless a financial guarantee contract is issued, it may approach a public sector entity or government to issue a financial guarantee contract

AG96. Where there is no active market for a directly equivalent guarantee contract; the entity considers whether a valuation technique other than observation of an active market is available and provides a reliable measure of fair value. Such a valuation technique may rely on mathematical models which consider financial risk. For example, National Government W guarantees a bond issue of Municipality X. As Municipality X has a government guarantee backing its bond issue, its bonds have a lower coupon than if they were not secured by a government guarantee. This is because the guarantee lowers the risk profile of the bonds for investors. The guarantee fee could be determined by using the credit spread between what the coupon rate would have been had the issue not been backed by a government guarantee and the rate with the guarantee in place. Where a fair value is obtainable either by observation of an active market or through another valuation technique, the entity recognizes the financial guarantee at that fair value in the statement of financial position and recognizes an expense of an equivalent amount in the statement of financial performance. When using a valuation technique that is not based on observation of an active market an entity needs to satisfy itself that the output of any model is reliable and understandable.

AG97. If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition. The entity assesses whether a

present obligation has arisen as a result of a past event related to a financial guarantee contract whether it is probable that such a present obligation will result in a cash outflow in accordance with the terms of the contract and whether a reliable estimate can be made of the outflow. It is possible that a present obligation related to a financial guarantee contract will arise at initial recognition where, for example, an entity enters into a financial guarantee contact to guarantee loans to a large number of small enterprises and, based on past experience, is aware that a proportion of these enterprises will default.

Subsequent Measurement of Financial Assets (paragraphs 47 and 48)

AG98. If a financial instrument that was previously recognized as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 49.

AG99. The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognized at CU102. The end of the reporting period occurs one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognized in net assets/equity. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortized to surplus or deficit using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognized in surplus or deficit when the asset is derecognized or becomes impaired.

AG100. Instruments that are classified as loans and receivables are measured at amortized cost without regard to the entity's intention to hold them to maturity.

Fair Value Measurement Considerations (paragraphs 50–52)

AG101. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

AG102. This Standard uses the terms "bid price" and "asking price" (sometimes

referred to as “current offer price”) in the context of quoted market prices, and the term “the bid-ask spread” to include only transaction costs. Other adjustments to arrive at fair value (e.g., for counterparty credit risk) are not included in the term “bid-ask spread.”

Active Market: Quoted Price

AG103. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm’s length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm’s length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument (i.e., without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

AG104. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (e.g., a change in the risk-free interest rate following the most recent price quote for a government bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (e.g., because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market

price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

AG105. If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

No Active Market: Valuation Technique

AG106. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

AG107. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

AG108. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition, in an exchange transaction, is the transaction price

(i.e., the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

AG109. The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. The application of paragraph AG108 may result in no gain or loss being recognized on the initial recognition of a financial asset or financial liability. In such a case, IPSAS 29 requires that a gain or loss shall be recognized after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

AG110. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (i.e., similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

AG111. The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information

from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

AG112. In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

No Active Market: Equity Instruments

AG113. The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 48(c) and 49) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or
(b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

AG114. There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 48(c) and 49) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

Inputs to Valuation Techniques

AG115. An appropriate technique for estimating the fair value of a particular

financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

(a) The time value of money (i.e., interest at the basic or risk-free rate). Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general market rate, such as a swap rate, as the benchmark rate. (If the rate used is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate). In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

(b) Credit risk. The effect on fair value of credit risk (i.e., the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.

(c) Foreign currency exchange prices. Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.

(d) Commodity prices. There are observable market prices for many commodities.

(e) Equity prices. Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.

(f) Volatility (i.e., magnitude of future changes in price of the financial instrument or other item). Measures of the volatility of actively

traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.

(g) Prepayment risk and surrender risk. Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount – see paragraph 52).

(h) Servicing costs for a financial asset or a financial liability. Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

Gains and Losses (paragraphs 64–66)

AG116. An entity applies IPSAS 4 to financial assets and financial liabilities that are monetary items in accordance with IPSAS 4 and denominated in a foreign currency. Under IPSAS 4, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognized in surplus or deficit. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 106–112) or a hedge of a net investment (see paragraph 113). For the purpose of recognizing foreign exchange gains and losses under IPSAS 4, a monetary available-for-sale financial asset is treated as if it were carried at amortized cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortized cost are recognized in surplus or deficit and other changes in carrying amount are recognized in accordance with paragraph 64(b). For available-for-sale financial assets that are not monetary items under IPSAS 4 (e.g., equity instruments), the gain or loss that is recognized directly in net assets/equity under paragraph 64(b) includes any related foreign exchange component. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognized in surplus or deficit.

Impairment and Uncollectibility of Financial Assets (paragraphs 67–79)

Financial Assets Carried at Amortized Cost (paragraphs 72–74)

AG117. Impairment of a financial asset carried at amortized cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortized cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 72 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortized cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

AG118. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.

AG119. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognizes an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period (paragraph 47 of IPSAS 19 contains guidance on how to determine the best estimate in a range of possible outcomes).

AG120. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (e.g., on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors,) The characteristics chosen are relevant to the estimation of future cash flows

for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

AG121. Impairment losses recognized on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

AG122. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

AG123. As an example of applying paragraph AG122, an entity may determine, on the basis of historical experience, that one of the main causes of default on loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognized for these "incurred but not reported" losses.

However, it would not be appropriate to recognize an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.

AG124. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

AG125. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g., for smaller balance loans) as long as they are consistent with the requirements in paragraphs 72–74 and AG120–AG124. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest Revenue after Impairment Recognition

AG126. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest revenue is thereafter recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Hedging (paragraphs 80–113)

Hedging Instruments (paragraphs 81–86)

Qualifying Instruments (paragraphs 81 and 82)

AG127. The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the surplus or deficit exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (e.g., a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce surplus or deficit exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

AG128. A held-to-maturity investment carried at amortized cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG129. An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 48(c) and 49) cannot be designated as a hedging instrument.

AG130. An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged items (paragraphs 87–94)

Qualifying items (paragraphs 87–89)

AG131. A firm commitment to acquire an entity or an integrated set of activities in a public sector combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general operational risks.

AG132. An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognizes in surplus or deficit the investor's share of the associate's surplus or deficit, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated controlled entity cannot be a hedged item in a fair value hedge because consolidation recognizes in surplus or deficit the controlled entity's surplus or deficit, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

AG133. Paragraph 89 states that in consolidated financial statements the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated surplus or deficit. For this purpose an entity can be a controlling entity, controlled entity, associate, joint venture or branch. If the foreign currency risk of a forecast transaction within the economic entity does not affect consolidated surplus or deficit, the transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management

charges between members of the same economic entity unless there is a related external transaction. However, when the foreign currency risk of a forecast transaction within the economic entity will affect consolidated surplus or deficit, the transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same economic entity if there is an onward sale of the inventory to a party external to the economic entity. Similarly, a forecast sale of property, plant and equipment within the economic entity from the entity that constructed it to the entity that will use the property, plant and equipment in its operations may affect consolidated surplus or deficit. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognized for the plant and equipment may change if the forecast transaction within the economic entity is denominated in a currency other than the functional currency of the purchasing entity.

AG134. If a hedge of a forecast transaction within the economic entity qualifies for hedge accounting, any gain or loss that is recognized directly in net assets/equity in accordance with paragraph 106(a) shall be reclassified into surplus or deficit in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated surplus or deficit.

AG135. An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, only cash flow losses that result from an increase in the price above the specified level are designated. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects surplus or deficit (paragraph 96(b)).

Designation of Financial Items as Hedged Items (paragraphs 90 and 91)

AG136. If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case

of a liability whose effective interest rate is below a market related interest rate, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at a market related rate and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g., only for changes that are attributable to changes in the market rate). For example, in the case of a financial liability whose effective interest rate is 100 basis points below the market rate, an entity can designate as the hedged item the entire liability (i.e., principal plus interest at the market rate minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in the market rate. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG140.

AG137. In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of CU100 that has an effective interest rate of 6 percent at a time when the market rate is 4 percent. It begins to hedge that asset some time later when the market rate has increased to 8 percent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of CU90, the effective yield would have been 9.5 percent. Because the market rate is less than this effective yield, the entity can designate a portion of the market rate of 8 percent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (i.e., CU90) and the amount repayable on maturity (i.e., CU100).

AG138. Paragraph 90 permits an entity to designate something other than the entire fair value change or cash flow variability of a financial instrument. For example:

(a) All of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or

(b) Some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all

or only some risks (i.e., a “portion” of the cash flows of the financial instrument may be designated for changes attributable to all or only some risks).

AG139. To be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. For example:

(a) For a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark interest rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable.

(b) Inflation is not separately identifiable and reliably measurable and cannot be designated as a risk or a portion of a financial instrument unless the requirements in (c) are met.

(c) A contractually specified inflation portion of the cash flows of a recognized inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation portion.

Designation of Non-Financial Items as Hedged Items (paragraph 92)

AG140. Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brent Crude oil using a forward contract to purchase Light Sweet Crude oil on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 98 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (e.g., a transaction in Brent Crude oil) and the hedging instrument (e.g.,

a transaction in Light Sweet Crude oil). If there is a valid statistical relationship between the two variables (i.e., between the unit prices of Brent Crude oil and Light Sweet Crude oil), the slope of the regression line can be used to establish the hedge ratio that will maximize expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximizes expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognized in surplus or deficit during the term of the hedging relationship.

Designation of Groups of Items as Hedged Items (paragraphs 93 and 94)

AG141. A hedge of an overall net position (e.g., the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on surplus or deficit of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has CU100 of assets and CU90 of liabilities with risks and terms of a similar nature and hedges the net CU10 exposure, it can designate as the hedged item CU10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of CU100 and a firm commitment to make a sale in the foreign currency of CU90, it can hedge the net amount of CU10 by acquiring a derivative and designating it as a hedging instrument associated with CU10 of the firm purchase commitment of CU100.

Hedge Accounting (paragraphs 95–113)

AG142. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

AG143. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e., a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

AG144. A hedge of a firm commitment (e.g., a hedge of the change in fuel price relating to an unrecognized contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However,

under paragraph 97 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Assessing Hedge Effectiveness

AG145. A hedge is regarded as highly effective only if both of the following conditions are met:

(a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG140.

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

AG146. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual financial statements.

AG147. This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

AG148. If an entity hedges less than 100 percent of the exposure on an item, such as 85 percent, it shall designate the hedged item as being 85 percent of the exposure and shall measure ineffectiveness based on the change in that designated 85 percent exposure. However, when hedging the designated 85 percent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG140.

AG149. If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

(a) The forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;

(b) The fair value of the forward contract at inception is zero; and

(c) Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and recognized in surplus or deficit or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

AG150. Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

AG151. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general operational risks, and must ultimately affect the entity's surplus or deficit. A hedge of the risk of obsolescence of a physical asset or the risk of legislative changes relating to the rehabilitation of damage to the environment is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

AG152. Paragraph 83(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.

AG153. If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG135, a designated one-sided risk does not include the time value of an option. Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.

AG154. In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

AG155. In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

AG156. If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate

Risk

AG157. For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)–(i) and paragraphs AG158–AG175 below.

(a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios (e.g., the entity may group its available-for-sale assets into a separate portfolio), in which case it applies the guidance below to each portfolio separately.

(b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.

(c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG169(b).

(d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g., a swap rate).

(e) The entity designates one or more hedging instruments for each repricing time period.

(f) Using the designations made in (c)–(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.

(g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined

actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognizes the change in fair value of the hedged item as a gain or loss in surplus or deficit and in one of two line items in the statement of financial position as described in paragraph 100. The change in fair value need not be allocated to individual assets or liabilities.

(h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognizes it as a gain or loss in surplus or deficit. The fair value of the hedging instrument(s) is recognized as an asset or liability in the statement of financial position.

(i) Any ineffectiveness will be recognized in surplus or deficit as the difference between the change in fair value referred to in (g) and that referred to in (h) (effectiveness is measured using the same materiality considerations as in other IPSASs).

AG158. This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

AG159. The portfolio identified in paragraph AG157(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

AG160. In applying paragraph AG157(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may

apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortizing loans to time periods based on expected repricing dates. However, the methodology for such an allocation shall be in accordance with the entity's risk management procedures and objectives.

AG161. As an example of the designation set out in paragraph AG157(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates as the hedged item assets in the amount of CU20 (a portion of the assets is designated as the Standard permits an entity to designate any amount of the available qualifying assets or liabilities, i.e., in this example any amount of the assets between CU0 and CU100). The designation is expressed as an "amount of a currency" (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn – i.e., all of the CU100 of assets in the above example – must be:

(a) Items whose fair value changes in response to changes in the interest rate being hedged; and

(b) Items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because paragraph 52 of the Standard specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG169(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with

no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 percent (CU30 / (CU100 - CU40) = 50 percent) of the liabilities with no demand feature.

AG162. The entity also complies with the other designation and documentation requirements set out in paragraph 98(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

(a) Which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.

(b) How the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.

(c) The number and duration of repricing time periods.

(d) How often the entity will test effectiveness and which of the two methods in paragraph AG169 it will use.

(e) The methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph AG169(b).

(f) When the entity tests effectiveness using the method described in paragraph AG169(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

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

AG163. The hedging instrument referred to in paragraph AG157(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG157(d). Such a portfolio of derivatives may contain offsetting risk positions. However, it

may not include written options or net written options, because paragraph 86 of the Standard and paragraph AG127 do not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph AG157(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because paragraph 84 of the Standard does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

AG164. When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG157(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 90 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 91 permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of expected, rather than contractual, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (e.g., to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph AG169. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate, and (c) can be reliably separated from changes that are attributable to the hedged interest rate (e.g., changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

AG165. The Standard does not specify the techniques used to determine the

amount referred to in paragraph AG157(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

AG166. Paragraph 100 requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph AG157(g). Specific allocation to individual assets (or liabilities) is not required.

AG167. Paragraph AG157(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

(a) Actual repricing dates being different from those expected, or expected repricing dates being revised;

(b) Items in the hedged portfolio becoming impaired or being derecognized;

(c) The payment dates of the hedging instrument and the hedged item being different; and

(d) Other causes (e.g., when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness (applying the same materiality considerations in other IPSASs) shall be identified and recognized in surplus or deficit.

AG168. Generally, the effectiveness of the hedge will be improved:

(a) If the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behavior.

(b) When the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high

ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behavior can be predicted more accurately.

(c) When the repricing time periods used are narrower (e.g., 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduce the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.

(d) The greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g., because of changes in prepayment expectations).

AG169. An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it shall calculate the amount of effectiveness either:

(a) As the difference between the change in the fair value of the hedging instrument (see paragraph AG157(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or

(b) Using the following approximation. The entity:

(i) Calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.

(ii) Applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.

(iii) Calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG157(g).

(iv) Recognizes ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG157(h)).

AG170. When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than

those excluded in accordance with paragraph AG164), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG169(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognized as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG169(b) are then repeated at the next date it tests effectiveness.

AG171. Items that were originally scheduled into a repricing time period may be derecognized because of earlier than expected prepayment or write-offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph AG157(g) that relates to the derecognized item shall be removed from the statement of financial position, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognized item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph AG157(g). When an item is derecognized, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognized item on a systematic and rational basis if the item was sold or became impaired.

AG172. In addition, any amount relating to a particular time period that has not been derecognized when the time period expires is recognized in surplus or deficit at that time (see paragraph 100). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item in the statement of financial position was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets attributable to period 1 have been either realized or rescheduled into other periods. Therefore, CU7 is derecognized from the statement of financial position and recognized in surplus or deficit. CU8 and CU10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG157(g).

AG173. As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first repricing time period expires, CU110 of assets are derecognized because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG157(g) that relates to the first time period is removed from the statement of financial position, plus 10 percent of the amount that relates to the second time period.

AG174. If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognized, the amount included in the separate line item referred to in paragraph AG157(g) that relates to the reduction shall be amortized in accordance with paragraph 104.

AG175. An entity may wish to apply the approach set out in paragraphs AG157–AG174 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with IPSAS 29. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 112(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG157–AG174 prospectively to subsequent accounting periods.

Appendix B

Reassessment of Embedded Derivatives

This Appendix is an integral part of IPSAS 29.

Introduction

B1. IPSAS 29 paragraph 11 describes an embedded derivative as "a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative."

B2. IPSAS 29 paragraph 12 requires an embedded derivative to be separated from the host contract and accounted for as a derivative 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).

B3. IPSAS 29 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives under the Standard. This appendix addresses whether:

(a) IPSAS 29 requires such an assessment to be made only when the entity first becomes a party to the contract, or if the assessment should be reconsidered throughout the life of the contract.

(b) A first-time adopter makes its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts this Standard for the first time.

B4. This appendix applies to all embedded derivatives within the scope of IPSAS 29 except the acquisition of contracts with embedded derivatives in a public sector combination or their possible reassessment at the date of acquisition.

Application of IPSAS 29 to the Reassessment of Embedded Derivatives

B5. An entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is either (a) a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract or (b) reclassification of a financial asset out of fair value through surplus or deficit category, in which cases an assessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

B6. The assessment whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on reclassification of a financial asset out of the fair value through surplus or deficit category in accordance with paragraph B5 shall be made on the basis of the circumstances that existed when the entity first became a party to the contract.

B7. On first time adoption of IPSAS 29, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph B5.

Appendix C

Hedges of a Net Investment in a Foreign Operation

This Appendix is an integral part of IPSAS 29.

Introduction

C1. Many reporting entities have investments in foreign operations (as defined in IPSAS 4, paragraph 10). Such foreign operations may be controlled entities, associates, joint ventures or branches. IPSAS 4 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognize foreign exchange differences directly in net assets/equity until it disposes of the foreign operation.

C2. Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements. This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint venters are accounted for using the equity method and financial statements that include a branch or joint operations as defined in IPSAS 37. The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.

C3. IPSAS 29 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognized directly in net assets/equity and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.

C4. This appendix applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with IPSAS 29. It should not be applied by analogy to other types of hedge accounting. This appendix refers to such an entity as a controlling entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a controlling entity apply equally to an entity that has a net investment in a foreign operation

that is a joint venture, an associate or a branch.

C5. This appendix provides guidance on:

(a) Identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation, given that an entity with many foreign operations may be exposed to a number of foreign currency risks. It specifically addresses:

(i) Whether the controlling entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the controlling entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the controlling entity's consolidated financial statements and the functional currency of the foreign operation; and

(ii) If the controlling entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate controlling entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate controlling entity (i.e., whether the fact that the net investment in the foreign operation is held through an intermediate controlling entity affects the economic risk to the ultimate controlling entity).

(b) Where in an economic entity the hedging instrument can be held. It specifically addresses:

(i) IPSAS 29 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This appendix addresses whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.

(ii) This appendix also addresses where, within an economic entity, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting i.e., whether a qualifying hedge

accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity within the economic entity, regardless of its functional currency, can hold the hedging instrument.

(c) How an entity should determine what amount of the gain or loss recognized in net assets/equity should be recognized directly in surplus or deficit for both the hedging instrument and the hedged item as IPSAS 4 and IPSAS 29 require cumulative amounts recognized directly in net assets/equity relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be recognized directly when the controlling entity disposes of the foreign operation. It specifically addresses:

(i) When a foreign operation that was hedged is disposed of, what amounts from the controlling entity's foreign currency translation reserve in respect of the hedging instrument and of that foreign operation should be recognized in surplus or deficit in the controlling entity's consolidated financial statements; and

(ii) Whether the method of consolidation affects the determination of the amounts to be recognized in surplus or deficit.

Application of IPSAS 29 to Hedges of a Net Investment in a Foreign Operation

Nature of the Hedged Risk and Amount of the Hedged Item for which a Hedging Relationship may be Designated

C6. Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the controlling entity's functional currency.

C7. In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the controlling entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a controlling entity depends on whether any lower level controlling entity of the foreign operation has applied hedge accounting

for all or part of the net assets of that foreign operation and that accounting has been maintained in the controlling entity's consolidated financial statements.

C8. The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any controlling entity (the immediate, intermediate or ultimate controlling entity) of that foreign operation. The fact that the net investment is held through an intermediate controlling entity does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate controlling entity.

C9. An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one controlling entity within the economic entity (e.g., both a direct and an indirect controlling entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate controlling entity. A hedging relationship designated by one controlling entity in its consolidated financial statements need not be maintained by another higher level controlling entity. However, if it is not maintained by the higher level controlling entity, the hedge accounting applied by the lower level controlling entity must be reversed before the higher level controlling entity's hedge accounting is recognized.

Where the Hedging Instrument can be Held

C10. A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the economic entity (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of IPSAS 29 paragraph 98 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the economic entity—should be clearly documented because of the possibility of different designations at different levels of the economic entity.

C11. For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the controlling entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total

change in value might be recognized in surplus or deficit, directly in net assets/equity, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognized in surplus or deficit or directly in net assets/equity. As part of the application of hedge accounting, the total effective portion of the change is included directly in net assets/equity. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

Disposal of a Hedged Foreign Operation

C12. When a foreign operation that was hedged is disposed of, the amount reclassified to surplus or deficit from the foreign currency translation reserve in the consolidated financial statements of the controlling entity in respect of the hedging instrument is the amount that IPSAS 29 paragraph 113 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.

C13. The amount recognized in surplus or deficit upon transfer from the foreign currency translation reserve in the consolidated financial statements of a controlling entity in respect of the net investment in that foreign operation in accordance with IPSAS 4 paragraph 57 is the amount included in that controlling entity's foreign currency translation reserve in respect of that foreign operation. In the ultimate controlling entity's consolidated financial statements, the aggregate net amount recognized in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate controlling entity uses the direct or the step-by-step method of consolidation, this may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation.

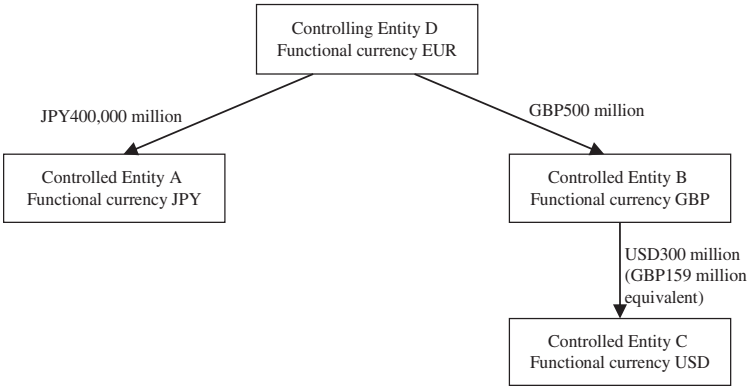
C14. The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate controlling entity. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate controlling entity(ies) and then translated into the functional currency of the ultimate controlling entity (or the presentation currency if different).

C15. The use of the step-by-step method of consolidation may result in a different amount being recognized in surplus or deficit from that used to

determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by IPSAS 4. However, it is an accounting policy choice that should be followed consistently for all net investments.

Example

C16. The following example illustrates the application of the preceding paragraphs using the entity structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with IPSAS 29, although this testing is not discussed. Controlling Entity D, being the ultimate controlling entity, presents its consolidated financial statements in its functional currency of euro (EUR). Each of the controlled entities i.e., Controlled Entity A, Controlled Entity B and Controlled Entity C, is wholly owned. Controlling Entity D £500 million net investment in Controlled Entity B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Controlled Entity B's US$300 million net investment in Controlled Entity C (functional currency US dollars (USD)). In other words, Controlled Entity B's net assets other than its investment in Controlled Entity C are £341 million.



Nature of Hedged Risk for which a Hedging Relationship may be Designated (paragraphs C6–C9)

C17. Controlling Entity D can hedge its net investment in each of Controlled Entities A, B and C for the foreign exchange risk between their respective functional currencies (Japanese yen (JPY), pounds sterling and US dollars) and euro. In addition, Controlled Entity D can hedge the USD/GBP foreign exchange risk between the functional currencies of

Controlled Entity B and Controlled Entity C. In its consolidated financial statements, Controlled Entity B can hedge its net investment in Controlled Entity C for the foreign exchange risk between their functional currencies of US dollars and pounds sterling. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Controlling Entity D could designate the forward foreign exchange risk.

Amount of Hedged item for which a Hedging Relationship may be Designated (paragraphs C6–C9)

C18. Controlling Entity D wishes to hedge the foreign exchange risk from its net investment in Controlled Entity C. Assume that Controlled Entity A has an external borrowing of US$300 million. The net assets of Controlled Entity A at the start of the reporting period are ¥400,000 million including the proceeds of the external borrowing of US$300 million.

C19. The hedged item can be an amount of net assets equal to or less than the carrying amount of Controlling Entity D's net investment in Controlled Entity C (US$300 million) in its consolidated financial statements. In its consolidated financial statements Controlling Entity D can designate the US$300 million external borrowing in Controlled Entity A as a hedge of the EUR/USD spot foreign exchange risk associated with its net investment in the US$300 million net assets of Controlled Entity C. In this case, both the EUR/USD foreign exchange difference on the US$300 million external borrowing in Controlled Entity A and the EUR/USD foreign exchange difference on the US$300 million net investment in Controlled Entity C are included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements after the application of hedge accounting.

C20. In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Controlled Entity A would be recognized in Controlling Entity D's consolidated financial statements as follows:

- USD/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit; and
- JPY/EUR spot foreign exchange rate change directly in net assets/equity.

Instead of the designation in paragraph C19, in its consolidated financial statements Controlling Entity D can designate the US$300 million

external borrowing in Controlled Entity A as a hedge of the GBP/USD spot foreign exchange risk between Controlled Entity C and Controlled Entity B. In this case, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Entity A would instead be recognized in Controlled Entity D's consolidated financial statements as follows:

- The GBP/USD spot foreign exchange rate change in the foreign currency translation reserve relating to Controlled Entity C;
- GBP/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit; and
- JPY/EUR spot foreign exchange rate change directly in net assets/equity.

C21. Controlling Entity D cannot designate the US$300 million external borrowing in Controlled Entity A as a hedge of both the EUR/USD spot foreign exchange risk and the GBP/USD spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Controlled Entity B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the economic entity comprising Controlled Entity B and Controlled Entity C.

Where in an Economic Entity can the Hedging Instrument be Held (paragraphs C10 and C11)?

C22. As noted in paragraph C20, the total change in value in respect of foreign exchange risk of the US$300 million external borrowing in Controlled Entity A would be recorded in both surplus or deficit (USD/JPY spot risk) and directly in net assets/equity (EUR/JPY spot risk) in Controlling Entity D's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness
of the hedge designated in paragraph C19 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Controlling Entity D against the US dollar functional currency of Controlled Entity C, in accordance with the hedge documentation. The method of consolidation (i.e., direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts Recognized in Surplus or Deficit on Disposal of a Foreign Operation (paragraphs C12 and C13)

C23. When Controlled Entity C is disposed of, the amounts are recognized in surplus or deficit in Controlling Entity D's consolidated financial statements upon transfer from its foreign currency translation reserve (FCTR) are:

(a) In respect of the US$300 million external borrowing of Controlled Entity A, the amount that IPSAS 29 requires to be identified, i.e., the total change in value in respect of foreign exchange risk that was recognized directly in net assets/equity as the effective portion of the hedge; and

(b) In respect of the US$300 million net investment in Controlled Entity C, the amount determined by the entity's consolidation method. If Controlling Entity D uses the direct method, its FCTR in respect of Controlled Entity C will be determined directly by the EUR/USD foreign exchange rate. If Controlling Entity D uses the step-by-step method, its FCTR in respect of Controlled Entity C will be determined by the FCTR recognized by Controlled Entity B reflecting the GBP/USD foreign exchange rate, translated to Controlling Entity D's functional currency using the EUR/GBP foreign exchange rate. Controlling Entity D's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be recognized in surplus or deficit when it disposes of Controlled Entity C to be the amount that it would have recognized if it had always used the direct method, depending on its accounting policy.

Hedging More Than One Foreign Operation (paragraphs C7, C9, and C11)

C24. The following examples illustrate that in the consolidated financial statements of Controlling Entity D, the risk that can be hedged is always the risk between its functional currency (euro) and the functional currencies of Controlled Entities B and C. No matter how the hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements when both foreign operations are hedged are US$300 million for EUR/USD risk and £341 million for EUR/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Controlling Entity D's consolidated surplus or deficit. Of course, it would be possible for Controlling Entity D to designate US$300 million only for changes in the USD/GBP spot foreign exchange rate or £500 million only for changes in the GBP/EUR

spot foreign exchange rate.

Entity D Holds Both USD and GBP Hedging Instruments

C25. Controlling Entity D may wish to hedge the foreign exchange risk in relation to its net investment in Controlled Entity B as well as that in relation to Controlled Entity C. Assume that Controlling Entity D holds suitable hedging instruments denominated in US dollars and pounds sterling that it could designate as hedges of its net investments in Controlled Entity B and Controlled Entity C. The designations Controlling Entity D can make in its consolidated financial statements include, but are not limited to, the following:

(a) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in Controlled Entity C with the risk being the spot foreign exchange exposure (EUR/USD) between Controlling Entity D and Controlled Entity C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between Controlling Entity D and Controlled Entity B.

(b) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in Controlled Entity C with the risk being the spot foreign exchange exposure (GBP/USD) between Controlled Entity B and Controlled Entity C and up to £500 million hedging instrument designated as a hedge of £500 million of the net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between Controlling Entity D and Controlled Entity B.

C26. The EUR/USD risk from Controlling Entity D's net investment in Controlled Entity C is a different risk from the EUR/GBP risk from Controlling Entity D's net investment in Controlled Entity B. However, in the case described in paragraph C25(a), by its designation of the USD hedging instrument it holds, Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in Controlled Entity C. If Controlling Entity D also designated a GBP instrument it holds as a hedge of its £500 million net investment in Controlled Entity B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in Controlled Entity C, would be hedged twice for GBP/EUR risk in Controlling Entity D's consolidated financial statements.

C27. In the case described in paragraph C25(b), if Controlling Entity D designates the hedged risk as the spot foreign exchange exposure

(GBP/USD) between Controlled Entity B and Controlled Entity C, only the GBP/USD part of the change in the value of its US$300 million hedging instrument is included in Controlling Entity D's foreign currency translation reserve relating to Controlled Entity C. The remainder of the change (equivalent to the GBP/EUR change on £159 million) is included in Controlling Entity D's consolidated surplus or deficit, as in paragraph C20. Because the designation of the USD/GBP risk between Controlled entities B and C does not include the GBP/EUR risk, Controlled Entity D is also able to designate up to £500 million of its net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (GBP/EUR) between Controlling Entity D and Controlled Entity B.

Entity B Holds the USD Hedging Instrument

C28. Assume that Controlled Entity B holds US$300 million of external debt, the proceeds of which were transferred to Controlling Entity D by an inter-entity loan denominated in pounds sterling. Because both its assets and liabilities increased by £159 million, Controlled Entity B's net assets are unchanged. Controlled Entity B could designate the external debt as a hedge of the GBP/USD risk of its net investment in Controlled Entity C in its consolidated financial statements. Controlling Entity D could maintain Controlled Entity B's designation of that hedging instrument as a hedge of its US$300 million net investment in Controlled Entity C for the GBP/USD risk (see paragraph C9) and Controlling Entity D could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in Controlled Entity B. The first hedge, designated by Controlled Entity B, would be assessed by reference to Controlled Entity B's functional currency (pounds sterling) and the second hedge, designated by Controlling Entity D, would be assessed by reference to Controlling Entity D's functional currency (euro). In this case, only the GBP/USD risk from Controlling Entity D's net investment in Controlled Entity C has been hedged in Controlling Entity D's consolidated financial statements by the USD hedging instrument, not the entire EUR/USD risk. Therefore, the entire EUR/GBP risk from Controlling Entity D's £500 million net investment in Controlled Entity B may be hedged in the consolidated financial statements of Controlling Entity D.

C29. However, the accounting for Controlled Entity D's £159 million loan payable to Controlled Entity B must also be considered. If Controlling Entity D's loan payable is not considered part of its net investment in Controlled Entity B because it does not satisfy the conditions in IPSAS 4 paragraph 18, the GBP/EUR foreign exchange difference arising on

translating it would be included in Controlling Entity D's consolidated surplus or deficit. If the £159 million loan payable to Controlled Entity B is considered part of Controlling Entity D's net investment, that net investment would be only £341 million and the amount Controlling Entity D could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.

C30. If Controlling Entity D reversed the hedging relationship designated by Controlled Entity B, Controlling Entity D could designate the US$300 million external borrowing held by Controlled Entity B as a hedge of its US$300 million net investment in Controlled Entity C for the EUR/USD risk and designate the GBP hedging instrument it holds itself as a hedge of only up to £341 million of the net investment in Controlled Entity B. In this case the effectiveness of both hedges would be computed by reference to Controlling Entity D's functional currency (euro). Consequently, both the USD/GBP change in value of the external borrowing held by Controlled Entity B and the GBP/EUR change in value of Controlling Entity D's loan payable to Controlled Entity B (equivalent to USD/EUR in total) would be included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements. Because Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in Controlled Entity C, it can hedge only up to £341 million for the EUR/GBP risk of its net investment in Controlled Entity B.

Appendix D

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 29.

Introduction

BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in IPSAS 29, *Financial Instruments: Recognition and Measurement*. As this Standard is based on IAS 39, *Financial Instruments: Recognition and Measurement* issued by the IASB, the Basis for Conclusions outlines only those areas where IPSAS 29 departs from the main requirements of IAS 39.

BC2. This project on financial instruments forms part of the IPSASB's convergence program which aims to converge IPSASs with IFRSs. The IPSASB acknowledges that there are other aspects of financial instruments, insofar as they relate to the public sector, which are not addressed in IAS 39. These will be addressed by future projects of the IPSASB. In particular, the IPSASB acknowledges that future projects are required to address:

- Certain transactions undertaken by central banks; and
- Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature.

BC3. In developing this Standard, the IPSASB agreed to retain the existing text of IAS 39 wherever consistent with existing IPSASs, and deal with certain public sector specific issues through additional application guidance.

BC4. In September 2007, the IASB issued amendments to IAS 1, *Presentation of Financial Statements* which introduced "comprehensive income" into the presentation of financial statements. As the IPSASB has not yet considered comprehensive income, along with some of the other amendments proposed in IAS 1, those amendments have not been included in IPSAS 29. The text of IAS 39 as published at December 31, 2008, including certain amendments made by the IASB to IAS 39 in April 2009 as part of its improvements project, have been included in the text of IPSAS 29. The IPSASB acknowledged that IFRS 9, *Financial Instruments* was issued in November 2009. The IPSASB also recognized that the IASB plans further significant modifications to IAS 39. The IPSASB therefore decided to consider any modifications to IASB

requirements for financial instruments as part of a future project.[6]

Scope

BC5. Assets and liabilities may arise out of contractual non-exchange revenue transactions. The initial recognition and measurement of assets and liabilities arising out of non-exchange revenue transactions is addressed in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. IPSAS 23 does not provide requirements and guidance for the subsequent measurement or derecognition of these assets and liabilities. The IPSASB considered the interaction between this Standard and IPSAS 23 for assets and liabilities that arise out of non-exchange revenue transactions that meet the definition of financial assets and financial liabilities.

BC6. The IPSASB agreed that where an asset acquired in a non-exchange transaction is a financial asset, an entity:

- Initially recognizes the asset using IPSAS 23; and
- Initially measures the asset using IPSAS 23 and, considers the requirements in this Standard to determine the appropriate treatment for any transaction costs incurred to acquire the asset.

As IPSAS 23 does not prescribe subsequent measurement or derecognition requirements for assets acquired in a non-exchange transaction, this Standard is applied to those assets if they are financial assets.

BC7. For liabilities, the IPSASB agreed that liabilities arising from conditions imposed on a transfer of resources in accordance with IPSAS 23 are initially recognized and initially measured using that IPSAS, as these liabilities usually do not meet the definition of a financial liability at initial recognition (see IPSAS 28). After initial recognition, if circumstances indicate that the liability is a financial liability, an entity assesses if the liability recognized in accordance with IPSAS 23 should be derecognized and a financial liability recognized in accordance with this Standard.

BC8. The IPSASB agreed that other liabilities that arise from non-exchange revenue transactions, for example, the return of resources based on a restriction on the use of an asset, are recognized and measured in

[6] In January 2015 the IPSASB introduced the concept of investment entities in IPSAS 35 and required investment entities, as defined in that Standard, to measure their investments in controlled entities, other than those providing investment-related services or activities, at fair value through surplus or deficit.

accordance with this Standard if they meet the definition of a financial liability.

Initial Measurement

BC9. The IPSASB acknowledged that there is an interaction between IPSAS 23 and this Standard for assets acquired through a non-exchange transaction that also meet the definition of a financial asset. IPSAS 23 requires that assets acquired in a non-exchange revenue transaction are measured initially at fair value. This Standard requires financial assets to be measured initially at fair value, plus transaction costs, if the asset is not subsequently measured at fair value through surplus or deficit. The two measurement approaches are broadly consistent, except for the treatment of transaction costs.

BC10. The IPSASB concluded that it would be inappropriate for financial assets arising from non-exchange transactions to be measured differently from those arising from exchange transactions. Consequently, the IPSASB agreed that assets acquired in a non-exchange transaction should be measured initially at fair value using the requirements in IPSAS 23, but that this Standard should also be considered where transaction costs are incurred to acquire the asset.

Concessionary Loans

BC11. Concessionary loans can either be granted or received by an entity. They pose particular accounting issues because their terms are not market related. The IPSASB therefore considered how the off-market portion of a concessionary loan should be accounted for. In ED 38, the IPSASB proposed that an entity should account for concessionary loans by analyzing the substance of the transaction into its component parts and accounting for each component separately and that the IPSASB therefore determined that the off-market portion of a concessionary loan should be accounted for as follows:

- The issuer of a concessionary loan accounts for the off-market portion of the loan as an expense in the year the loan is issued; and
- The recipient of a concessionary loan accounts for the off-market portion of the loan in accordance with IPSAS 23.

BC12. Some respondents to ED 38 disagreed with the proposed treatment of concessionary loans because they do not believe that fair value is an appropriate measurement basis, while others disagreed with the proposed treatment of the off-market portion of concessionary loans as an expense.

BC13. Respondents who disagreed with fair value as a measurement basis cited both conceptual and practical difficulties in measuring concessionary loans at fair value. At a conceptual level, it was noted that some concessionary loans issued by public sector entities may not be available in an orderly market because of the risk profiles of the borrowers, e.g., small business loans, or loans granted by governments in their capacity as a lender of last resort. For loans that would not ordinarily be found in an orderly market, respondents argued that while it may be possible to obtain a fair value, that fair value does not provide a faithful representation of the transaction. They argued that because an orderly market for such transactions does not exist, the transaction price on initial measurement represents the fair value of the loan. Those respondents who cited practical difficulties in determining fair value noted that, because of these difficulties, fair values are often determined using estimates. In their view the use of such estimates would make the information potentially unreliable. As a means of overcoming these practical difficulties, respondents suggested that, as an alternative to fair value, nominal cost or the lender's borrowing rate should be used as a measurement basis.

BC14. The IPSASB takes the view that the use of fair value enables the most faithfully representative determination of the concession element of a concessionary loan. Also, because the loans granted at no or low interest are not unique to the public sector, the IPSASB was not persuaded that there is a public sector specific reason to depart from the fair value principles in IAS 39. They also noted that IPSAS 30 requires specific disclosures on the measurement of financial instruments, including those instances where unobservable market inputs have been used. Consequently, the IPSASB decided to retain fair value as a measurement basis for concessionary loans.

BC15. Respondents who disagreed with expensing the off-market portion of the concessionary loan, noted that because the off-market portion represents a subsidy, it may be more appropriate to recognize an asset initially and recognize an expense subsequently by reducing this asset as and when the conditions of the subsidy are met or on a time proportion basis. The IPSASB, however, considered that the initial granting of the loan results in a commitment of resources, in the form of a loan and a subsidy, on day one. The IPSASB was of the view that initial recognition of this subsidy as an expense on recognition of the transaction provides the most useful information for accountability purposes.

Financial Guarantees Issued Through a Non-Exchange Transaction

BC16. The IPSASB acknowledged that in the public sector financial guarantee contracts are frequently issued through a non-exchange transaction, i.e., they are issued for no consideration or for nominal consideration, often in order to further the issuer's broad social policy objectives, rather than for commercial purposes. While entities may issue guarantees at below fair value in the private sector, this is not common and is for commercial reasons, such as when a controlling entity issues a guarantee to a holder on behalf of a controlled entity. In the public sector the maximum credit risk exposure of such guarantees may be extremely large. Such guarantees are generally issued because an active market does not exist and, in some cases, it would be impossible for the guarantee to be provided by a private sector issuer because of the maximum extent of the credit risk exposure. The IPSASB considered the approach to measurement at initial recognition, and subsequent to initial recognition, for such financial guarantee contracts.

BC17. Where the financial guarantee contract is entered into for consideration, the IPSASB considered whether the amount of such consideration should be deemed to be a fair value. Application Guidance in IAS 39 states that "the fair value of a financial instrument on initial recognition is normally the transaction price." In the public sector the IPSASB considered that in many cases the transaction price related to a financial guarantee contract will not reflect fair value and that recognition at such an amount would be an inaccurate and misleading reflection of the issuer's exposure to financial risk. The IPSASB concluded that where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an exchange transaction and therefore represents a fair value. If the consideration does represent a fair value, the IPSASB concluded that entities should recognize the financial guarantee at the amount of the consideration and that subsequent measurement should be at the higher of the amount determined in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9, *Revenue from Exchange Transactions*. Where the transaction price is not a fair value, an entity should be required to determine measurement at initial recognition in the same way as if no consideration had been paid.

BC18. The IPSASB therefore considered the approach to the determination of measurement at initial recognition for financial guarantee contracts provided for no consideration or for a consideration that is not a fair

value. The IPSASB identified a valuation hierarchy that could be used in initially measuring a financial guarantee contract provided for no consideration or for consideration that is not a fair value:

- An entity assesses whether the fair value of the financial guarantee contract can be determined by observing a price in an active market;
- Where a price cannot be determined by observing a price in an active market, an entity uses a valuation technique; and
- If fair value cannot be determined for a financial guarantee contract, an entity measures a financial guarantee contract at initial recognition and subsequently in accordance with IPSAS 19.

BC19. There may be cases where an active market exists for financial guarantee contracts equivalent to or similar to that issued. In such cases a fair value should be estimated through observation of that active market. Where no active market exists, the IPSASB considered whether an entity should be required to move immediately to an approach based on IPSAS 19. The IPSASB noted that many valuation techniques are highly complex and, as noted in paragraphs AG107 and AG108 may give rise to a range of outcomes. It is arguable that the cost of developing such techniques exceeds the benefits to users of the information provided. An approach based on IPSAS 19 may provide a more reliable and understandable measure of an issuer's risk exposure as a result of entering into a financial guarantee contract. The IPSASB also acknowledged that where an entity does not recognize a liability in accordance with IPSAS 19, the entity makes the disclosures required for contingent liabilities in IPSAS 19 unless an outflow of resources is remote. The information provided to users on risk exposure related to financial guarantees provided at nil or nominal consideration also includes the credit risk disclosures in IPSAS 30, *Financial Instruments: Disclosures*. Conversely, the IPSASB acknowledged that there are current IPSASs that require the use of experts, such as actuaries, to develop valuation techniques that are inherently complex, such as IPSAS 39, *Employee Benefits*. On balance the IPSASB concluded that, in the absence of an active market, entities should be permitted to use a valuation technique that does not rely on an observable market where they are satisfied that such a technique provides a reliable and understandable method of determining a fair value for a financial guarantee contract entered into by an issuer by means of a non-exchange transaction. This is particularly the case for non-standard guarantees where there is limited data available on defaults and credit risk.

Revision of IPSAS 29 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

BC20. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

(a) Removes the standard paragraphs about the applicability of IPSASs to "public sector entities other than GBEs" from the scope section of each Standard;

(b) Replaces the term "GBE" with the term "commercial public sector entities", where appropriate; and

(c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

Revision of IPSAS 29 as a result of *Improvements to IPSAS, 2021*

BC21. The IPSASB reviewed the revisions to IAS 39, *Financial Instruments: Recognition and Measurement*, included in *Interest Rate Benchmark Reform* (Amendments to IFRS 9, IAS 39 and IFRS 7) issued by the IASB in September 2019, and the IASB's rationale for making these amendments as set out in its Basis for Conclusions and concurred that there was no public sector specific reason for not adopting these amendments, henceforth labeled as *Interest Rate Benchmark Reform*.

BC22. The IPSASB reviewed the revisions to IAS 39, *Financial Instruments: Recognition and Measurement*, included in *Interest Rate Benchmark Reform—Phase 2* (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16) issued by the IASB in August 2020, and the IASB's rationale for making these amendments as set out in its Basis for Conclusions and concurred that there was no public sector specific reason for not adopting these amendments, henceforth labeled as *Interest Rate Benchmark Reform—Phase 2*.

BC23. In addition to the above amendments to IPSAS 29 (as amended by IPSAS 41 when it was first published in 2018), the IPSASB considered that entities still applying IPSAS 29 (prior to the adoption of IPSAS 41) could benefit from the amendments to the hedging section included in paragraphs 113A-113ZC of IPSAS 29 (as amended by IPSAS 41 when it

was first published in 2018) and the amendments on the practical expedient for changes in the contractual cash flows of financial instruments included in paragraphs 72A-72E of IPSAS 41.

BC24. While the amendments in paragraphs 72A-72E of IPSAS 41 were unnecessary in the IASB's IPSAS 29 equivalent standard, IAS 39, they are necessary in IPSAS 29 (prior to the adoption of IPSAS 41) because the sections on contractual cash flows are effective until January 1, 2023.

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 29.

Section A: Scope

A.1 *Practice of Settling Net: Forward Contract to Purchase a Commodity*

Entity XYZ enters into a fixed price forward contract to purchase one million liters of oil in accordance with its expected usage requirements. The contract permits XYZ 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?

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. However, if XYZ 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 executory contract.

A.2 *Option to Put a Non-Financial Asset*

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for CU150 million. The current value of the building is CU175 million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (IPSAS 29, paragraph 4 and IPSAS 29, paragraph AG22).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery (IPSAS 29, paragraph 6). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a

choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from IPSAS 29 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract rather than an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building 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 would not be accounted for as a derivative.

Section B: Definitions

B.1 *Definition of a Derivative: Examples of Derivatives and Underlyings*

What are examples of common derivative contracts and the identified underlying?

IPSAS 29 defines a derivative as follows:

A *derivative* is a financial instrument or other contract within the scope of this Standard 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.**

Type of contract	**Main pricing-settlement variable (underlying variable)**
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity instruments of another entity)
Credit swap	Credit rating, credit index or credit price

Type of contract	Main pricing-settlement variable (underlying variable)
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity instruments of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity instruments of another entity)

The above list provides examples of contracts that normally qualify as derivatives under IPSAS 29. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions of IPSAS 29 may apply, for example, if it is a weather derivative (see IPSAS 29.AG5), a contract to buy or sell a non-financial item such as commodity (see IPSAS 29.4 and IPSAS 29.AG22) or a contract settled in an entity's own shares (see IPSAS 28.25–IPSAS 28.29). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.2 *Definition of a Derivative: Settlement at a Future Date, Interest Rate Swap with Net or Gross Settlement*

For the purpose of determining whether an interest rate swap is a derivative financial instrument under IPSAS 29, does it make a difference

whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 percent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a CU100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 percent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.3 *Definition of a Derivative: Prepaid Interest Rate Swap (Fixed Rate Payment Obligation Prepaid at Inception or Subsequently)*

If a party prepays its obligation under a pay-fixed, receive-variable interest rate swap at inception, is the swap a derivative financial instrument?

Yes.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 percent per year. Entity S prepays its fixed obligation under the swap of CU50 million (CU100 million × 10 percent × 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the CU100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires 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, such as a variable rate bond. Therefore, the contract fulfills the “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” provision of IPSAS 29. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under IPSAS 29.

B.4 *Definition of a Derivative: Prepaid Pay-Variable, Receive-Fixed Interest Rate Swap*

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the "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" criterion of a derivative.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 percent times the swap's notional amount, i.e., CU10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 percent on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the "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" criterion of IPSAS 29. Therefore, the contract is not accounted for as a derivative under IPSAS 29. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.5 *Definition of a Derivative: Offsetting Loans*

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 under IPSAS 29?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, 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). 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:

- They are entered into at the same time and in contemplation of one another;
- They have the same counterparty;
- They relate to the same risk; and
- 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.

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.

B.6 *Definition of a Derivative: Option Not Expected to be Exercised*

The definition of a derivative in IPSAS 29.10 requires that the instrument "is settled at a future date." Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.7 *Definition of a Derivative: Foreign Currency Contract Based on Sales Volume*

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?

Yes. The contract has two underlying variables (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. IPSAS 29 does not exclude from its scope derivatives that are based on sales volume.

B.8 *Definition of a Derivative: Prepaid Forward*

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the "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" test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is CU50 per share; the one-year forward price of T is CU55 per share. XYZ is required to prepay the forward contract at inception with a CU50 million payment. The initial investment in the forward contract of CU50 million is less than the notional amount applied to the underlying, one million shares at the forward price of CU55 per share, i.e., CU55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.9 *Definition of a Derivative: Initial Net Investment*

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.10 *Definition of Held for Trading: Portfolio with a Recent Actual Pattern of Short-Term Profit-Taking*

The definition of a financial asset or financial liability held for trading states that "a financial asset or financial liability is classified as held for trading if

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." What is a "portfolio" for the purposes of applying this definition?

Although the term "portfolio" is not explicitly defined in IPSAS 29, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (IPSAS 29.10). If there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.11 *Definition of Held for Trading: Balancing a Portfolio*

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?

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. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

B.12 *Definition of Held-to-Maturity Financial Assets: Index-Linked Principal*

Entity A purchases a five-year equity-index-linked note with an original issue price of CU10 at a market price of CU12 at the time of purchase. The note requires no interest payments before maturity. At maturity, the note requires payment of the original issue price of CU10 plus a supplemental redemption amount that depends on whether a specified share price index exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the share index at maturity and the level of the share index when the note was issued divided by the level of the share index at the time of issue. Entity A has the positive intention and ability to hold the note to maturity. Can Entity A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of CU10 and fixed maturity and Entity A has the positive intention and ability to hold it to maturity (IPSAS 29.10). However, the equity index feature is a call option not closely related to the debt host, which must be separated as an embedded derivative under IPSAS 29.12. The purchase price of CU12 is allocated between the host debt instrument and the embedded derivative. For example, if the fair value of the embedded option at acquisition is CU4, the host debt instrument is measured at CU8 on initial recognition. In this case, the discount of CU2 that is implicit in the host bond (principal of CU10 minus the original carrying amount of CU8) is amortized to surplus or deficit over the term to maturity of the note using the effective interest method.

B.13 *Definition of Held-to-Maturity Financial Assets: Index-Linked Interest*

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes. However, the commodity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (IPSAS 29.12). IPSAS 29.14 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

B.14 *Definition of Held-to-Maturity Financial Assets: Sale Following Rating Downgrade*

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily. A downgrade is likely to indicate a decline in the issuer's creditworthiness. IPSAS 29 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in IPSAS 29 and therefore not raise a question about the entity's intention to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in IPSAS 29. A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class could often be regarded as reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be regarded as significant.

B.15 *Definition of Held-to-Maturity Financial Assets: Permitted Sales*

Would sales of held-to-maturity financial assets due to a change in management compromise the classification of other financial assets as held to maturity?

Yes. A change in management is not identified under IPSAS 29.AG35 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held to maturity. Sales in response to such a change in management would, therefore, call into question the entity's intention to hold investments to maturity.

To illustrate: Entity X has a portfolio of financial assets that is classified as held to maturity. In the current period, at the direction of the governing body, the senior management team has been replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in order to carry out an expansion strategy designated and approved by the governing body. Although the previous management team had been in place since the entity's inception and Entity X had never before undergone a major restructuring, the sale nevertheless calls into question Entity X's intention to hold remaining held-to-maturity financial assets to maturity.

B.16 *Definition of Held-to-Maturity Investments: Sales in Response to Entity-Specific Capital Requirements*

In some countries, regulators of banks or other industries may set entity-specific capital requirements that are based on an assessment of the risk in that particular entity. IPSAS 29.AG35(e) indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the industry's capital requirements may do so under IPSAS 29 without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in entity-specific capital requirements imposed by regulators (i.e., capital requirements applicable to a particular entity, but not to the industry) raise such doubt?

Yes, such sales "taint" the entity's intention to hold other financial assets as held to maturity unless it can be demonstrated that the sales fulfill the condition in IPSAS 29.10 in that they result from an increase in capital requirements, which is an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

B.17 *Definition of Held-to-Maturity Financial Assets: Pledged Collateral, Repurchase Agreements (repos), and Securities Lending Agreements*

An entity cannot have a demonstrated ability to hold to maturity an investment if it is subject to a constraint that could frustrate its intention to

hold the financial asset to maturity. Does this mean that a debt instrument that has been pledged as collateral, or transferred to another party under a repo or securities lending transaction, and continues to be recognized cannot be classified as a held-to-maturity investment?

No. An entity's intention and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or securities lending agreement. However, an entity does not have the positive intention and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments.

B.18 *Definition of Held-to-Maturity Financial Assets: "Tainting"*

In response to unsolicited tender offers, Entity A sells a significant amount of financial assets classified as held to maturity on economically favorable terms. Entity A does not classify any financial assets acquired after the date of the sale as held to maturity. However, it does not reclassify the remaining held-to-maturity investments since it maintains that it still intends to hold them to maturity. Is Entity A in compliance with IPSAS 29?

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held to maturity (HTM) results in the conditions in IPSAS 29.10 and IPSAS 29. AG35 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as available-for-sale financial assets. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under IPSAS 29.60. IPSAS 29.10 makes it clear that at least two full financial years must pass before an entity can again classify financial assets as HTM.

B.19 *Definition of Held-to-Maturity Investments: Sub-Categorization for the Purpose of Applying the "Tainting" Rule*

Can an entity apply the conditions for held-to-maturity classification in IPSAS 29.10 separately to different categories of held-to-maturity financial assets, such as debt instruments denominated in US dollars and debt instruments denominated in euro?

No. The "tainting rule" in IPSAS 29.10 is clear. If an entity has sold or reclassified more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

B.20 *Definition of Held-to-Maturity Investments: Application of the "Tainting" Rule on Consolidation*

Can an entity apply the conditions in IPSAS 29.10 separately to held-to-

maturity financial assets held by different entities in an economic entity, for example, if separate entities are in different countries with different legal or economic environments?

No. If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in IPSAS 29.10 are met.

B.21 *Definition of Loans and Receivables: Equity Instrument*

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes. If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met. IPSAS 27.13–IPSAS 27.27 provide guidance about the classification of a financial instrument as a liability or as an equity instrument from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under IPSAS 28, it cannot be classified within loans and receivables by the holder.

B.22 *Definition of Loans and Receivables: Banks' Deposits in Other Banks*

Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit fall within loans and receivables under IPSAS 29.10?

Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

B.23 *Definition of Amortized Cost: Perpetual Debt Instruments with Fixed or Market-Based Variable Rate*

Sometimes entities purchase or issue debt instruments that are required to be measured at amortized cost and in respect of which the issuer has no obligation to repay the principal amount. Interest may be paid either at a fixed rate or at a variable rate. Would the difference between the initial amount paid or received and zero ("the maturity amount") be amortized immediately on initial recognition for the purpose of determining amortized cost if the rate of interest is fixed or specified as a market-based variable

rate?

No. Since there are no repayments of principal, there is no amortization of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortized cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (IPSAS 29.10).

B.24 *Definition of Amortized Cost: Perpetual Debt Instruments with Decreasing Interest Rate*

If the stated rate of interest on a perpetual debt instrument decreases over time, would amortized cost equal the principal amount in each period?

No. From an economic perspective, some or all of the interest payments are repayments of the principal amount. For example, the interest rate may be stated as 16 percent for the first ten years and as zero percent in subsequent periods. In that case, the initial amount is amortized to zero over the first ten years using the effective interest method, since a portion of the interest payments represents repayments of the principal amount. The amortized cost is zero after year 10 because the present value of the stream of future cash payments in subsequent periods is zero (there are no further cash payments of either principal or interest in subsequent periods).

B.25 *Example of Calculating Amortized Cost: Financial Asset*

Financial assets that are excluded from fair valuation and have a fixed maturity should be measured at amortized cost. How is amortized cost calculated?

Under IPSAS 29, amortized cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortized cost is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a principal amount of CU1,250 and carries fixed interest of 4.7 percent that is paid annually (CU1,250 × 4.7 percent = CU59 per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity

expects the borrower not to prepay.

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 percent annually. The table below provides information about the amortized cost, interest revenue and cash flows of the debt instrument in each reporting period.

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086	109	59	1,136
20X3	1,136	113	59	1,190
20X4	1,190	119	1,250 + 59	–

On the first day of 20X2 the entity revises its estimate of cash flows. It now expects that 50 percent of the principal will be prepaid at the end of 20X2 and the remaining 50 percent at the end of 20X4. In accordance with IPSAS 29.AG20, the opening balance of the debt instrument in 20X2 is adjusted. The adjusted amount is calculated by discounting the amount the entity expects to receive in 20X2 and subsequent years using the original effective interest rate (10 percent). This results in the new opening balance in 20X2 of CU1,138. The adjustment of CU52 (CU1,138 – CU1,086) is recorded in surplus or deficit in 20X2. The table below provides information about the amortized cost, interest revenue and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086 + 52	114	625 + 59	568
20X3	568	57	30	595
20X4	595	60	625 + 30	–

If the debt instrument becomes impaired, say, at the end of 20X3, the impairment loss is calculated as the difference between the carrying amount (CU595) and the present value of estimated future cash flows discounted at the original effective interest rate (10 percent).

B.26 *Example of Calculating Amortized Cost: Debt Instruments with Stepped Interest Payments*

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively ("stepped interest") over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at CU1,250 and has a maturity amount of CU1,250, would the amortized cost equal CU1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount (IPSAS 29.10).

The following example illustrates how amortized cost is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument ("stepped interest").

On January 1, 2000, Entity A issues a debt instrument for a price of CU1,250. The principal amount is CU1,250 and the debt instrument is repayable on December 31, 2004. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 percent in 2000 (CU75), 8.0 percent in 2001 (CU100), 10.0 percent in 2002 (CU125), 12.0 percent in 2003 (CU150), and 16.4 percent in 2004 (CU205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 percent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining amortized cost in each period. In each period, the amortized cost at the beginning of the period is multiplied by the effective interest rate of 10 percent and added to the amortized cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortized cost in each period is as follows:

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost at the end of the year

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost at the end of the year
20X0	1,250	125	75	1,300
20X1	1,300	130	100	1,330
20X2	1,330	133	125	1,338
20X3	1,338	134	150	1,322
20X4	1,322	133	1,250 + 205	–

B.27 *Regular Way Contracts: No Established Market*

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. IPSAS 29.10 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in IPSAS 29.10, is not limited to a formal stock exchange or organized over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.28 *Regular Way Contracts: Forward Contract*

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for CU10 per share. The contract is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.29 *Regular Way Contracts: Which Customary Settlement Provisions Apply?*

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases one million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.30 *Regular Way Contracts: Share Purchase by Call Option*

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.31 *Recognition and Derecognition of Financial Liabilities Using Trade Date or Settlement Date Accounting*

IPSAS 29 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. IPSAS 29 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in IPSAS 29.18 and IPSAS 29.41 apply. IPSAS 29.16 states that financial liabilities are recognized on the date the

entity “becomes a party to the contractual provisions of the instrument.” Such contracts generally are not recognized unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IPSAS 29. IPSAS 29.41 specifies that financial liabilities are derecognized only when they are extinguished, i.e., when the obligation specified in the contract is discharged or cancelled or expires.

Section C: Embedded Derivatives

C.1 *Embedded Derivatives: Separation of Host Debt Instrument*

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the entity makes its own judgment of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of CU40,000 annually and a principal payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid instrument.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid instrument. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid instrument could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid instrument. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 *Embedded Derivatives: Separation of Embedded Option*

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid instrument. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid instrument?

No. The economic behavior of a hybrid instrument with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid instrument) should be based on the stated terms of the option feature documented in the hybrid instrument. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid instrument.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid instrument being exercised generally is not zero, it would be inconsistent with the likely economic behavior of the hybrid instrument to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behavior of the hybrid instrument, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the

option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid instrument. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid instrument, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid instrument.

C.3 *Embedded Derivatives: Accounting for a Convertible Bond*

What is the accounting treatment of an investment in a bond (financial asset) that is convertible into equity instruments of the issuing entity or another entity before maturity?

An investment in a convertible bond that is convertible before maturity generally cannot be classified as a held-to-maturity investment because that would be inconsistent with paying for the conversion feature – the right to convert into equity instruments before maturity.

An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative.

If the bond is classified as available for sale (i.e., fair value changes recognized in net assets/equity until the bond is sold), the equity conversion option (the embedded derivative) is separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognized in surplus or deficit unless the option is part of a cash flow hedging relationship.

If the convertible bond is measured at fair value with changes in fair value recognized in surplus or deficit, separating the embedded derivative from the host bond is not permitted.

C.4 *Embedded Derivatives: Equity Kicker*

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an "equity kicker") in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be.

Assuming that the subordinated loan is not measured at fair value with changes in fair value recognized in surplus or deficit (IPSAS 29.12(c)), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (IPSAS 29.12(a)). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, 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 it is settled at a future date (IPSAS 29.12(b) and IPSAS 29.10(a)). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. IPSAS 29.AG21 states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.5 *Embedded Derivatives: Identifying Debt or Equity Instruments as Host Contracts*

Entity A purchases a five-year "debt" instrument issued by Entity B with a principal amount of CU1 million that is indexed to the share price of Entity C. At maturity, Entity A will receive from Entity B the principal amount plus or minus the change in the fair value of 10,000 shares of Entity C. The current share price is CU110. No separate interest payments are made by Entity B. The purchase price is CU1 million. Entity A classifies the debt instrument as available for sale. Entity A concludes that the instrument is a hybrid instrument with an embedded derivative because of the equity-indexed principal. For the purposes of separating an embedded derivative, is the host contract an equity instrument or a debt instrument?

The host contract is a debt instrument because the hybrid instrument has a stated maturity, i.e., it does not meet the definition of an equity instrument (IPSAS 28.9 and IPSAS 28.14). It is accounted for as a zero coupon debt instrument. Thus, in accounting for the host instrument, Entity A imputes interest on CU1 million over five years using the applicable market interest rate at initial recognition. The embedded non-option derivative is separated so as to have an initial fair value of zero (see Question C.1).

C.6 *Embedded Derivatives: Synthetic Instruments*

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed

interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since IPSAS 29.AG46(a) requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ("synthetic instrument" accounting) for the purpose of applying IPSAS 29. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.5, which had no substance apart from the resulting interest rate swap.

C.7 *Embedded Derivatives: Purchases and Sales Contracts in Foreign Currency Instruments*

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world, and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under IPSAS 29?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contact as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in surplus or deficit unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 *Embedded Foreign Currency Derivatives: Unrelated Foreign Currency Provision*

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IPSAS 29 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (IPSAS 29.4 and IPSAS 29.AG22). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under IPSAS 29.12, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (IPSAS 29.AG46(d)).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from IPSAS 29.AG45(d) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under IPSAS 29.12.

C.9 *Embedded Foreign Currency Derivatives: Currency of International Commerce*

IPSAS 29.AG46(d) refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are

routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.10 *Embedded Derivatives: Holder Permitted, But Not Required, to Settle Without Recovering Substantially all of its Recognized Investment*

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recognized investment and the issuer does not have such a right (e.g., a puttable debt instrument), does the contract satisfy the condition in IPSAS 29.AG46(a) that the holder would not recover substantially all of its recognized investment?

No. The condition that "the holder would not recover substantially all of its recognized investment" is not satisfied if the terms of the combined instrument permit, but do not require, the investor to settle the combined instrument in a manner that causes it not to recover substantially all of its recognized investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that "the holder would not recover substantially all of its recognized investment" applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognized investment.

C.11 *Embedded Derivatives: Reliable Determination of Fair Value*

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No. In this case, the entire combined contract is treated as a financial instrument held for trading (IPSAS 29.14). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The entity might conclude, however, that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment.

Section D: Recognition and Derecognition

D.1 *Initial Recognition*

D.1.1 **Recognition: Cash Collateral**

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (e.g., a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognize the cash collateral it has received as an asset?

Yes. The ultimate realization of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realized by Entity A. Therefore, Entity A recognizes the cash as an asset and a payable to Entity B while Entity B derecognizes the cash and recognizes a receivable from Entity A.

D.2 *Regular Way Purchase or Sale of a Financial Asset*

D.2.1 **Trade Date vs. Settlement Date: Amounts to be Recorded for a Purchase**

How are the trade date and settlement date accounting principles in the Standard applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a purchase of a financial asset. On December 29, 20X1, an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On December 31, 20X1 (financial year-end) and on January 4, 20X2 (settlement date) the fair value of the asset is CU1,002 and CU1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

Settlement Date Accounting			
Balances	**Held-to-maturity investments carried at amortized cost**	**Available-for-sale assets remeasured to fair value with changes in net assets/equity**	**Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit**
December 29, 20X1			
Financial asset	–	–	–

Settlement Date Accounting			
Balances	**Held-to-maturity investments carried at amortized cost**	**Available-for-sale assets remeasured to fair value with changes in net assets/equity**	**Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit**
Financial liability	–	–	–
December 31, 20X1			
Receivable	–	2	2
Financial asset	–	–	–
Financial liability	–	–	–
Net assets/equity (fair value adjustment)	–	(2)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(2)
January 4, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Net assets/equity (fair value adjustment)	–	(3)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(3)

Trade Date Accounting			
Balances	**Held-to-maturity investments carried at amortized cost**	**Available-for-sale assets remeasured to fair value with changes in net assets/equity**	**Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit**
December 29, 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
December 31, 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Net assets/equity (fair value adjustment)	–	(2)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(2)
January 4, 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Net assets/equity (fair value adjustment)	–	(3)	–
Accumulated surplus or deficit (through surplus or deficit)	–	–	(3)

D.2.2 Trade Date vs. Settlement Date: Amounts to be Recorded for a Sale

How are the trade date and settlement date accounting principles in the Standard applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a sale of a financial asset. On December 29, 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its amortized cost is CU1,000. On December 31, 20X2 (financial year-end), the fair value of the asset is CU1,012. On January 4, 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement Date Accounting			
Balances	**Held-to-maturity investments carried at amortized cost**	**Available-for-sale assets remeasured to fair value with changes in net assets/equity**	**Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit**
December 29, 20X2			
Receivable			
Financial asset			
Net assets/equity (fair value adjustment)			

Settlement Date Accounting			
Balances	**Held-to-maturity investments carried at amortized cost**	**Available-for-sale assets remeasured to fair value with changes in net assets/equity**	**Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit**
Accumulated surplus or deficit (through surplus or deficit)			
December 31, 20X2			
Receivable			
Financial asset			
Net assets/equity (fair value adjustment)			
Accumulated surplus or deficit (through surplus or deficit)			
January 4, 20X3			
Net assets/equity (fair value adjustment)			
Accumulated surplus or deficit (through surplus or deficit)			

Trade Date Accounting			
Balances	**Held-to-maturity investments carried at amortized cost**	**Available-for-sale assets remeasured to fair value with changes in net assets/equity**	**Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit**
December 29, 20X2			
Receivable			
Financial asset			
Equity (fair value adjustment)			
Accumulated surplus or deficit (through surplus or deficit)			
December 31, 20X2			
Receivable			
Financial asset			
Net assets/equity (fair value adjustment)			
Accumulated surplus or deficit (through surplus or deficit)			

Trade Date Accounting			
Balances	**Held-to-maturity investments carried at amortized cost**	**Available-for-sale assets remeasured to fair value with changes in net assets/equity**	**Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit**
January 4, 20X3			
Net assets/equity (fair value adjustment)			
Accumulated surplus or deficit (through surplus or deficit)			

D.2.3 Settlement Date Accounting: Exchange of Non-Cash Financial Assets

If an entity recognizes sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognized in accordance with IPSAS 29.66?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under IPSAS 29.66 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognized on the trade date as described in IPSAS 29.AG70. In that case, the entity recognizes a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on December 29, 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is carried at amortized cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both

assets have a fair value of CU1,010 on December, 29, while the amortized cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for loans and receivables and trade date accounting for assets held for trading. On December 31, 20X2 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On January, 4 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

December 29, 20X2

Dr		Bond B	CU1,010	
	Cr	Payable		CU1,010

December 31, 20X2

Dr		Trading loss	CU1	
	Cr	Bond B		CU1

January 4, 20X3

Dr		Payable	CU1,010	
Dr		Trading loss	CU2	
	Cr	Note Receivable A		CU1,000
	Cr	Bond B		CU2
	Cr	Realization gain		CU10

Section E: Measurement

E.1 *Initial Measurement of Financial Assets and Financial Liabilities*

E.1.1 **Initial Measurement: Transaction Costs**

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value

through surplus or deficit. How should this requirement be applied in practice?

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 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.

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.

E.2 *Fair Value Measurement Considerations*

E.2.1 **Fair Value Measurement Considerations for Investment Funds**

IPSAS 29.AG104 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors on the basis of mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets on the basis of mid-market prices?

No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in IPSAS 29.AG104 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund

may wish to provide a reconciliation between the fair values recognized in its statement of financial position and the prices used for the net asset value calculation.

E.2.2 **Fair Value Measurement: Large Holding**

Entity A holds 15 percent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is CU100. Daily trading volume is 0.1 percent of outstanding shares. Because Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price, Entity A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A would be able to obtain a price of CU105, i.e., a 5 percent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

Under IPSAS 29.AG103, a published price quotation in an active market is the best estimate of fair value. Therefore, Entity A uses the published price quotation (CU100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

E.3 *Gains and Losses*

E.3.1 **Available-For-Sale Financial Assets: Exchange of Shares**

Entity A holds a small number of shares in Entity B. The shares are classified as available for sale. On December 20, 20X0, the fair value of the shares is CU120 and the cumulative gain recognized in net assets/equity is CU20. On the same day, Entity B is acquired by Entity C. As a result, Entity A receives shares in Entity C in exchange for those it had in Entity B of equal fair value. Under IPSAS 29.64(b), should Entity A reclassify the cumulative gain of CU20 recognized in net assets/equity to surplus or deficit?

Yes. The transaction qualifies for derecognition under IPSAS 29. IPSAS 29.64(b) requires the cumulative gain or loss on an available-for-sale financial asset that has been recognized in net assets/equity to be recognized in surplus or deficit when the asset is derecognized. In the exchange of shares, Entity A disposes of the shares it had in Entity B and receives shares in Entity C.

E.3.2 **IPSAS 29 and IPSAS 4 Available-For-Sale Financial Assets: Separation of Currency Component**

For an available-for-sale monetary financial asset, the entity recognizes changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit in accordance with IPSAS 4.27(a) and IPSAS 4.32

and other changes in the carrying amount in net assets/equity in accordance with IPSAS 29. How is the cumulative gain or loss that is recognized in net assets/equity determined?

It is the difference between the amortized cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity. For the purpose of applying IPSAS 4.32 the asset is treated as an asset measured at amortized cost in the foreign currency.

To illustrate: on December 31, 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a principal amount of FC1,250, carries fixed interest of 4.7 percent that is paid annually (FC1,250 × 4.7 percent = FC59 per year), and has an effective interest rate of 10 percent. Entity A classifies the bond as available for sale, and thus recognizes gains and losses in net assets/equity. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 (= FC1,000 × 1.5).

Dr		Bond	LC1,500	
	Cr	Cash		LC1,500

On December 31, 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 (= FC1,060 × 2). The amortized cost is FC1,041 (= LC2,082). In this case, the cumulative gain or loss to be recognized and accumulated in net assets/equity is the difference between the fair value and the amortized cost on December 31, 20X2, i.e., LC38 (= LC2,120 – LC2,082).

Interest received on the bond on December 31, 20X2 is FC59 (= LC118). Interest revenue determined in accordance with the effective interest method is FC100 (= 1,000 × 10 percent). The average exchange rate during the year is FC1 to LC1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (IPSAS 4.25). Thus, reported interest revenue is LC175 (= FC100 × 1.75) including accretion of the initial discount of LC72 (= [FC100 – FC59] × 1.75). Accordingly, the exchange difference on the bond that is recognized in surplus or deficit is LC510 (= LC2,082 – LC1,500 – LC72). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.00 – 1.75]).

Dr		Bond	LC620	

Dr		Cash	LC118	
	Cr	Interest revenue		LC175
	Cr	Exchange gain		LC525
	Cr	Fair value change in net assets/equity		LC38

On December 31, 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 (= FC1,070 × 2.50). The amortized cost is FC1,086 (= LC2,715). The cumulative gain or loss to be accumulated in net assets/equity is the difference between the fair value and the amortized cost on December 31, 20X3, i.e., negative LC40 (= LC2,675 – LC2,715). Thus, the amount recognized in net assets/equity equals the change in the difference during 20X3 of LC78 (= LC40 + LC38).

Interest received on the bond on December 31, 20X3 is FC59 (= LC148). Interest revenue determined in accordance with the effective interest method is FC104 (= FC1,041 × 10 percent). The average exchange rate during the year is FC1 to LC2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (IPSAS 4.25). Thus, recognized interest revenue is LC234 (= FC104 × 2.25) including accretion of the initial discount of LC101 (= [FC104 – FC59] × 2.25). Accordingly, the exchange difference on the bond that is recognized in surplus or deficit is LC532 (= LC2,715 – LC2,082 – LC101). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.50 – 2.25]).

Dr		Bond	LC555	
Dr		Cash	LC148	
Dr		Fair value change in net assets/equity	LC78	
	Cr	Interest revenue		LC234
	Cr	Exchange gain		LC547

E.3.3 **IPSAS 29 and IPSAS 4 Exchange Differences Arising on Translation of Foreign Entities: Net Assets/Equity or,**

Surplus or Deficit?

IPSAS 4.37 and IPSAS 4.57 states that all exchange differences resulting from translating the financial statements of a foreign operation should be recognized in net assets/equity until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets classified as at fair value through surplus or deficit and financial assets that are available for sale.

IPSAS 29.64 requires that changes in fair value of financial assets classified as at fair value through surplus or deficit should be recognized in surplus or deficit and changes in fair value of available-for-sale investments should be recognized in net assets/equity.

If the foreign operation is a controlled entity whose financial statements are consolidated with those of its controlling entity, in the consolidated financial statements how are IPSAS 29.64 and IPSAS 4.44 applied?

IPSAS 29 applies in the accounting for financial instruments in the financial statements of a foreign operation and IPSAS 4 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign controlled entity (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under IPSAS 29.

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 (= LCY100 × 2.00) in the consolidated financial statements.

At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognizes the trading asset at LCY110 in its statement of financial position and recognizes a fair value gain of LCY10 in its surplus or deficit. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 (= LCY110 × 3.00) in the currency of Country X. Therefore, Entity A recognizes the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of changes in net assets/equity of B "at the

exchange rates at the dates of the transactions" (IPSAS 4.44(b)). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ([3.00 + 2.00] / 2 = 2.50, in accordance with IPSAS 4.25). Therefore, while the fair value of the trading asset has increased by LCX130 (= LCX330 – LCX200), Entity A recognizes only LCX25 (= LCY10 × 2.5) of this increase in consolidated surplus or deficit to comply with IPSAS 4.44(b). The resulting exchange difference, i.e., the remaining increase in the fair value of the debt instrument (LCX130 – LCX25 = LCX105), is accumulated in net assets/equity until the disposal of the net investment in the foreign operation in accordance with IPSAS 4.57.

E.3.4 IPSAS 29 and IPSAS 4: Interaction between IPSAS 29 and IPSAS 4

IPSAS 29 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in surplus or deficit. IPSAS 4 includes rules about the reporting of foreign currency items and the recognition of exchange differences in surplus or deficit. In what order are IPSAS 4 and IPSAS 29 applied?

Statement of Financial Position

Generally, the measurement of a financial asset or financial liability at fair value, cost or amortized cost is first determined in the foreign currency in which the item is denominated in accordance with IPSAS 29. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IPSAS 4 (IPSAS 29.AG116). For example, if a monetary financial asset (such as a debt instrument) is carried at amortized cost under IPSAS 29, amortized cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognized using the closing rate in the entity's financial statements (IPSAS 4.27). That applies regardless of whether a monetary item is measured at cost, amortized cost or fair value in the foreign currency (IPSAS 4.28). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is carried at fair value in the foreign currency (IPSAS 4.27(c)) and at a historical rate if it is not carried at fair value under IPSAS 29 because its fair value cannot be reliably measured (IPSAS 4.27(b) and IPSAS 29.48).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IPSAS 29, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognized using a historical rate under IPSAS 4 (IPSAS 29.99), i.e., the foreign currency amount is recognized using the closing rate. This exception applies to non-monetary items that are

carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (IPSAS 4.27(b)).

Surplus or Deficit

The recognition of a change in the carrying amount of a financial asset or financial liability in surplus or deficit depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (e.g., most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognizing changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognizing a monetary item at a rate different from that at which it was initially recognized during the period, or recognized in previous financial statements, is recognized in surplus or deficit or in net assets/equity in accordance with IPSAS 4 (IPSAS 29.AG116, IPSAS 4.32 and IPSAS 4.37), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges in IPSAS 29 apply IPSAS 29.106). Differences arising from recognizing a monetary item at a foreign currency amount different from that at which it was previously recognized are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognized in surplus or deficit or in net assets/equity in accordance with IPSAS 29. For example, although an entity recognizes gains and losses on available-for-sale monetary financial assets in net assets/equity (IPSAS 29.64(b)), the entity nevertheless recognizes the changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit (IPSAS 4.27(a)).

Any changes in the carrying amount of a non-monetary item are recognized in surplus or deficit or in net assets/equity in accordance with IPSAS 29 (IPSAS 29.AG116). For example, for available-for-sale financial assets the entire change in the carrying amount, including the effect of changes in foreign currency rates, is recognized in net assets/equity. If the non-monetary item is designated as a cash flow hedge of an unrecognized firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in IPSAS 29 apply (IPSAS 29.106).

When some portion of the change in carrying amount is recognized in net

assets/equity and some portion is recognized in surplus or deficit, for example, if the amortized cost of a foreign currency bond classified as available for sale has increased in foreign currency (resulting in a gain in surplus or deficit) but its fair value has decreased in the functional currency (resulting in a loss recognized in net assets/equity), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognized in surplus or deficit or in net assets/equity.

E.4 *Impairment and Uncollectibility of Financial Assets*

E.4.1 **Objective Evidence of Impairment**

Does IPSAS 29 require that an entity be able to identify a single, distinct past causative event to conclude that it is probable that an impairment loss on a financial asset has been incurred?

No. IPSAS 29.68 states "It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment." Also, IPSAS 29.69 states that "a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information." Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

E.4.2 **Impairment: Future Losses**

Does IPSAS 29 permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Entity A lends CU1,000 to Customer B, can it recognize an immediate impairment loss of CU10 if Entity A, based on historical experience, expects that 1 percent of the principal amount of loans given will not be collected?

No. IPSAS 29.45 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, IPSAS 29.67 requires that an impairment loss is recognized only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with IPSAS 29.45 and IPSAS 29.67 to reduce the carrying amount of a loan

asset on initial recognition through the recognition of an immediate impairment loss.

E.4.3 **Assessment of Impairment: Principal and Interest**

Because of Customer B's financial difficulties, Entity A is concerned that Customer B will not be able to make all principal and interest payments due on a loan in a timely manner. It negotiates a restructuring of the loan. Entity A expects that Customer B will be able to meet its obligations under the restructured terms. Would Entity A recognize an impairment loss if the restructured terms are as reflected in any of the following cases?

(a) **Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.**

(b) **Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.**

(c) **Customer B will pay the full principal amount of the original loan on the original due date with interest only at a lower interest rate than the interest rate inherent in the original loan.**

(d) **Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.**

(e) **Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.**

IPSAS 29.67 indicates that an impairment loss has been incurred if there is objective evidence of impairment. The amount of the impairment loss for a loan measured at amortized cost is the difference between the carrying amount of the loan and the present value of future principal and interest payments discounted at the loan's original effective interest rate. In cases (a)–(d) above, the present value of the future principal and interest payments discounted at the loan's original effective interest rate will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognized in those cases.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan's original effective interest rate will

equal the carrying amount of the loan. Therefore, there is no impairment loss. However, this fact pattern is unlikely given Customer B's financial difficulties.

E.4.4 Assessment of Impairment: Fair Value Hedge

A loan with fixed interest rate payments is hedged against the exposure to interest rate risk by a receive-variable, pay-fixed interest rate swap. The hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. Should an assessment of impairment in the loan take into account the fair value adjustment for interest rate risk?

Yes. The loan's original effective interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, the original effective interest rate and amortized cost of the loan are adjusted to take into account recognized fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan.

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the estimated future cash flows of the loan discounted at the adjusted effective interest rate. When a loan is included in a portfolio hedge of interest rate risk, the entity should allocate the change in the fair value of the hedged portfolio to the loans (or groups of similar loans) being assessed for impairment on a systematic and rational basis.

E.4.5 Impairment: Provision Matrix

An entity calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix that specifies fixed provision rates for the number of days a loan has been classified as non-performing (zero percent if less than 90 days, 20 percent if 90–180 days, 50 percent if 181–365 days and 100 percent if more than 365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables under IPSAS 29.72?

Not necessarily. IPSAS 29.72 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

E.4.6 Impairment: Excess Losses

Does IPSAS 29 permit an entity to recognize impairment or bad debt losses

in excess of impairment losses that are determined on the basis of objective evidence about impairment in identified individual financial assets or identified groups of similar financial assets?

No. IPSAS 29 does not permit an entity to recognize impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics (IPSAS 29.73) on the basis of objective evidence about the existence of impairment in those assets (IPSAS 29.67). Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognized as impairment or bad debt losses under IPSAS 29. However, if an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics (IPSAS 29.73).

E.4.7 Recognition of Impairment on a Portfolio

IPSAS 29.72 requires that impairment be recognized for financial assets carried at amortized cost. IPSAS 29.73 states that impairment may be measured and recognized individually or on a portfolio basis for a group of similar financial assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortized cost, does IPSAS 29 allow non-recognition of the impairment of the first asset?

No. If an entity knows that an individual financial asset carried at amortized cost is impaired, IPSAS 29.72 requires that the impairment of that asset should be recognized. It states: “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” (emphasis added). Measurement of impairment on a portfolio basis under IPSAS 29.73 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

E.4.8 Impairment: Recognition of Collateral

If an impaired financial asset is secured by collateral that does not meet the recognition criteria for assets in other Standards, is the collateral recognized as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral is not recognized as an asset separate from the

impaired financial asset unless it meets the recognition criteria for an asset in another Standard.

E.4.9 Impairment of Non-Monetary Available-For-Sale Financial Asset

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses recognized in net assets/equity becomes impaired, should the cumulative net loss recognized in net assets/equity, including any portion attributable to foreign currency changes, be reclassified from net assets/equity to surplus or deficit as a reclassification adjustment?

Yes. IPSAS 29.76 states that when a decline in the fair value of an available-for-sale financial asset has been recognized in net assets/equity and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognized in net assets/equity should be recognized in surplus or deficit even though the asset has not been derecognized. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognized in net assets/equity is also recognized in surplus or deficit. Any subsequent losses, including any portion attributable to foreign currency changes, are also recognized in surplus or deficit until the asset is derecognized.

E.4.10 Impairment: Whether the Available-For-Sale Reserve in Net Assets/Equity can be Negative

IPSAS 29 requires that gains and losses arising from changes in fair value on available-for-sale financial assets are recognized in net assets/equity. If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognized in net assets/equity be recognized in surplus or deficit?

Not necessarily. The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired. An entity assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of assets may be impaired, in accordance with IPSAS 29.68–70. IPSAS 29.69 states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. Additionally, a decline in the fair value of a financial asset below its cost or amortized cost is not necessarily evidence of impairment (e.g., a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

Section F: Hedging

F.1 *Hedging Instruments*

F.1.1 Hedging the Fair Value Exposure of a Bond Denominated in a Foreign Currency

Entity J, whose functional currency is the Japanese yen, has issued 5 million five-year US dollar fixed rate debt. Also, it owns a 5 million five-year fixed rate US dollar bond which it has classified as available for sale. Can Entity J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No. IPSAS 29.81 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Entity J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

Alternatively, can the US dollar liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

Yes. However, hedge accounting is unnecessary because the amortized cost of the hedging instrument and the hedged item are both remeasured using closing rates. Regardless of whether Entity J designates the relationship as a cash flow hedge or a fair value hedge, the effect on surplus or deficit is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognized in surplus or deficit to correspond with the recognition of the change in spot rate on the hedged item in surplus or deficit as required by IPSAS 4.

F.1.2 Hedging with a Non-Derivative Financial Asset or Liability

Entity J's functional currency is the Japanese yen. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of 5 million US dollars. It has also entered into a fixed price sales commitment for 5 million US dollars that matures in two years and is not accounted for as a derivative because it meets the exemption for normal sales in paragraph 4. Can Entity J designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting?

No. IPSAS 29.81 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk.

Alternatively, can Entity J designate its US dollar liability as a cash flow hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment?

Yes. IPSAS 29 permits the designation of a non-derivative asset or liability as a hedging instrument in either a cash flow hedge or a fair value hedge of the exposure to changes in foreign exchange rates of a firm commitment (IPSAS 29.97). Any gain or loss on the non-derivative hedging instrument that is recognized in net assets/equity during the period preceding the future sale is recognized in surplus or deficit when the sale takes place (IPSAS 29.106).

Alternatively, can Entity J designate the sales commitment as the hedging instrument instead of the hedged item?

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under IPSAS 29.12 and IPSAS 29.AG46, it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

F.1.3 Hedge Accounting: Use of Written Options in Combined Hedging Instruments

Issue (a) – Does IPSAS 29.AG127 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because IPSAS 29.AG127 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) – What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

(a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.

(b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are

the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

F.1.4 Internal Hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different entities within an economic entity or divisions within a single legal entity. Does IPSAS 29.82 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. IPSAS 29 does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial statements for hedging transactions within an economic entity, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in IPSAS 35.40 requires that a controlling entity "Eliminate in full intra-economic entity assets and liabilities, net assets/equity, revenue, expenses and cash flows relating to transactions between entities of the economic entity".

On the other hand, hedging transaction within an economic entity may be designated as a hedge in the individual or separate financial statements of an individual entity, if the transaction is an external transaction from the perspective of the economic entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarizes the application of IPSAS 29 to internal hedging transactions.

- IPSAS 29 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.
- Internal derivative contracts between two separate entities within an economic entity can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the economic entity.
- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or

separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.

- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the economic entity can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the economic entity.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by individual entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the treasury division of Entity A enters into an internal interest rate swap with another division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the treasury division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, IPSAS 29 does not allow hedge accounting treatment for the hedging transaction undertaken by the treasury and other divisions. IPSAS 29.82 indicates that only derivatives that involve a party external to the entity can be designated as hedging instruments and, further, that any gains or losses on transactions within an economic entity or within individual entities should be eliminated on consolidation. Therefore, transactions between different divisions within Entity A do not qualify for hedge accounting treatment in the financial statements of Entity A. Similarly, transactions between different entities within an economic entity do not qualify for hedge accounting treatment in consolidated financial statements.

However, if in addition to the internal swap in the above example the trading division enters into an interest rate swap or other contract with an external party that offsets the exposure hedged in the internal swap, hedge accounting is permitted under IPSAS 29. For the purposes of IPSAS 29, the hedged item is the loan (or group of similar loans) in the treasury division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions of them that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under IPSAS 29, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the treasury division are identified and the other conditions for hedge accounting are met. It should be noted, however, that IPSAS 29.88 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

F.1.5 Offsetting Internal Derivative Contracts Used to Manage Interest Rate Risk

If a central treasury function enters into internal derivative contracts with controlled entities and various divisions within the economic entity to manage interest rate risk on a centralized basis, can those contracts qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts?

No. An internal contract designated at the controlled entity level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in surplus or deficit (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in net assets/equity (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There is also no basis for recognizing the gain or loss on the internal derivative in net assets/equity for one entity and recognizing it in surplus or deficit by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the controlled entity or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the controlled entity or division levels would be used to offset each other on consolidation. Accordingly, since IPSAS 29.81 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the controlled entity or division level that are not laid off with external parties must be reversed on consolidation.

It should be noted, however, that there will be no effect on surplus or deficit and net assets/equity of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at the controlled entity or division level and, in the case of cash flow hedges, where the hedged items affect surplus or deficit in the same period. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognized in surplus or deficit, and their use as cash flow hedges by two separate entities or divisions within the economic entity will also result in the fair value amounts being offset against each other in net assets/equity. However, there may be an effect on individual line items in both the consolidated statement of changes in net assets/equity and the consolidated statement of financial

position, for example when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognized in a different line item in the statement of financial position or statement of changes in net assets/equity. In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, gains and losses recognized would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognized in surplus or deficit and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognized in net assets/equity.

Question F.1.4 describes the application of IPSAS 29 to internal hedging transactions.

F.1.6 Offsetting Internal Derivative Contracts Used to Manage Foreign Currency Risk

If a central treasury function enters into internal derivative contracts with controlled entities and various divisions within the economic entity to manage foreign currency risk on a centralized basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. IPSAS 35 requires all internal transactions to be eliminated in consolidated financial statements. As stated in IPSAS 29.82, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the economic entity. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the controlled entity or division level and are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on surplus or deficit or net assets/equity if (a) the internal derivatives are used in the same type of hedge relationship (i.e., fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognized in net assets/equity are recognized in surplus or deficit in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognized in surplus or deficit or in net assets/equity will offset on consolidation resulting in the same

surplus or deficit and net assets/equity as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of changes in net assets/equity, and the consolidated statement of financial position, that would need to be eliminated. In addition, there is an effect on surplus or deficit and net assets/equity if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on surplus or deficit and net assets/equity for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognized in net assets/equity are recognized in surplus or deficit in different periods (because the hedged items affect surplus or deficit in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because IPSAS 29.81 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognized firm commitments. This is because an unrecognized firm commitment or forecast transaction does not qualify as a hedging instrument under IPSAS 29. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements. As a result, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an asset or liability (basis adjustment) or recognized in net assets/equity would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument.

F.1.7 **Internal Derivatives: Examples of Applying Question F.1.6**

In each case, FC = foreign currency, LC = local currency (which is the entity's functional currency), and TC = treasury center.

Case 1: Offset of Fair Value Hedges

Controlled Entity A has trade receivables of FC100, due in 60 days, which it

hedges using a forward contract with TC. Controlled Entity B has payables of FC50, also due in 60 days, which it hedges using a forward contact with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive LC in 60 days.

At the end of month 1, FC weakens against LC. A incurs a foreign exchange loss of LC10 on its receivables, offset by a gain of LC10 on its forward contract with TC. B makes a foreign exchange gain of LC5 on its payables offset by a loss of LC5 on its forward contract with TC. TC makes a loss of LC10 on its internal forward contract with A, a gain of LC5 on its internal forward contract with B, and a gain of LC5 on its external forward contract.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries

Dr		Foreign exchange loss	LC10	
	Cr	Receivables		LC10
Dr		*Internal contract TC*	*LC10*	
	Cr	*Internal gain TC*		*LC10*

B's entries

Dr		Payables	LC5	
	Cr	Foreign exchange gain		LC5
Dr		*Internal loss TC*	*LC5*	
	Cr	*Internal contract TC*		*LC5*

TC's entries

Dr		*Internal loss A*	*LC10*	
	Cr	*Internal contract A*		*LC10*

Dr		*Internal contract B*	*LC5*	
	Cr	*Internal gain B*		*LC5*
Dr		External forward contract	LC5	
	Cr	Foreign exchange gain		LC5

Both A and B could apply hedge accounting in their individual financial statements provided all conditions in IPSAS 29 are met. However, in this case, no hedge accounting is required because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognized immediately in surplus or deficit of A and B without hedge accounting.

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, the payable in B hedges FC50 of the receivables in A. The external forward contract in TC hedges the remaining FC50 of the receivable in A. Hedge accounting is not necessary in the consolidated financial statements because monetary items are measured at spot foreign exchange rates under IPSAS 4 irrespective of whether hedge accounting is applied.

The net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IPSAS 29.

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
External forward contract	LC5	–
Gains and losses	–	–
Internal contracts	–	–

Case 2: Offset of Cash Flow Hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future

expenses of FC500 (rental for offices), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a “loss” of LC20 on its anticipated revenues because the LC value of these revenues decreases. This is offset by a “gain” of LC20 on its forward contract with TC.

B incurs a “gain” of LC50 on its anticipated advertising cost because the LC value of the expense decreases. This is offset by a “loss” of LC50 on its transaction with TC.

TC incurs a “gain” of LC50 on its internal transaction with B, a “loss” of LC20 on its internal transaction with A and a loss of LC30 on its external forward contract.

A and B complete the necessary documentation, the hedges are effective, and both A and B qualify for hedge accounting in their individual financial statements. A recognizes the gain of LC20 on its internal derivative transaction in net assets/equity and B recognizes the loss of LC50 in net assets/equity. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A’s entries

Dr		*Internal contract TC*	*LC20*	
	Cr	*Net assets/equity*		*LC20*

B’s entries

Dr		*Net assets/equity*	*LC50*	
	Cr	*Internal contract TC*		*LC50*

TC’s entries

Dr		*Internal loss A*	*LC20*	

	Cr	*Internal contract Cr A*		*LC20*
Dr		*Internal contract B*	*LC50*	
	Cr	*Internal gain B*		*LC50*
Dr		Foreign exchange loss	LC30	
	Cr	External forward contract		LC30

For the consolidated financial statements, TC's external forward contract on FC300 is designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. IPSAS 29 requires that in the consolidated financial statements at the end of month 1, the accounting effects of the internal derivative transactions must be eliminated.

However, the net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries in order for the requirements of IPSAS 29 to be met.

	Debit	*Credit*
External forward contract	–	LC30
Net assets/equity	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 3: Offset of Fair Value and Cash Flow Hedges

Assume that the exposures and the internal derivative transactions are the same as in cases 1 and 2. However, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for LC in 90 days.

TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential between FC and LC is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a

minimal effect on surplus or deficit in TC.

As in cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A recognizes a gain of LC20 on its internal derivative transaction in net assets/equity and B recognizes a loss of LC50 on its internal derivative transaction in net assets/equity.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries

Dr		Foreign exchange loss	LC10	
	Cr	Receivables		LC10
Dr		*Internal contract TC*	*LC10*	
	Cr	*Internal gain TC*		*LC10*
Dr		*Internal contract TC*	*LC20*	
	Cr	*Net assets/equity*		*LC20*

B's entries

Dr		Payables	LC5	
	Cr	Foreign exchange gain		LC5
Dr		*Internal loss TC*	*LC5*	
	Cr	*Internal contract TC*		*LC5*
Dr		*Net assets/equity*	*LC50*	
	Cr	*Internal contract TC*		*LC50*

TC's entries

Dr		*Internal loss A*	*LC10*	
	Cr	*Internal contract A*		*LC10*
Dr		*Internal loss A*	*LC20*	
	Cr	*Internal contract A*		*LC20*
Dr		*Internal contract B*	*LC5*	
	Cr	*Internal gain B*		*LC5*
Dr		*Internal contract B*	*LC50*	
	Cr	*Internal gain B*		*LC50*
Dr		Foreign exchange loss	LC25	
	Cr	External forward contract		LC25

TOTAL (for the internal derivatives)	**A**	**B**	**Total**
	LC	*LC*	*TC*
Surplus or deficit (fair value hedges)	10	(5)	5
Net assets/equity (cash flow hedges)	20	(50)	(30)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e., those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	Debit	*Credit*
Receivables	–	LC10

Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	LC30	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable LC5; Cr Net assets/equity LC5;
- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC10; Cr Receivable LC10; and
- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC25; Cr External forward contract LC25.

In the consolidated financial statements at the end of month 1, IPSAS 29 requires the accounting effects of the internal derivative transactions to be eliminated.

However, the total net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IPSAS 29.

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	LC30	–

Gains and losses	–	–
Internal contracts	–	–

Case 4: Offset of Fair Value and Cash Flow Hedges with Adjustment to Carrying Amount of Inventory

Assume similar transactions as in case 3, except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. Assume also that the entity has a policy of basis-adjusting hedged forecast non-financial items. At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of LC50 on B's internal derivative, recognized in net assets/equity in month 1, is adjusted against the carrying amount of inventory in B. The gain of LC20 on A's internal derivative is recognized in net assets/equity as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and a proportion of the receivable (FC50) offset FC300 of the anticipated inventory purchase. There is a natural hedge between the remaining FC200 of anticipated cash outflow in B and the anticipated cash inflow of FC200 in A. This relationship does not qualify for hedge accounting under IPSAS 29 and this time there is only a partial offset between gains and losses on the internal derivatives that hedge these amounts.

At the end of months 1 and 2, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries (all at the end of month 1)

Dr		Foreign exchange loss	LC10	
	Cr	Receivables		LC10
Dr		*Internal contract TC*	*LC10*	
	Cr	*Internal gain TC*		*LC10*
Dr		*Internal contract TC*	*LC20*	
	Cr	*Net assets/equity*		*LC20*

B's entries

At the end of month 1:				
Dr		Payables	LC5	
	Cr	Foreign exchange gain		LC5
Dr		*Internal loss TC*	*LC5*	
	Cr	*Internal contract TC*		*LC5*
Dr		*Net assets/equity*	*LC50*	
	Cr	*Internal contract TC*		*LC50*

At the end of month 2:				
Dr		Inventory	LC50	
	Cr	Net assets/equity		LC50

TC's entries (all at the end of month 1)

Dr		*Internal loss A*	*LC10*	
	Cr	*Internal contract A*		*LC10*
Dr		*Internal loss A*	*LC20*	
	Cr	*Internal contract A*		*LC20*
Dr		*Internal contract B*	*LC5*	
	Cr	*Internal gain B*		*LC5*

Dr		*Internal contract B*	*LC50*	
	Cr	*Internal gain B*		*LC50*
Dr		Foreign exchange loss	LC25	
	Cr	Forward		LC25

TOTAL (for the internal derivatives)	*A*	*B*	*Total*
	LC	*LC*	*TC*
Surplus or deficit (fair value hedges)	10	(5)	5
Net assets/equity (cash flow hedges)	20	–	20
Basis adjustment (inventory)	–	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e., those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	–	LC20
Basis adjustment (inventory)	LC50	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at

the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Payables LC5; Cr Net assets/equity LC5.
- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC10; Cr Receivable LC10; and at the end of month 2, Dr Inventory LC10; Cr Net assets/equity LC10.
- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Net assets/equity LC25; Cr External forward contract LC25; and at the end of month 2, Dr Inventory LC25; Cr Net assets/equity LC25.

The total net balances after elimination of the accounting entries relating to the internal derivatives are as follows:

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	–	LC5
Basis adjustment (inventory)	LC35	–
Gains and losses	–	–
Internal contracts	–	–

These total net balances are different from those that would be recognized if the internal derivatives were not eliminated, and it is these net balances that IPSAS 29 requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances before elimination of the internal derivatives are as follows:

(a) To reclassify LC15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not

hedged by an external instrument (neither the external forward contract of FC250 in TC nor the external payable of FC100 in A); and

(b) To reclassify the gain of LC15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

Dr		Net assets/equity	LC15	
	Cr	Inventory		LC15

F.1.8 Combination of Written and Purchased Options

In most cases, IPSAS 29.AG127 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with one counterparty, can an entity split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No. IPSAS 29.83 specifies that a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question F.1.3 addresses the issue of whether and when a combination of options is considered as a written option.

F.1.9 Delta-Neutral Hedging Strategy

Does IPSAS 29 permit an entity to apply hedge accounting for a "delta-neutral" hedging strategy and other dynamic hedging strategies under which the quantity of the hedging instrument is constantly adjusted in order to maintain a desired hedge ratio, for example, to achieve a delta-neutral position insensitive to changes in the fair value of the hedged item?

Yes. IPSAS 29.83 states that "a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting." For example, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that

all other criteria for hedge accounting in IPSAS 29.98 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

F.1.10 Hedging Instrument: Out of the Money Put Option

Entity A has an investment in one share of Entity B, which it has classified as available for sale. To give itself partial protection against decreases in the share price of Entity B, Entity A acquires a put option on one share of Entity B and designates the change in the intrinsic value of the put as a hedging instrument in a fair value hedge of changes in the fair value of its share in Entity B. The put gives Entity A the right to sell one share of Entity B at a strike price of CU90. At the inception of the hedging relationship, the share has a quoted price of CU100. Since the put option gives Entity A the right to dispose of the share at a price of CU90, the put should normally be fully effective in offsetting price declines below CU90 on an intrinsic value basis. Price changes above CU90 are not hedged. In this case, are changes in the fair value of the share of Entity B for prices above CU90 regarded as hedge ineffectiveness under IPSAS 29.98 and recognized in surplus or deficit under IPSAS 29.99?

No. IPSAS 29.83 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument. The changes in the intrinsic value of the option provide protection against the risk of variability in the fair value of one share of Entity B below or equal to the strike price of the put of CU90. For prices above CU90, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on one share of Entity B for prices above CU90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognizing gains and losses on the hedged item.

Therefore, Entity A recognizes changes in the fair value of the share in net assets/equity if it is associated with variation in its price above CU90 (IPSAS 29.64 and IPSAS 29.101). Changes in the fair value of the share associated with price declines below CU90 form part of the designated fair value hedge and are recognized in surplus or deficit under IPSAS29.99(b). Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognized in surplus or deficit (IPSAS 29.99(a)). Changes in the time value of the put are excluded from the designated hedging relationship and recognized in surplus or deficit under IPSAS 29.65(a).

F.1.11 Hedging Instrument: Proportion of the Cash Flows of a Cash Instrument

In the case of foreign exchange risk, a non-derivative financial asset or

non-derivative financial liability can potentially qualify as a hedging instrument. Can an entity treat the cash flows for specified periods during which a financial asset or financial liability that is designated as a hedging instrument remains outstanding as a proportion of the hedging instrument under IPSAS 29.84, and exclude the other cash flows from the designated hedging relationship?

No. IPSAS 29.84 indicates that a hedging relationship may not be designated for only a portion of the time period in which the hedging instrument is outstanding. For example, the cash flows during the first three years of a ten-year borrowing denominated in a foreign currency cannot qualify as a hedging instrument in a cash flow hedge of the first three years of revenue in the same foreign currency. On the other hand, a non-derivative financial asset or financial liability denominated in a foreign currency may potentially qualify as a hedging instrument in a hedge of the foreign currency risk associated with a hedged item that has a remaining time period until maturity that is equal to or longer than the remaining maturity of the hedging instrument (see Question F.2.17).

F.1.12 Hedges of More Than One Type of Risk

Issue (a) – Normally a hedging relationship is designated between an entire hedging instrument and a hedged item so that there is a single measure of fair value for the hedging instrument. Does this preclude designating a single financial instrument simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge?

No. For example, entities commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. IPSAS 29.85 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in IPSAS 29.85 are met.

Issue (b) – If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

IPSAS 30.25 requires disclosures separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. The instrument in question would be reported in the IPSAS 30.25 disclosures separately for each type of hedge.

F.1.13 Hedging Instrument: Dual Foreign Currency Forward Exchange Contract

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a ten-year fixed rate pound sterling-denominated note receivable. The principal amounts of the asset and

liability when converted into the Japanese yen are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pounds sterling at the end of five years. If Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments, can it qualify for hedge accounting?

Yes. IPSAS 29.85 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows.

(a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and yen, and yen and pounds, respectively.

(b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward protects it for only the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question F.2.17.

(c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

F.1.14 Concurrent Offsetting Swaps and Use of One as a Hedging Instrument

Entity A enters into an interest rate swap and designates it as a hedge of the fair value exposure associated with fixed rate debt. The fair value hedge meets the hedge accounting criteria of IPSAS 29. Entity A simultaneously enters into a second interest rate swap with the same swap counterparty that has terms that fully offset the first interest rate swap. Is Entity A required to view the two swaps as one unit and therefore precluded from applying fair value hedge accounting to the first swap?

It depends. IPSAS 29 is transaction-based. If the second swap was not entered into in contemplation of the first swap or there is a substantive business purpose for structuring the transactions separately, then the swaps are not viewed as one

unit.

For example, some entities have a policy that requires a centralized treasury (which is a controlled entity in an economic entity) enter into third-party derivative contracts on behalf of other controlled entities within the organization to hedge the controlled entities' interest rate risk exposures. The treasury also enters into internal derivative transactions with those controlled entities in order to track those hedges operationally within the organization. Because the treasury also enters into derivative contracts as part of its trading operations, or because it may wish to rebalance the risk of its overall portfolio, it may enter into a derivative contract with the same third party during the same business day that has substantially the same terms as a contract entered into as a hedging instrument on behalf of another controlled entity. In this case, there is a valid business purpose for entering into each contract.

Judgment is applied to determine whether there is a substantive business purpose for structuring the transactions separately. For example, if the sole purpose is to obtain fair value accounting treatment for the debt, there is no substantive business purpose.

F.2 *Hedged Items*

F.2.1 **Whether a Derivative can be Designated as a Hedged Item**

Does IPSAS 29 permit designating a derivative instrument (whether a stand-alone or separately recognized embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognized in surplus or deficit unless they are designated and effective hedging instruments (IPSAS 29.10). As an exception, IPSAS 29.AG127 permits the designation of a purchased option as the hedged item in a fair value hedge.

F.2.2 **Cash Flow Hedge: Anticipated Issue of Fixed Rate Debt**

Is hedge accounting allowed for a hedge of an anticipated issue of fixed rate debt?

Yes. This would be a cash flow hedge of a highly probable forecast transaction that will affect surplus or deficit (IPSAS 29.96) provided that the conditions in IPSAS 29.98 are met.

To illustrate: Entity R periodically issues new bonds to refinance maturing bonds,

provide working capital and for various other purposes. When Entity R decides it will be issuing bonds, it may hedge the risk of changes in the long-term interest rate from the date it decides to issue the bonds to the date the bonds are issued. If long-term interest rates go up, the bond will be issued either at a higher rate or with a higher discount or smaller premium than was originally expected. The higher rate being paid or decrease in proceeds is normally offset by the gain on the hedge. If long-term interest rates go down, the bond will be issued either at a lower rate or with a higher premium or a smaller discount than was originally expected. The lower rate being paid or increase in proceeds is normally offset by the loss on the hedge.

For example, in August 2000 Entity R decided it would issue CU200 million seven-year bonds in January 2001. Entity R performed historical correlation studies and determined that a seven-year treasury bond adequately correlates to the bonds Entity R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Entity R hedged the anticipated issue of the bonds by selling (shorting) CU186 million worth of futures on seven-year treasury bonds. From August 2000 to January 2001 interest rates increased. The short futures positions were closed in January 2001, the date the bonds were issued, and resulted in a CU1.2 million gain that will offset the increased interest payments on the bonds and, therefore, will affect surplus or deficit over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecast issue of debt.

F.2.3 **Hedge Accounting: Core Deposit Intangibles**

Is hedge accounting treatment permitted for a hedge of the fair value exposure of core deposit intangibles?

It depends on whether the core deposit intangible is generated internally or acquired (e.g., as part of a public sector combination).

Internally generated core deposit intangibles are not recognized as intangible assets under IPSAS 31, *Intangible Assets*. Because they are not recognized, they cannot be designated as a hedged item.

If a core deposit intangible is acquired together with a related portfolio of deposits, the core deposit intangible is required to be recognized separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in IPSAS 31. A recognized core deposit intangible asset could be designated as a hedged item, but only if it meets the conditions in paragraph 98, including the requirement in paragraph 98 that the effectiveness of the hedge can be measured reliably. Because it is often difficult to measure reliably the fair value of a core deposit intangible asset other than on initial recognition, it is unlikely that the requirement in paragraph 98(d) will be met.

F.2.4 Hedge Accounting: Hedging of Future Foreign Currency Revenue Streams

Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable. Under IPSAS 29.96(b) a hedge of an anticipated sale may qualify as a cash flow hedge. For example, an entity which owns and operates a cross-border toll road may use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are "highly probable," as required by IPSAS 29.98, it may designate a currency borrowing as a cash flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognized in net assets/equity until the revenues occur.

It is unlikely that an entity can reliably predict 100 percent of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the "highly probable" criterion.

F.2.5 Cash Flow Hedges: "All in One" Hedge

If a derivative instrument is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price, can the derivative instrument be designated as the hedging instrument in a cash flow hedge of that gross settlement assuming the other cash flow hedge accounting criteria are met?

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative. This applies to all fixed price contracts that are accounted for as derivatives under IPSAS 29.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under IPSAS 29 (e.g., because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin), the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, if an entity enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a

derivative because its term exceeds the regular way delivery period in the marketplace, the entity may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired.

F.2.6 Hedge Relationships: Entity-Wide Risk

An entity has a fixed rate asset and a fixed rate liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset and designates the interest rate swap as a fair value hedge of the fixed rate asset. Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Yes. IPSAS 29 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure to interest rate increases that is offset by the interest rate swap.

F.2.7 Cash Flow Hedge: Forecast Transaction Related to an Entity's Net Assets/Equity

Can a forecast transaction in the entity's own equity instruments or forecast dividend or similar payments to owners be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecast transaction must expose the entity to a particular risk that can affect surplus or deficit (IPSAS 29.96). The classification of financial instruments as liabilities or net assets/equity generally provides the basis for determining whether transactions or other payments relating to such instruments are recognized in surplus or deficit IPSAS 28. For example, distributions to holders of an equity instrument are debited by the issuer directly to net assets/equity (IPSAS 28.40). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend or similar distribution that has not yet been paid and is recognized as a financial liability may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.

F.2.8 Hedge Accounting: Risk of a Transaction Not Occurring

Does IPSAS 29 permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall operational risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognized assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (IPSAS 29.96).

F.2.9 Held-to-Maturity Investments: Hedging Variable Interest Rate Payments

Can an entity designate a pay-variable, receive-fixed interest rate swap as a cash flow hedge of a variable rate, held-to-maturity investment?

No. It is inconsistent with the designation of a debt investment as being held to maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. IPSAS 29.88 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk "because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates."

F.2.10 Hedged Items: Purchase of Held-to-Maturity Investment

An entity forecasts the purchase of a financial asset that it intends to classify as held to maturity when the forecast transaction occurs. It enters into a derivative contract with the intent to lock in the current interest rate and designates the derivative as a hedge of the forecast purchase of the financial asset. Can the hedging relationship qualify for cash flow hedge accounting even though the asset will be classified as a held-to-maturity investment?

Yes. With respect to interest rate risk, IPSAS 29 prohibits hedge accounting for financial assets that are classified as held-to-maturity (IPSAS 29.88). However, even though the entity intends to classify the asset as held to maturity, the instrument is not classified as such until the transaction occurs.

F.2.11 Cash Flow Hedges: Reinvestment of Funds Obtained from Held-to-Maturity Investments

An entity owns a variable rate asset that it has classified as held to maturity. It enters into a derivative contract with the intention to lock in the

current interest rate on the reinvestment of variable rate cash flows, and designates the derivative as a cash flow hedge of the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on the held-to-maturity asset. Assuming that the other hedge accounting criteria are met, can the hedging relationship qualify for cash flow hedge accounting even though the interest payments that are being reinvested come from an asset that is classified as held to maturity?

Yes. IPSAS 29.88 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question F.2.8 specifies that this applies not only to fair value hedges, i.e., hedges of the exposure to fair value interest rate risk associated with held-to-maturity investments that pay fixed interest, but also to cash flow hedges, i.e., hedges of the exposure to cash flow interest rate risk associated with held-to-maturity investments that pay variable interest at current market rates. However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecast future interest receipts on debt instruments resulting from the forecast reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecast to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

F.2.12 Hedge Accounting: Prepayable Financial Asset

If the issuer has the right to prepay a financial asset, can the investor designate the cash flows after the prepayment date as part of the hedged item?

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are “highly probable” (IPSAS 29.98). For example, cash flows after the prepayment date may qualify as highly probable if they result from a group or pool of similar assets (e.g., mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

F.2.13 Fair Value Hedge: Risk That Could Affect Surplus or Deficit

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are classified as loans and receivables?

Yes. Under IPSAS 29, loans and receivables are carried at amortized cost. Many

entities hold the bulk of their loans and receivables until maturity. Thus, changes in the fair value of such loans and receivables that are due to changes in market interest rates will not affect surplus or deficit. IPSAS 29.96 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect surplus or deficit. Therefore, IPSAS 29.96 may appear to preclude fair value hedge accounting for loans and receivables. However, it follows from IPSAS 29.88 that loans and receivables can be hedged items with respect to interest rate risk since they are not designated as held-to-maturity investments. The entity could sell them and the change in fair values would affect surplus or deficit. Thus, fair value hedge accounting is permitted for loans and receivables.

F.2.14 Intragroup and Intra-entity Hedging Transactions

An Australian entity, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by a Swiss entity, which prepares consolidated financial statements (which include the Australian subsidiary) in Swiss francs. The Swiss controlling entity enters into a forward contract to hedge the change in yen relative to the Australian dollar. Can that hedge qualify for hedge accounting in the consolidated financial statements, or must the Australian controlled that has the foreign currency exposure be a party to the hedging transaction?

The hedge can qualify for hedge accounting provided the other hedge accounting criteria in IPSAS 29 are met. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's surplus or deficit and, therefore, would also affect consolidated surplus or deficit. IPSAS 29 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

F.2.15 Internal Contracts: Single Offsetting External Derivative

An entity uses what it describes as internal derivative contracts to document the transfer of responsibility for interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For example, if the central treasury function has entered into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division, it would enter into an interest

rate swap with an external counterparty that exactly offsets the four internal swaps. Assuming that the hedge accounting criteria are met, in the entity's financial statements would the single offsetting external derivative qualify as a hedging instrument in a hedge of a part of the underlying items on a gross basis?

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. IPSAS 29.94 indicates that a hedge of an overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis. Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An entity follows the approach outlined in IPSAS 29.94 and IPSAS 29.AG141 to designate part of the underlying cash flows as the hedged position.

F.2.16 Internal Contracts: External Derivative Contracts that are Settled Net

Issue (a) – An entity uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. For each internal derivative contract, the central treasury function enters into a derivative contract with a single external counterparty that offsets the internal derivative contract. For example, if the central treasury function has entered into a receive-5 percent-fixed, pay-LIBOR interest rate swap with another division that has entered into the internal contract with central treasury to hedge the exposure to variability in interest cash flows on a pay-LIBOR borrowing, central treasury would enter into a pay-5 percent-fixed, receive-LIBOR interest rate swap on the same principal terms with the external counterparty. Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled since there is a netting agreement with the external counterparty. Assuming that the other hedge accounting criteria are met, can the individual external derivative contracts, such as the pay-5 percent-fixed, receive-LIBOR interest rate swap above, be designated as hedging instruments of underlying gross exposures, such as the exposure to changes in variable interest payments on the pay-LIBOR borrowing above, even though the external derivatives are settled on a net basis?

Generally, yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross

basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty, provided the hedge accounting criteria in IPSAS 29 are met. See also Question F.1.13.

Issue (b) – Treasury observes that by entering into the external offsetting contracts and including them in the centralized portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the entity. Therefore, it enters into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally, yes. The purpose of structuring the external derivative contracts in this manner is consistent with the entity's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid purpose qualify as hedging instruments. Moreover, the answer to Question F.1.13 specifies that hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the same counterparty if there is a substantive purpose for structuring the transactions separately.

F.2.17 Partial Term Hedging

IPSAS 29.84 indicates that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Entity A acquires a 10 percent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as available-for-sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

F.2.18 Hedging Instrument: Cross-Currency Interest Rate Swap

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a 10-year fixed rate pound sterling-denominated note receivable. Entity A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Entity A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Entity A?

Yes. IPSAS 29.90 permits hedge accounting for components of risk, if effectiveness can be measured. Also, IPSAS 29.85 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be identified clearly, effectiveness can be demonstrated, and specific designation of the hedging instrument and different risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and US dollars. The swap is measured at fair value with changes in fair value recognized in surplus or deficit. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five-year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under IPSAS 4 and the changes to their carrying amounts recognized in surplus or deficit.

F.2.19 Hedged Items: Hedge of Foreign Currency Risk of Publicly Traded Shares

Entity A acquires shares in Entity B on a foreign stock exchange for their fair value of 1,000 in foreign currency (FC). It classifies the shares as available for sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell FC750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of

Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to FC750 in foreign currency?

Yes. IPSAS 29 permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (IPSAS 29.90). Therefore, Entity A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of FC750 associated with the shares or as a cash flow hedge of a forecast sale of the shares, provided the timing of the sale is identified. Any variability in the fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below FC750.

F.2.20 Hedge Accounting: Stock Index

An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does IPSAS 29 permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, IPSAS 29.93 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

F.2.21 Hedge Accounting: Netting of Assets and Liabilities

May an entity group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An entity's hedging strategy and risk management practices may assess cash flow risk on a net basis but IPSAS 29.94 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. IPSAS 29.AG141 provides an example of how an entity might assess its risk on a net

basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

F.3 *Hedge Accounting*

F.3.1 Cash Flow Hedge: Fixed Interest Rate Cash Flows

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt instrument. Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

No. IPSAS 29.96(b) states that a cash flow hedge is "a hedge of the exposure to variability in cash flows." In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

F.3.2 Cash Flow Hedge: Reinvestment of Fixed Interest Rate Cash Flows

An entity manages interest rate risk on a net basis. On January 1, 2001, it forecasts aggregate cash inflows of CU100 on fixed rate assets and aggregate cash outflows of CU90 on fixed rate liabilities in the first quarter of 2002. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecast net cash inflow of CU10. The entity designates as the hedged item the first CU10 of cash inflows on fixed rate assets in the first quarter of 2002. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 2002 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the entity could also hedge the interest rate exposure associated with the forecast reinvestment of the interest and principal it receives on fixed rate assets (see Question F.6.2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (e.g., if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the

reinvestment of interest cash inflows on fixed rate assets). However, potentially it could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

F.3.3 Foreign Currency Hedge

Entity A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

(a) **A fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognized in surplus or deficit; or**

(b) **A cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognized net assets/equity?**

IPSAS 29 does not preclude either of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk are recognized immediately in surplus or deficit. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognized in net assets/equity, that amount is recognized in surplus or deficit in the same period or periods during which the hedged item (the liability) affects surplus or deficit, i.e., when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to surplus or deficit in the same periods during which the liability is remeasured, not when the payment occurs. See Question F.3.4.

F.3.4 Foreign Currency Cash Flow Hedge

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to surplus or deficit (IPSAS 4.27 and IPSAS 4.32).

If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the

receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognized immediately in surplus or deficit and the gain or loss on remeasuring the receivable is also recognized in surplus or deficit.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognized in net assets/equity, and the ineffective portion in surplus or deficit (IPSAS 29.106). The amount recognized in net assets/equity is recognized in surplus or deficit in the same period or periods during which changes in the measurement of the receivable affect surplus or deficit (IPSAS 29.111).

F.3.5 Fair Value Hedge: Variable Rate Debt Instrument

Does IPSAS 29 permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

F.3.6 Fair Value Hedge: Inventory

IPSAS 29.96(a) states that a fair value hedge is "a hedge of the exposure to changes in fair value of a recognized asset or liability ... that is attributable to a particular risk and could affect surplus or deficit." Can an entity designate inventories, such as oil inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the oil price, although inventories are measured at the lower of cost and net realizable value or cost and current replacement cost under IPSAS 12, *Inventories*?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect surplus or deficit when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realizable value test under IPSAS 12. The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

F.3.7 **Hedge Accounting: Forecast Transaction**

For cash flow hedges, a forecast transaction that is subject to a hedge must be "highly probable." How should the term "highly probable" be interpreted?

The term "highly probable" indicates a much greater likelihood of happening than the term "more likely than not." An assessment of the likelihood that a forecast transaction will take place is not based solely on management's intentions because intentions are not verifiable. A transaction's probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

(a) The frequency of similar past transactions;

(b) The financial and operational ability of the entity to carry out the transaction;

(c) Substantial commitments of resources to a particular activity (e.g., the undertaking of specific infrastructure projects);

(d) The extent of loss or disruption of operations that could result if the transaction does not occur;

(e) The likelihood that transactions with substantially different characteristics might be used to achieve the same purpose (e.g., an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of debt instruments); and

(f) The entity's operational plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an

assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

F.3.8 Retrospective Designation of Hedges

Does IPSAS 29 permit an entity to designate hedge relationships retrospectively?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in IPSAS 29.98 are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

F.3.9 Hedge Accounting: Designation at the Inception of the Hedge

Does IPSAS 29 permit an entity to designate and formally document a derivative contract as a hedging instrument after entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, IPSAS 29 requires a hedging instrument to be designated and formally documented as such from the inception of the hedge relationship (IPSAS 29.98); in other words, a hedge relationship cannot be designated retrospectively. Also, it precludes designating a hedging relationship for only a portion of the time period during which the hedging instrument remains outstanding (IPSAS 29.84). However, it does not require the hedging instrument to be acquired at the inception of the hedge relationship.

F.3.10 Hedge Accounting: Identification of Hedged Forecast Transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with

sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

F.3.11 **Cash Flow Hedge: Documentation of Timing of Forecast Transaction**

For a hedge of a forecast transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date on, or time period in which, the forecast transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (IPSAS 29.AG151) and it must be possible to measure its effectiveness reliably (IPSAS 29.98(d)). Also, the hedged forecast transaction must be highly probable (IPSAS 29.98(c)). To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance with IPSAS 29.98(d), it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecast transaction is no longer expected to occur, hedge accounting is discontinued in accordance with IPSAS 29.112(c).

F.4 *Hedge Effectiveness*

F.4.1 **Hedging on an After-Tax Basis**

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

IPSAS 29 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

F.4.2 Hedge Effectiveness: Assessment on Cumulative Basis

IPSAS 29.98(b) requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognized in surplus or deficit as it occurs.

To illustrate: an entity designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25–50 basis points, while LIBOR changes daily. Over a period of 1–2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.

F.4.3 Hedge Effectiveness: Counterparty Credit Risk

Must an entity consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An entity cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument. When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the entity considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the entity. For a cash flow hedge, if it becomes probable that a counterparty will default, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change, which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

F.4.4 Hedge Effectiveness: Effectiveness Tests

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

IPSAS 29 does not provide specific guidance about how effectiveness tests are performed. IPSAS 29 specifies that a hedge is normally regarded as highly

effective only if (a) at inception and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results are within a range of 80–125 percent. IPSAS 29.AG145 also states that the expectation in (a) can be demonstrated in various ways.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An entity is required to document at the inception of the hedge how effectiveness will be assessed and then to apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, i.e., a comparison of hedging gains and losses with the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

F.4.5 Hedge Effectiveness: Less than 100 Percent Offset

If a cash flow hedge is regarded as highly effective because the actual risk offset is within the allowed 80–125 percent range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge recognized in net assets/equity?

No. IPSAS 29.106(a) indicates that only the effective portion is recognized in net assets/equity. IPSAS 29.106(b) requires the ineffective portion to be recognized in surplus or deficit.

F.4.6 Assuming Perfect Hedge Effectiveness

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No. IPSAS 29.98(e) requires an entity to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (IPSAS 29.AG150). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge

of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

F.5 *Cash Flow Hedges*

F.5.1 Hedge Accounting: Non-Derivative Monetary Asset or Non-Derivative Monetary Liability Used as a Hedging Instrument

If an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognized in surplus or deficit (IPSAS 4.32) and the exchange differences on the hedging instrument be recognized in net assets/equity until the repayment of the liability (IPSAS 29.106)?

No. Exchange differences on the monetary asset and the monetary liability are both recognized in surplus or deficit in the period in which they arise (IPSAS 4.32). IPSAS 29.AG116 specifies that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are recognized in surplus or deficit.

F.5.2 Cash Flow Hedges: Performance of Hedging Instrument (1)

Entity A has a floating rate liability of CU1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of CU49 in the fair value of the swap. This increase consists of a change of CU50 resulting from an increase in market interest rates and a change of minus CU1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by CU50. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognized in surplus or deficit?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk (IPSAS 29.AG150). However, because Entity A determines that the hedge relationship is still highly effective, it recognizes the effective portion of the change in fair value of the swap, i.e., the net change in fair value of CU49, in net assets/equity. There

is no debit to surplus or deficit for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, i.e., CU50, exceeds the cumulative change in value of the hedging instrument, i.e., CU49.

Dr		Swap	CU49	
	Cr	Net assets/equity		CU49

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with IPSAS 29.112.

Would the answer change if the fair value of the swap instead increases to CU51 of which CU50 results from the increase in market interest rates and CU1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to surplus or deficit of CU1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, i.e., CU51, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, i.e., CU50. The difference of CU1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognized in surplus or deficit.

Dr		Swap	CU51	
	Cr	Net assets/equity		CU50
	Cr	Surplus or deficit		CU1

F.5.3 **Cash Flow Hedges: Performance of Hedging Instrument (2)**

On September 30, 20X1, Entity A hedges the anticipated sale of 24 barrels of oil on March 1, 20X2 by entering into a short forward contract on 24 barrels of oil. The contract requires net settlement in cash determined as the difference between the future spot price of oil on a specified commodity exchange and CU1,000. Entity A expects to sell the oil in a different, local market. Entity A

determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On December 31, the spot price of oil has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is CU1,100. The fair value of Entity A's forward contract is negative CU80. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognized in surplus or deficit?

No. In a cash flow hedge, ineffectiveness is not recognized in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is CU80, while the fair value of the cumulative change in expected future cash flows on the hedged item is CU100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognized in surplus or deficit (IPSAS 29.106(b)). Because Entity A determines that the hedge relationship is still highly effective, it recognizes the entire change in fair value of the forward contract (CU80) in net assets/equity.

Dr		Net assets/equity	CU80	
	Cr	Forward		CU80

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with IPSAS 29.112.

F.5.4 Cash Flow Hedges: Forecast Transaction Occurs Before the Specified Period

An entity designates a derivative as a hedging instrument in a cash flow hedge of a forecast transaction, such as a forecast sale of a commodity. The hedging relationship meets all the hedge accounting conditions, including the requirement to identify and document the period in which the transaction is expected to occur within a reasonably specific and narrow range of time (see Question F.2.17). If, in a subsequent period, the forecast transaction is expected to occur in an earlier period than originally

anticipated, can the entity conclude that this transaction is the same as the one that was designated as being hedged?

Yes. The change in timing of the forecast transaction does not affect the validity of the designation. However, it may affect the assessment of the effectiveness of the hedging relationship. Also, the hedging instrument would need to be designated as a hedging instrument for the whole remaining period of its existence in order for it to continue to qualify as a hedging instrument (see IPSAS 29.84 and Question F.2.17).

F.5.5 Cash Flow Hedges: Measuring Effectiveness for a Hedge of a Forecast Transaction in a Debt Instrument

A forecast investment in an interest-earning asset or forecast issue of an interest-bearing liability creates a cash flow exposure to interest rate changes because the related interest payments will be based on the market rate that exists when the forecast transaction occurs. The objective of a cash flow hedge of the exposure to interest rate changes is to offset the effects of future changes in interest rates so as to obtain a single fixed rate, usually the rate that existed at the inception of the hedge that corresponds with the term and timing of the forecast transaction. During the period of the hedge, it is not possible to determine what the market interest rate for the forecast transaction will be at the time the hedge is terminated or when the forecast transaction occurs. In this case, how is the effectiveness of the hedge assessed and measured?

During this period, effectiveness can be measured on the basis of changes in interest rates between the designation date and the interim effectiveness measurement date. The interest rates used to make this measurement are the interest rates that correspond with the term and occurrence of the forecast transaction that existed at the inception of the hedge and that exist at the measurement date as evidenced by the term structure of interest rates.

Generally it will not be sufficient simply to compare cash flows of the hedged item with cash flows generated by the derivative hedging instrument as they are paid or received, since such an approach ignores the entity's expectations of whether the cash flows will offset in subsequent periods and whether there will be any resulting ineffectiveness.

The discussion that follows illustrates the mechanics of establishing a cash flow hedge and measuring its effectiveness. For the purpose of the illustrations, assume that an entity expects to issue a CU100,000 one-year debt instrument in three months. The instrument will pay interest quarterly with principal due at maturity. The entity is exposed to interest rate increases and establishes a hedge of the interest cash flows of the debt by entering into a forward starting interest

rate swap. The swap has a term of one year and will start in three months to correspond with the terms of the forecast debt issue. The entity will pay a fixed rate and receive a variable rate, and the entity designates the risk being hedged as the LIBOR-based interest component in the forecast issue of the debt.

Yield Curve

The yield curve provides the foundation for computing future cash flows and the fair value of such cash flows both at the inception of, and during, the hedging relationship. It is based on current market yields on applicable reference bonds that are traded in the marketplace. Market yields are converted to spot interest rates ("spot rates" or "zero coupon rates") by eliminating the effect of coupon payments on the market yield. Spot rates are used to discount future cash flows, such as principal and interest rate payments, to arrive at their fair value. Spot rates also are used to compute forward interest rates that are used to compute variable and estimated future cash flows. The relationship between spot rates and one-period forward rates is shown by the following formula:

Spot-forward relationship

$$F = \frac{(1 + SR_t)^t}{(1 + SR_{t-1})^{t-1}} - 1$$

where F = forward rate (%)

SR = spot rate (%)

t = period in time (e.g., 1, 2, 3, 4, 5)

Also, for the purpose of this illustration, assume that the following quarterly-period term structure of interest rates using quarterly compounding exists at the inception of the hedge.

Yield curve at inception – (beginning of period 1)					
Forward periods	*1*	*2*	*3*	*4*	*5*
Spot rates	3.75%	4.50%	5.50%	6.00%	6.25%
Forward rates	3.75%	5.25%	7.51%	7.50%	7.25%

The one-period forward rates are computed on the basis of spot rates for the applicable maturities. For example, the current forward rate for Period 2

calculated using the formula above is equal to $[1.0450^2/1.0375] - 1 = 5.25$ percent. The current one-period forward rate for Period 2 is different from the current spot rate for Period 2, since the spot rate is an interest rate from the beginning of Period 1 (spot) to the end of Period 2, while the forward rate is an interest rate from the beginning of Period 2 to the end of Period 2.

Hedged Item

In this example, the entity expects to issue a CU100,000 one-year debt instrument in three months with quarterly interest payments. The entity is exposed to interest rate increases and would like to eliminate the effect on cash flows of interest rate changes that may happen before the forecast transaction takes place. If that risk is eliminated, the entity would obtain an interest rate on its debt issue that is equal to the one-year forward coupon rate currently available in the marketplace in three months. That forward coupon rate, which is different from the forward (spot) rate, is 6.86 percent, computed from the term structure of interest rates shown above. It is the market rate of interest that exists at the inception of the hedge, given the terms of the forecast debt instrument. It results in the fair value of the debt being equal to par at its issue.

At the inception of the hedging relationship, the expected cash flows of the debt instrument can be calculated on the basis of the existing term structure of interest rates. For this purpose, it is assumed that interest rates do not change and that the debt would be issued at 6.86 percent at the beginning of Period 2. In this case, the cash flows and fair value of the debt instrument would be as follows at the beginning of Period 2.

Issue of Fixed Rate Debt **Beginning of period 2 - No rate changes (spot based on forward rates)**						
	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
Spot rates			5.25%	6.38%	6.75%	6.88%
Forward rates			5.25%	7.51%	7.50%	7.25%
	CU		*CU*	*CU*	*CU*	*CU*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716

Issue of Fixed Rate Debt **Beginning of period 2 - No rate changes (spot based on forward rates)**						
Principal						100,000
Fair value:						
Interest	6,592		1,694	1,663	1,632	1,603
Principal	93,408					93,408[(a)]
Total	100,000					
(a) CU100,000/(1 + [0.0688/4]) [4]						

Since it is assumed that interest rates do not change, the fair value of the interest and principal amounts equals the par amount of the forecast transaction. The fair value amounts are computed on the basis of the spot rates that exist at the inception of the hedge for the applicable periods in which the cash flows would occur had the debt been issued at the date of the forecast transaction. They reflect the effect of discounting those cash flows on the basis of the periods that will remain after the debt instrument is issued. For example, the spot rate of 6.38 percent is used to discount the interest cash flow that is expected to be paid in Period 3, but it is discounted for only two periods because it will occur two periods after the forecast transaction.

The forward interest rates are the same as shown previously, since it is assumed that interest rates do not change. The spot rates are different but they have not actually changed. They represent the spot rates one period forward and are based on the applicable forward rates.

Hedging Instrument

The objective of the hedge is to obtain an overall interest rate on the forecast transaction and the hedging instrument that is equal to 6.86 percent, which is the market rate at the inception of the hedge for the period from Period 2 to Period 5. This objective is accomplished by entering into a forward starting interest rate swap that has a fixed rate of 6.86 percent. Based on the term structure of interest rates that exist at the inception of the hedge, the interest rate swap will have such a rate. At the inception of the hedge, the fair value of the fixed rate payments on the interest rate swap will equal the fair value of the variable rate payments, resulting in the interest rate swap having a fair value of zero. The expected cash flows of the interest rate swap and the related fair value amounts

are shown as follows.

Interest Rate Swap						
	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	CU		*CU*	*CU*	*CU*	*CU*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716
Forecast variable interest			1,313	1,877	1,876	1,813
Forecast based on forward rate			*5.25%*	*7.51%*	*7.50%*	*7.25%*
Net interest			(403)	161	160	97
Fair value:						
Discount rate (spot)			*5.25%*	*6.38%*	*6.75%*	*6.88%*
Fixed interest	6,592		1,694	1,663	1,632	1,603
Forecast variable interest	6,592		1,296	1,819	1,784	1,693
Fair value of interest rate swap	0		(398)	156	152	90

At the inception of the hedge, the fixed rate on the forward swap is equal to the fixed rate the entity would receive if it could issue the debt in three months under terms that exist today.

Measuring Hedge Effectiveness

If interest rates change during the period the hedge is outstanding, the effectiveness of the hedge can be measured in various ways.

Assume that interest rates change as follows immediately before the debt is issued at the beginning of Period 2.

Yield Curve - Rates Increase 200 Basis Points

Forward periods	*1*	*2*	*3*	*4*	*5*
Remaining periods		*1*	*2*	*3*	*4*
Spot rates		5.75%	6.50%	7.50%	8.00%
Forward rates		5.75%	7.25%	9.51%	9.50%

Under the new interest rate environment, the fair value of the pay-fixed at 6.86 percent, receive-variable interest rate swap that was designated as the hedging instrument would be as follows.

Fair Value of Interest Rate Swap						
	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	CU	*CU*	*CU*	*CU*	*CU*	*CU*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716
Forecast variable interest			1,438	1,813	2,377	2,376
Forecast based on new forward rate			*5.25%*	*7.25%*	*9.51%*	*9.50%*
Net interest			(279)	97	661	660
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Fixed interest	6,562		1,692	1,662	1,623	1,585
Forecast variable interest	7,615		1,417	1,755	2,248	2,195
Fair value of net interest	1,053		(275)	93	625	610

In order to compute the effectiveness of the hedge, it is necessary to measure the change in the present value of the cash flows or the value of the hedged forecast transaction. There are at least two methods of accomplishing this

measurement.

Method A Compute Change in Fair Value of Debt						
	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	CU		*CU*	*CU*	*CU*	*CU*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716
Principal						100,000
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Interest	6,562		1,692	1,662	1,623	1,585
Principal	92,385					92,385 [(a)]
Total	98,947					
Fair value at inception	100,000					
Fair value difference	(1,053)					
CU100,000/(1 + [0.08/4]) ^{4}						

Under Method A, a computation is made of the fair value in the new interest rate environment of debt that carries interest that is equal to the coupon interest rate that existed at the inception of the hedging relationship (6.86 percent). This fair value is compared with the expected fair value as of the beginning of Period 2 that was calculated on the basis of the term structure of interest rates that existed at the inception of the hedging relationship, as illustrated above, to determine the change in the fair value. Note that the difference between the change in the fair value of the swap and the change in the expected fair value of the debt exactly offset in this example, since the terms of the swap and the forecast transaction match each other.

Method B Compute Change in Fair Value of Cash Flows						
	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
Market rate at inception			6.86%	6.86%	6.86%	6.86%
Current forward rate			5.75%	7.25%	9.51%	9.50%
Rate difference			1.11%	(0.39%)	(2.64%)	(2.64%)
Cash flow difference (principal × rate)			CU279	(CU97)	(CU661)	(CU660)
Discount rate (spot)			5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,053)		CU275	(CU93)	(CU625)	(CU610)

Under Method B, the present value of the change in cash flows is computed on the basis of the difference between the forward interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. The market rate that existed at the inception of the hedge is the one-year forward coupon rate in three months. The present value of the change in cash flows is computed on the basis of the current spot rates that exist at the effectiveness measurement date for the applicable periods in which the cash flows are expected to occur. This method also could be referred to as the “theoretical swap” method (or “hypothetical derivative” method) because the comparison is between the hedged fixed rate on the debt and the current variable

rate, which is the same as comparing cash flows on the fixed and variable rate legs of an interest rate swap.

As before, the difference between the change in the fair value of the swap and the change in the present value of the cash flows exactly offset in this example, since the terms match.

Other Considerations

There is an additional computation that should be performed to compute ineffectiveness before the expected date of the forecast transaction that has not been considered for the purpose of this illustration. The fair value difference has been determined in each of the illustrations as of the expected date of the forecast transaction immediately before the forecast transaction, i.e., at the beginning of Period 2. If the assessment of hedge effectiveness is done before the forecast transaction occurs, the difference should be discounted to the current date to arrive at the actual amount of ineffectiveness. For example, if the measurement date were one month after the hedging relationship was established and the forecast transaction is now expected to occur in two months, the amount would have to be discounted for the remaining two months before the forecast transaction is expected to occur to arrive at the actual fair value. This step would not be necessary in the examples provided above because there was no ineffectiveness. Therefore, additional discounting of the amounts, which net to zero, would not have changed the result.

Under Method B, ineffectiveness is computed on the basis of the difference between the forward coupon interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. Computing the change in cash flows based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date is inappropriate if the objective of the hedge is to establish a single fixed rate for a series of forecast interest payments. This objective is met by hedging the exposures with an interest rate swap as illustrated in the above example. The fixed interest rate on the swap is a blended interest rate composed of the forward rates over the life of the swap. Unless the yield curve is flat, the comparison between the forward interest rate exposures over the life of the swap and the fixed rate on the swap will produce different cash flows whose fair values are equal only at the inception of the hedging relationship. This difference is shown in the table below.

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*

	Total					
Remaining periods			*1*	*2*	*3*	*4*
Forward rate at inception			5.25%	7.51%	7.50%	7.25%
Current forward rate			5.75%	7.25%	9.51%	9.50%
Rate difference			(0.50%)	0.26%	(2.00%)	(2.25%)
Cash flow difference (principal × rate)			(CU125)	CU64	(CU501)	(CU563)
Discount rate (spot)			5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,055)		(CU123)	CU62	(CU474)	(CU520)
Fair value of interest rate swap	CU1,053					
Ineffectiveness	(CU2)					

If the objective of the hedge is to obtain the forward rates that existed at the inception of the hedge, the interest rate swap is ineffective because the swap has a single blended fixed coupon rate that does not offset a series of different forward interest rates. However, if the objective of the hedge is to obtain the forward coupon rate that existed at the inception of the hedge, the swap is effective, and the comparison based on differences in forward interest rates suggests ineffectiveness when none may exist. Computing ineffectiveness based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date would be an appropriate measurement of ineffectiveness if the hedging objective is to lock in those forward interest rates. In that case, the appropriate hedging instrument would be a series of forward contracts each of which matures on a repricing date that corresponds with the date of the forecast transactions.

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and IPSAS 29 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (IPSAS 29.83). It is recognized, however, that if the fixed interest rate on the interest rate swap is equal to the

fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

F.5.6 Cash Flow Hedges: Firm Commitment to Purchase Property, Plant and Equipment in a Foreign Currency

Entity A has the Local Currency (LC) as its functional currency and presentation currency. On June 30, 20X1, it enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver LC109,600 on June 30, 20X2 at an initial cost and fair value of zero. It designates the forward exchange contract as a hedging instrument in a cash flow hedge of a firm commitment to purchase spare parts for its electricity distribution network on March 31, 20X2 and the resulting payable of FC100,000, which is to be paid on June 30, 20X2. All hedge accounting conditions in IPSAS 29 are met.

As indicated in the table below, on June 30, 20X1, the spot exchange rate is LC1.072 to FC1, while the twelve-month forward exchange rate is LC1.096 to FC1. On December 31, 20X1, the spot exchange rate is LC1.080 to FC1, while the six-month forward exchange rate is LC1.092 to FC1. On March 31, 20X2, the spot exchange rate is LC1.074 to FC1, while the three-month forward rate is LC1.076 to FC1. On June 30, 20X2, the spot exchange rate is LC1.072 to FC1. The applicable yield curve in the local currency is flat at 6 percent per year throughout the period. The fair value of the forward exchange contract is negative LC388 on December 31, 20X1 {([1.092 × 100,000] – 109,600)/1.06(6/12)}, negative LC1.971 on March 31, 20X2 {([1.076 × 100,000] – 109,600)/1.06((3/12))}, and negative LC2,400 on June 30, 20X2 {1.072 × 100,000 – 109,600}.

Date	Spot rate	Forward rate to June 30, 20X2	Fair value of forward contract
June 30, 20X1	1.072	1.096	–
December 31, 20X1	1.080	1.092	(388)
March 31, 20X2	1.074	1.076	(1,971)
June 30, 20X2	1.072	–	(2,400)

Issue (a) – What is the accounting for these transactions if the hedging relationship is designated as being for changes in the fair value of the forward exchange contract and the entity's accounting policy is to apply basis adjustment to non-financial assets that result from hedged forecast transactions?

The accounting entries are as follows.

June 30, 20X1

Dr		Forward	LC0	
	Cr	Cash		LC0
To record the forward exchange contract at its initial amount of zero (IPSAS 29.45). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract and the assessment of hedge effectiveness are based on the forward price (IPSAS 29.AG149).				

December 31, 20X1

Dr		Net assets/equity	LC388	
	Cr	Forward liability		LC388
To record the change in the fair value of the forward exchange contract between June 30, 20X1 and December 31, 20X1, i.e., LC388 – 0 = LC388, in net assets/equity (IPSAS 29.106). The hedge is fully effective because the loss on the forward exchange contract (LC388) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(LC388) = {([1.092 × 100,000] – 109,600)/1.06(6/12)} – {([1.096 × 100,000] – 109,600)/1.06}]				

March 31, 20X2

Dr		Net assets/equity	LC1,583	
	Cr	Forward liability		LC1,583
To record the change in the fair value of the forward exchange contract between January 1, 20X2 and March 31, 20X2 (i.e., LC1,971 – LC388 = LC1,583) in net				

assets/equity (IPSAS 29.106). The hedge is fully effective because the loss on the forward exchange contract (LC1,583) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(LC1,583) = {([1.076 × 100,000] – 109,600)/1.06(3/12)} – {([1.092 × 100,000] – 109,600)/1.06(6/12)}]

Dr		Property, plant and equipment (purchase price)	LC107,400	
Dr		Property, plant and equipment (hedging loss)	LC1,971	
	Cr	Net assets/equity		LC1,971
	Cr	Payable		LC107,400

To recognize the purchase of the spare parts at the spot rate (1.074 × FC100,000) and remove the cumulative loss on the forward exchange contract that has been recognized in net assets/equity (LC1,971) and include it in the initial measurement of the spare parts purchased. Accordingly, the initial measurement of the is LC109,371 consisting of a purchase consideration of LC107,400 and a hedging loss of LC1,971.

June 30, 20X2

Dr		Payable	LC107,400	
	Cr	Cash		LC107,200
	Cr	Surplus or deficit		LC200
To record the settlement of the payable at the spot rate (FC100,000 × 1.072 = 107,200) and the associated exchange gain of LC200 (LC107,400 – LC107,200).				

Dr		Surplus or deficit	LC429	
	Cr	Forward liability		LC429
To record the loss on the forward exchange contract between April 1, 20X2 and June 30, 20X2 (i.e., LC2,400 – LC1,971 = LC429) in surplus or deficit. The hedge is regarded as fully effective because the loss on the forward exchange contract (LC429) exactly offsets the change in the fair value of the payable based on the forward price (LC429 = ([1.072 × 100,000] – 109,600 – {([1.076 × 100,000] – 109,600)/1.06(3/12)}).				

Dr		Forward liability	LC2,400	
	Cr	Cash		LC2,400
To record the net settlement of the forward exchange contract.				

Issue (b) – What is the accounting for these transactions if the hedging relationship instead is designated as being for changes in the spot element of the forward exchange contract and the interest element is excluded from the designated hedging relationship (IPSAS 29.83)?

The accounting entries are as follows.

June 30, 20X1

Dr		Forward	LC0	
	Cr	Cash		LC0
To record the forward exchange contract at its initial amount of zero (IPSAS 29.45). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the premium or discount on the forward contract is excluded from the assessment of effectiveness (IPSAS 29.AG149).				

December 31, 20X1

Dr		Surplus or deficit (interest element)	LC1,165	
	Cr	Net assets/equity (spot element)		LC777
	Cr	Forward liability		LC388
To record the change in the fair value of the forward exchange contract between June 30, 20X1 and December 31, 20X1, i.e., LC388 – 0 = LC388. The change in the present value of spot settlement of the forward exchange contract is a gain of LC777 ({([1.080 × 100,000] – 107,200)/1.06(6/12)} – {([1.072 × 100,000] – 107,200)/1.06}), which is recognized in net assets/equity (IPSAS 29.106). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,165 (388 + 777), which is recognized in surplus or deficit (IPSAS 29.83 and IPSAS 29.64(a)). The hedge is fully effective because the gain in the spot element of the forward contract (LC777) exactly offsets the change in the purchase price at spot rates (LC777 = {([1.080 × 100,000] – 107,200)/1.06(6/12)} – {([1.072 × 100,000] – 107,200)/1.06}).				

March 31, 20X2

Dr		Net assets/equity (spot element)	LC580	
Dr		Surplus or deficit (interest element)	LC1,003	
	Cr	Forward liability		LC1,583
To record the change in the fair value of the forward exchange contract between January 1, 20X2 and March 31, 20X2, i.e., LC1,971 – LC388 = LC1,583. The change in the present value of the spot settlement of the forward exchange contract is a loss of LC580 ({([1.074 × 100,000] – 107,200)/1.06(3/12)} – {([1.080 × 100,000] – 107,200)/1.06(6/12)}), which is recognized in net assets/equity (IPSAS 29.106(a)). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,003 (LC1,583 – LC580), which is recognized in surplus or deficit (IPSAS 29.83 and IPSAS 29.,64(a)). The hedge is fully effective because the loss in the spot element of the forward contract (LC580) exactly offsets the change in the purchase price at spot rates [(580) = {([1.074 × 100,000] – 107,200)/1.06(3/12)} – {([1.080 × 100,000] – 107,200) /1.06(6/12)}].				

Dr		Property, plant and equipment (purchase price)	LC107,400	
Dr		Net assets/equity	LC197	
	Cr	Property, plant and equipment (hedging gain)		LC197
	Cr	Payable		LC107,400
To recognize the purchase of spare parts at the spot rate (= 1.074 × FC100,000) and remove the cumulative gain on the spot element of the forward exchange				

contract that has been recognized in net assets/equity (LC777 – LC580 = LC197) and include it in the initial measurement of the spare parts. Accordingly, the initial measurement of the spare parts is LC107,203, consisting of a purchase consideration of LC107,400 and a hedging gain of LC197.

June 30, 20X2

Dr		Payable	LC107,400	
	Cr	Cash		LC107,200
	Cr	Surplus or deficit		LC200
To record the settlement of the payable at the spot rate (FC100,000 × 1.072 = LC107,200) and the associated exchange gain of LC200 (– [1.072 – 1.074] × FC100,000).				

Dr		Surplus or deficit (spot element)	LC197	
Dr		Surplus or deficit (interest element)	LC232	
	Cr	Forward liability		LC429
To record the change in the fair value of the forward exchange contract between April 1, 20X2 and June 30, 20X2 (i.e., LC2,400 – LC1,971 = LC429). The change in the present value of the spot settlement of the forward exchange contract is a loss of LC197 ([1.072 × 100,000] – 107,200 – {([1.074 × 100,000] – 107,200)/1.06(3/12)}), which is recognized in surplus or deficit. The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC232 (LC429 – LC197), which is recognized in surplus or deficit. The hedge is fully effective because the loss in the spot element of the forward contract (LC197) exactly offsets the change in the present value of the spot settlement of the				

payable [(LC197) = {[1.072 × 100,000] – 107,200 – {([1.074 × 100,000] – 107,200)/1.06(3/12)}].

Dr		Forward liability	LC2,400	
	Cr	Cash		LC2,400
To record the net settlement of the forward exchange contract.				

The following table provides an overview of the components of the change in fair value of the hedging instrument over the term of the hedging relationship. It illustrates that the way in which a hedging relationship is designated affects the subsequent accounting for that hedging relationship, including the assessment of hedge effectiveness and the recognition of gains and losses.

Period ending	**Change in spot settlement**	**Fair value of change in spot settlement**	**Change in forward settlement**	**Fair value of change in forward settlement**	**Fair value of change in interest element**
	LC	*LC*	*LC*	*LC*	*LC*
June 20X1	–	–	–	–	–
December 20X1	800	777	(400)	(388)	(1,165)
March 20X2	(600)	(580)	(1,600)	(1,583)	(1,003)
June 20X2	(200)	(197)	(400)	(429)	(232)
Total	–	–	(2,400)	(2,400)	(2,400)

F.6 *Hedges: Other Issues*

F.6.1 **Hedge Accounting: Management of Interest Rate Risk in Entities Such as Departments of Finance**

Entities, such as departments of finance, often manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have

systems to accumulate critical information throughout the entity about their financial assets, financial liabilities and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many entities use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If an entity manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under IPSAS 29?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to the net exposure (IPSAS 29.94, IPSAS 29.AG141 and IPSAS 29.AG154). It is not possible to designate a net position as a hedged item under IPSAS 29 because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognized in surplus or deficit.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting in IPSAS 29.98 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately affects the entity's surplus or deficit (IPSAS 29.AG153) and the entity designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their objective.

The factors an entity must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question F.6.2.

F.6.2 Hedge Accounting Considerations when Interest Rate Risk is Managed on a Net Basis

If an entity manages its exposure to interest rate risk on a net basis, what are the issues the entity should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues (a) – (l) below deal with the main issues. First, Issues (a) and (b) discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria

and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues (c) – (l) expand on various aspects of the accounting for cash flow hedges. Issues (c) – (f) consider the application of the hedge accounting criteria for cash flow hedges in IPSAS 29, and Issues (g) and (h) discuss the required accounting treatment. Finally, Issues (i) – (l) elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue (a) – Can a derivative that is used to manage interest rate risk on a net basis be designated under IPSAS 29 as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Both types of designation are possible under IPSAS 29. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets, liabilities and firm commitments or as a cash flow hedge of forecast transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

In economic terms, it does not matter whether the derivative instrument is regarded as a fair value hedge or as a cash flow hedge. Under either perspective of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offset the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue (b).

To illustrate: a department of finance has the following assets and liabilities with a maturity of two years.

	Variable interest		**Fixed interest**
	CU		**CU**
Assets	60		100
Liabilities	(100)		(60)

Net	(40)	40

The entity takes out a two-year swap with a notional principal of CU40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be regarded and designated either as a fair value hedge of CU40 of the fixed rate assets or as a cash flow hedge of CU40 of the variable rate liabilities.

Issue (b) – What are the critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of a derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses for these categories are different. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of Prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the highly probable test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (IPSAS 29.98(b)). This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group.

Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. If an entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. However, for that period, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. Furthermore, the fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecast cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (IPSAS 29.98(c) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument (IPSAS 29.98(b)). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecast transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecast transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems Considerations

The accounting for fair value hedges differs from that for cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective interest rate of the hedged item (IPSAS 29.99). As a consequence of fair value hedging activities, the

changes in fair value have to be allocated to the assets or liabilities being hedged in order for the entity to be able to recompute their effective interest rate, determine the subsequent amortization of the fair value adjustment to surplus or deficit, and determine the amount that should be recognized in surplus or deficit when assets are sold or liabilities extinguished (IPSAS 29.99 and IPSAS 29.103). To comply with the requirements for fair value hedge accounting, it will generally be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective interest rate of the hedged items, and amortize the changes to surplus or deficit over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecast transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognized in net assets/equity (IPSAS 29.105). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the cumulative gains and losses recognized in net assets/equity from changes in the fair value of a hedging instrument should be recognized in surplus or deficit (IPSAS 29.111 and IPSAS 29.112). For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling the changes in the cash flows of the derivative and the recognition of such changes in surplus or deficit.

The timing of the recognition in surplus or deficit can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecast transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced, each of which creates a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rates are matched with the derivative hedging instrument. IPSAS 29.111 specifies that the amounts recognized in net assets/equity should be recognized in surplus or deficit in the same period or periods during which the hedged item affects surplus or deficit.

Issue (c) – If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by IPSAS 29.98(a)?

The following would be included in the documentation.

The hedging relationship – The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.

The entity's risk management objective and strategy for undertaking the hedge – The entity's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.

The type of hedge – The hedge is documented as a cash flow hedge.

The hedged item – The hedged item is documented as a group of forecast transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for example, scheduled on a monthly basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue (e), the forecast transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The hedged risk – The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based on the same yield curve as the derivative hedging instrument.

The hedging instrument – Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecast transactions occurring in the specified future time periods designated as being hedged.

The method of assessing effectiveness – The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecast transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

Issue (d) – If the hedging relationship is designated as a cash flow hedge, how does an entity satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in IPSAS 29.98(b)?

An entity may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue (e) – If the hedging relationship is designated as a cash flow hedge, how does an entity demonstrate a high probability of the forecast transactions occurring as required by IPSAS 29.98(c)?

An entity may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecast transactions that are designated as being hedged are highly probable to occur. Such a schedule should be supported by management's stated intentions and past practice of reinvesting cash inflows and refinancing cash outflows.

For example, an entity may forecast aggregate gross cash inflows of CU100 and aggregate gross cash outflows of CU90 in a particular time period in the near future. In this case, it may wish to designate the forecast reinvestment of gross cash inflows of CU10 as the hedged item in the future time period. If more than CU10 of the forecast cash inflows are contractually specified and have low credit risk, the entity has strong evidence to support an assertion that gross cash inflows of CU10 are highly probable to occur and to support the designation of the forecast reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecast transactions occurring may also be demonstrated under other circumstances.

Issue (f) – If the hedging relationship is designated as a cash flow hedge, how does an entity assess and measure effectiveness under IPSAS 29.98(d) and IPSAS 29.98(e)?

Effectiveness is required to be measured at a minimum at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the recognition in surplus or deficit of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the

applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecast transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognized initially in net assets/equity are recognized in surplus or deficit.

Issue (g) – If the hedging relationship is designated as a cash flow hedge, how does an entity account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions in IPSAS 29.106–IPSAS 29.111, as follows:

(a) The portion of gains and losses on hedging derivatives determined to result from effective hedges is recognized in net assets/equity whenever effectiveness is measured; and

(b) The ineffective portion of gains and losses resulting from hedging derivatives is recognized in surplus or deficit.

IPSAS 29.111 specifies that the amounts recognized in net assets/equity should be recognized in surplus or deficit in the same period or periods during which the hedged item affects surplus or deficit. Accordingly, when the forecast transactions occur, the amounts previously recognized in net assets/equity are recognized in surplus or deficit. For example, if an interest rate swap is designated as a hedging instrument of a series of forecast cash flows, the changes in the cash flows of the swap are removed from net assets/equity and recognized in surplus or deficit in the periods when the forecast cash flows and the cash flows of the swap offset each other.

Issue (h) – If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognized in net assets/equity if the hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecast transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for example, the forecast transactions are no longer highly probable, the net cumulative gain or loss recognized in net assets/equity remains in net assets/equity until the forecast transaction occurs (IPSAS 29.112(a) and IPSAS 29.112(b)). If the hedged forecast transactions are no longer expected to occur, the net cumulative gain or loss is recognized in surplus or deficit (IPSAS 29.112(c)).

Issue (i) – IPSAS 29.84 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, does IPSAS 29.84 preclude redesignating the hedging instrument?

No. IPSAS 29.84 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity. IPSAS 29.84 does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the ineffective portion of the gain or loss on the derivative instrument is recognized immediately in surplus or deficit (IPSAS 29.106) and hedge accounting based on the previous designation of the hedge relationship cannot be continued (IPSAS 29.112). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognized in net assets/equity remaining in net assets/equity?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognized in surplus or deficit in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognized in net assets/equity are recognized in surplus or deficit in the same period or periods during which the hedged forecast transaction affects surplus or deficit (such as in the periods that interest expenses are recognized). However, if an entity expects at any time that all or a portion of a net loss recognized net assets/equity will not be recovered in one or more future periods, it shall reclassify immediately into surplus or deficit the amount that is not expected to be recovered.

Issue (k) – In the answer to Issue (c) above it was indicated that the

designated hedged item is a portion of a cash flow exposure. Does IPSAS 29 permit a portion of a cash flow exposure to be designated as a hedged item?

Yes. IPSAS 29 does not specifically address a hedge of a portion of a cash flow exposure for a forecast transaction. However, IPSAS 29.90 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecast reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by IPSAS 29.92, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecast transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue (l) – In the answer to Issue (c) above it was indicated that the hedged item is documented as a group of forecast transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities and option features, how can an entity satisfy the tests in IPSAS 29.87 and IPSAS 29.93 requiring the hedged group to have similar risk characteristics?

IPSAS 29.87 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics. IPSAS 29.93 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated, and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecast transactions. For hedges of cash flow exposures relating to a group of forecast transactions, the overall exposure of the forecast transactions and the assets or liabilities that are repriced may have very different risks. The exposure from forecast transactions may differ depending on the terms that are expected as they relate to credit exposures, maturities, options and other features. Although the overall risk

exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, provided they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free or benchmark interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (i.e., the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (IPSAS 29.83). For example, if a portfolio of assets consists of assets rated A, BB and B, and the current market interest rates for these assets are LIBOR+20 basis points, LIBOR+40 basis points and LIBOR+60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments based on LIBOR are made to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

F.6.3 Illustrative Example of Applying the Approach in Question F.6.2

The purpose of this example is to illustrate the process of establishing, monitoring and adjusting hedge positions and of qualifying for cash flow hedge accounting in applying the approach to hedge accounting described in Question F.6.2 when an entity manages its interest rate risk on an entity-wide basis. To this end, this example identifies a methodology that allows for the use of hedge accounting and takes advantage of existing risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

The approach illustrated here reflects only one of a number of risk management processes that could be employed and could qualify for hedge accounting. Its use is not intended to suggest that other alternatives could not or should not be used. The approach being illustrated could also be applied in other

circumstances (such as for cash flow hedges), for example, hedging the rollover of commercial paper financing.

Identifying, Assessing and Reducing Cash Flow Exposures

The discussion and illustrations that follow focus on the risk management activities of an entity, such as a department of finance that manages its interest rate risk by analyzing expected cash flows in a particular currency on an entity-wide basis. The cash flow analysis forms the basis for identifying the interest rate risk of the entity, entering into hedging transactions to manage the risk, assessing the effectiveness of risk management activities, and qualifying for and applying cash flow hedge accounting.

The illustrations that follow assume that an entity had the following expected future net cash flows and hedging positions outstanding in a specific currency, consisting of interest rate swaps, at the beginning of Period X0. The cash flows shown are expected to occur at the end of the period and, therefore, create a cash flow interest exposure in the following period as a result of the reinvestment or repricing of the cash inflows or the refinancing or repricing of the cash outflows.

The illustrations assume that the entity has an ongoing interest rate risk management program. Schedule I shows the expected cash flows and hedging positions that existed at the beginning of Period X0. It is included here to provide a starting point in the analysis. It provides a basis for considering existing hedges in connection with the evaluation that occurs at the beginning of Period X1.

Schedule I End of Period: Expected Cash Flows and Hedging Positions							
Quarterly period	*X0*	*X1*	*X2*	*X3*	*X4*	*X5*	*n*
(units)	*CU*	*CU*	*CU*	*CU*	*CU*	*CU*	*CU*
Expected net cash flows		1,100	1,500	1,200	1,400	1,500	x,xxx
Outstanding interest rate swaps:							
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	2,000	1,200	1,200	1,200	x,xxx

Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after outstanding swaps		100	500	500	700	800	x.xxx

The schedule depicts five quarterly periods. The actual analysis would extend over a period of many years, represented by the notation "…n." An entity that manages its interest rate risk on an entity-wide basis re-evaluates its cash flow exposures periodically. The frequency of the evaluation depends on the entity's risk management policy.

For the purposes of this illustration, the entity is re-evaluating its cash flow exposures at the end of Period X0. The first step in the process is the generation of forecast net cash flow exposures from existing interest-earning assets and interest-bearing liabilities, including the rollover of short-term assets and short-term liabilities. Schedule II below illustrates the forecast of net cash flow exposures. A common technique for assessing exposure to interest rates for risk management purposes is an interest rate sensitivity gap analysis showing the gap between interest rate-sensitive assets and interest rate-sensitive liabilities over different time intervals. Such an analysis could be used as a starting point for identifying cash flow exposures to interest rate risk for hedge accounting purposes.

Schedule II Forecast Net Cash Flow and Repricing Exposures							
Quarterly period	*Notes*	*X1*	*X2*	*X3*	*X4*	*X5*	*n*
(units)		*CU*	*CU*	*CU*	*CU*	*CU*	*CU*
CASH INFLOW AND REPRICING EXPOSURES – from assets							
Principal and interest payments:							
Long-term fixed rate	(1)	2,400	3,000	3,000	1,000	1,200	x,xxx
Short-term (roll over)	(1)(2)	1,575	1,579	1,582	1,586	1,591	x,xxx

Schedule II Forecast Net Cash Flow and Repricing Exposures							
Variable rate – principal payments	(1)	2,000	1,000	–	500	500	x,xxx
Variable rate – estimated interest	(2)	125	110	105	114	118	x,xxx
Total expected cash inflows		*6,100*	*5,689*	*4,687*	*3,200*	*3,409*	*x,xxx*
Variable rate asset balances	(3)	8,000	7,000	7,000	6,500	6,000	x,xxx
Cash inflows and repricings	(4)	***14,100***	***12,689***	***11,687***	***9,700***	***9,409***	***x,xxx***
CASH OUTFLOW AND REPRICING EXPOSURES - from liabilities							
Principal and interest payments:							
Long-term fixed rate	(1)	2,100	400	500	500	301	x,xxx
Short-term (roll over)	(1)(2)	735	737	738	740	742	x,xxx
Variable rate – principal payments	(1)	–	–	2,000	–	1,000	x,xxx
Variable rate – estimated interest	(2)	100	110	120	98	109	x,xxx
Total expected cash outflows		*2,935*	*1,247*	*3,358*	*1,338*	*2,152*	*x,xxx*
Variable rate liability balances	(3)	8,000	8,000	6,000	6,000	5,000	x,xxx

Schedule II Forecast Net Cash Flow and Repricing Exposures							
Cash outflows and repricings	(4)	***10,935***	***9,247***	***9,358***	***7,338***	***7,152***	***x,xxx***
NET EXPOSURES	(5)	*3,165*	*3,442*	*2,329*	*2,362*	*2,257*	*x,xxx*

Schedule II Forecast Net Cash Flow and Repricing Exposures

1. The cash flows are estimated using contractual terms and assumptions based on management's intentions and market factors. It is assumed that short-term assets and liabilities will continue to be rolled over in succeeding periods. Assumptions about prepayments and defaults and the withdrawal of deposits are based on market and historical data. It is assumed that principal and interest inflows and outflows will be reinvested and refinanced, respectively, at the end of each period at the then current market interest rates and share the benchmark interest rate risk to which they are exposed.

2. Forward interest rates obtained from Schedule VI are used to forecast interest payments on variable rate financial instruments and expected rollovers of short-term assets and liabilities. All forecast cash flows are associated with the specific time periods (3 months, 6 months, 9 months, and 12 months) in which they are expected to occur. For completeness, the interest cash flows resulting from reinvestments, refinancings and repricings are included in the schedule and shown gross even though only the net margin may actually be reinvested. Some entities may choose to disregard the forecast interest cash flows for risk management purposes because they may be used to absorb operating costs and any remaining amounts would not be significant enough to affect risk management decisions.

3. The cash flow forecast is adjusted to include the variable rate asset and liability balances in each period in which such variable rate asset and liability balances are repriced. The principal amounts of these assets and liabilities are not actually being paid and, therefore, do not generate a cash flow. However, since interest is computed on the principal amounts for each period based on the then current market interest rate, such principal amounts expose the entity to the same interest rate risk as if they were cash flows being reinvested or refinanced.

4. The forecast cash flow and repricing exposures that are identified in each period

Schedule II Forecast Net Cash Flow and Repricing Exposures

represent the principal amounts of cash inflows that will be reinvested or repriced and cash outflows that will be refinanced or repriced at the market interest rates that are in effect when those forecast transactions occur.

5. The net cash flow and repricing exposure is the difference between the cash inflow and repricing exposures from assets and the cash outflow and repricing exposures from liabilities. In the illustration, the entity is exposed to interest rate declines because the exposure from assets exceeds the exposure from liabilities and the excess (i.e., the net amount) will be reinvested or repriced at the current market rate and there is no offsetting refinancing or repricing of outflows.

Note that some entities may regard some portion of their non-interest bearing demand deposits as economically equivalent to long-term debt. However, these deposits do not create a cash flow exposure to interest rates and would therefore be excluded from this analysis for accounting purposes.

Schedule II Forecast net cash flow and repricing exposures provides no more than a starting point for assessing cash flow exposure to interest rates and for adjusting hedging positions. The complete analysis includes outstanding hedging positions and is shown in Schedule III Analysis of expected net exposures and hedging positions. It compares the forecast net cash flow exposures for each period (developed in Schedule II) with existing hedging positions (obtained from Schedule I), and provides a basis for considering whether adjustment of the hedging relationship should be made.

Schedule III Analysis of Expected Net Exposures and Hedging Positions

Quarterly period	*X1*	*X2*	*X3*	*X4*	*X5*	*…n*
(units)	*CU*	*CU*	*CU*	*CU*	*CU*	*CU*
Net cash flow and repricing exposures (Schedule II)	3,165	3,442	2,329	2,362	2,257	x,xxx
Pre-existing swaps outstanding:						
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	1,200	1,200	1,200	x,xxx

Schedule III Analysis of Expected Net Exposures and Hedging Positions						
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after pre-existing swaps	*2,165*	*2,442*	*1,629*	*1,662*	*1,557*	*x,xxx*
Transactions to adjust outstanding hedging positions:						
Receive-fixed, pay variable swap 1 (notional amount, 10-years)	2,000	2,000	2,000	2,000	2,000	x,xxx
Pay-fixed, receive-variable swap 2 (notional amount, 3-years)			(1,000)	(1,000)	(1,000)	x,xxx
Swaps …X						x,xxx
Unhedged cash flow and repricing exposure	*165*	*442*	*629*	*662*	*557*	*x,xxx*

The notional amounts of the interest rate swaps that are outstanding at the analysis date are included in each of the periods in which the interest rate swaps are outstanding to illustrate the impact of the outstanding interest rate swaps on the identified cash flow exposures. The notional amounts of the outstanding interest rate swaps are included in each period because interest is computed on the notional amounts each period, and the variable rate components of the outstanding swaps are repriced to the current market rate quarterly. The notional amounts create an exposure to interest rates that in part is similar to the principal balances of variable rate assets and variable rate liabilities.

The exposure that remains after considering the existing positions is then evaluated to determine the extent to which adjustments of existing hedging positions are necessary. The bottom portion of Schedule III shows the beginning of Period X1 using interest rate swap transactions to reduce the net exposures further to within the tolerance levels established under the entity's risk management policy.

Note that in the illustration, the cash flow exposure is not entirely eliminated.

Many entities do not fully eliminate risk but rather reduce it to within some tolerable limit.

Various types of derivative instruments could be used to manage the cash flow exposure to interest rate risk identified in the schedule of forecast net cash flows (Schedule II). However, for the purpose of the illustration, it is assumed that interest rate swaps are used for all hedging activities. It is also assumed that in periods in which interest rate swaps should be reduced, rather than terminating some of the outstanding interest rate swap positions, a new swap with the opposite return characteristics is added to the portfolio.

In the illustration in Schedule III above, swap 1, a receive-fixed, pay-variable swap, is used to reduce the net exposure in Periods X1 and X2. Since it is a 10-year swap, it also reduces exposures identified in other future periods not shown. However, it has the effect of creating an over-hedged position in Periods X3–X5. Swap 2, a forward starting pay-fixed, receive-variable interest rate swap, is used to reduce the notional amount of the outstanding receive-fixed, pay-variable interest rate swaps in Periods X3–X5 and thereby reduce the over-hedged positions.

It also is noted that in many situations, no adjustment or only a single adjustment of the outstanding hedging position is necessary to bring the exposure to within an acceptable limit. However, when the entity's risk management policy specifies a very low tolerance of risk a greater number of adjustments to the hedging positions over the forecast period would be needed to further reduce any remaining risk.

To the extent that some of the interest rate swaps fully offset other interest rate swaps that have been entered into for hedging purposes, it is not necessary to include them in a designated hedging relationship for hedge accounting purposes. These offsetting positions can be combined, de-designated as hedging instruments, if necessary, and reclassified for accounting purposes from the hedging portfolio to the trading portfolio. This procedure limits the extent to which the gross swaps must continue to be designated and tracked in a hedging relationship for accounting purposes. For the purposes of this illustration it is assumed that CU500 of the pay-fixed, receive-variable interest rate swaps fully offset CU500 of the receive-fixed, pay-variable interest rate swaps at the beginning of Period X1 and for Periods X1–X5, and are de-designated as hedging instruments and reclassified to the trading account.

After reflecting these offsetting positions, the remaining gross interest rate swap positions from Schedule III are shown in Schedule IV as follows.

Schedule IV Interest Rate Swaps Designated as Hedges

Schedule IV Interest Rate Swaps Designated as Hedges						
Quarterly period	*X1*	*X2*	*X3*	*X4*	*X5*	*…n*
(units)	*CU*	*CU*	*CU*	*CU*	*CU*	*CU*
Receive-fixed, pay-variable (notional amounts)	3,500	3,500	2,700	2,700	2,700	x,xxx
Pay-fixed, receive-variable (notional amounts)	(500)	(500)	(1,000)	(1,000)	(1,000)	x,xxx
Net outstanding swaps positions	*3,000*	*3,000*	*1,700*	*1,700*	*1,700*	*x,xxx*

For the purposes of the illustrations, it is assumed that swap 2, entered into at the beginning of Period X1, only partially offsets another swap being accounted for as a hedge and therefore continues to be designated as a hedging instrument.

Hedge Accounting Considerations

Illustrating the Designation of the Hedging Relationship

The discussion and illustrations thus far have focused primarily on economic and risk management considerations relating to the identification of risk in future periods and the adjustment of that risk using interest rate swaps. These activities form the basis for designating a hedging relationship for accounting purposes.

The examples in IPSAS 29 focus primarily on hedging relationships involving a single hedged item and a single hedging instrument, but there is little discussion and guidance on portfolio hedging relationships for cash flow hedges when risk is being managed centrally. In this illustration, the general principles are applied to hedging relationships involving a component of risk in a portfolio having multiple risks from multiple transactions or positions.

Although designation is necessary to achieve hedge accounting, the way in which the designation is described also affects the extent to which the hedging relationship is judged to be effective for accounting purposes and the extent to which the entity's existing system for managing risk will be required to be modified to track hedging activities for accounting purposes. Accordingly, an entity may wish to designate the hedging relationship in a manner that avoids unnecessary systems changes by taking advantage of the information already

generated by the risk management system and avoids unnecessary bookkeeping and tracking. In designating hedging relationships, the entity may also consider the extent to which ineffectiveness is expected to be recognized for accounting purposes under alternative designations.

The designation of the hedging relationship needs to specify various matters. These are illustrated and discussed here from the perspective of the hedge of the interest rate risk associated with the cash inflows, but the guidance can also be applied to the hedge of the risk associated with the cash outflows. It is fairly obvious that only a portion of the gross exposures relating to the cash inflows is being hedged by the interest rate swaps. Schedule V The general hedging relationship illustrates the designation of the portion of the gross reinvestment risk exposures identified in Schedule II as being hedged by the interest rate swaps.

Schedule V The General Hedging Relationship						
Quarterly period	*X1*	*X2*	*X3*	*X4*	*X5*	*…n*
(units)	*CU*	*CU*	*CU*	*CU*	*CU*	*CU*
Cash inflow repricing exposure (Schedule II)	14,100	12,689	11,687	9,700	9,409	x,xxx
Receive-fixed, pay-variable swaps (Schedule IV)	3,500	3,500	2,700	2,700	2,700	x,xxx
Hedged exposure percentage	*24.8%*	*27.6%*	*23.1%*	*27.8%*	*28.7%*	*xx.x%*

The hedged exposure percentage is computed as the ratio of the notional amount of the receive-fixed, pay-variable swaps that are outstanding divided by the gross exposure. Note that in Schedule V there are sufficient levels of forecast reinvestments in each period to offset more than the notional amount of the receive-fixed, pay-variable swaps and satisfy the accounting requirement that the forecast transaction is highly probable.

It is not as obvious, however, how the interest rate swaps are specifically related to the cash flow interest risks designated as being hedged and how the interest rate swaps are effective in reducing that risk. The more specific designation is illustrated in Schedule VI The specific hedging relationship below. It provides a meaningful way of depicting the more complicated narrative designation of the hedge by focusing on the hedging objective to eliminate the cash flow variability associated with future changes in interest rates and to obtain an interest rate

equal to the fixed rate inherent in the term structure of interest rates that exists at the commencement of the hedge.

The expected interest from the reinvestment of the cash inflows and repricings of the assets is computed by multiplying the gross amounts exposed by the forward rate for the period. For example, the gross exposure for Period X2 of CU14,100 is multiplied by the forward rate for Periods X2–X5 of 5.50 percent, 6.00 percent, 6.50 percent and 7.25 percent, respectively, to compute the expected interest for those quarterly periods based on the current term structure of interest rates. The hedged expected interest is computed by multiplying the expected interest for the applicable three-month period by the hedged exposure percentage.

Schedule VI The Specific Hedging Relationship

	Term structure of interest rates					
Quarterly period	*X1*	*X2*	*X3*	*X4*	*X5*	*…n*
Spot rates	5.00%	5.25%	5.50%	5.75%	6.05%	x.xx%
Forward rates[(a)]	5.00%	5.50%	6.00%	6.50%	7.25%	x.xx%

Cash flow exposures and expected interest amounts

Repricing period	Time to forecast transaction	Gross amounts exposed	Expected interest					
			CU	CU	CU	CU	CU	CU
2	3 months	14,100		**194**	212	229	256	
3	6 months	12,689			**190**	206	230	xxx
4	9 months	11,687				**190**	212	xxx
5	12 months	9,700					**176**	xxx
6	15 months	9,409						**xxx**
Hedged percentage (Schedule V) in the previous period				24.8%	27.6%	23.1%	27.8%	xx.x%
Hedged expected interest				48	52	44	49	xx

Schedule VI The Specific Hedging Relationship
(a) The forward interest rates are computed from the spot interest rates and rounded for the purposes of the presentation. Computations that are based on the forward interest rates are made based on the actual computed forward rate and then rounded for the purposes of the presentation.

It does not matter whether the gross amount exposed is reinvested in long-term fixed rate debt or variable rate debt, or in short-term debt that is rolled over in each subsequent period. The exposure to changes in the forward interest rate is the same. For example, if the CU14,100 is reinvested at a fixed rate at the beginning of Period X2 for six months, it will be reinvested at 5.75 percent. The expected interest is based on the forward interest rates for Period X2 of 5.50 percent and for Period X3 of 6.00 percent, equal to a blended rate of 5.75 percent $(1.055 \times 1.060)^{0.5}$, which is the Period X2 spot rate for the next six months.

However, only the expected interest from the reinvestment of the cash inflows or repricing of the gross amount for the first three-month period after the forecast transaction occurs is designated as being hedged. The expected interest being hedged is represented by the shaded cells. The exposure for the subsequent periods is not hedged. In the example, the portion of the interest rate exposure being hedged is the forward rate of 5.50 percent for Period X2. In order to assess hedge effectiveness and compute actual hedge ineffectiveness on an ongoing basis, the entity may use the information on hedged interest cash inflows in Schedule VI and compare it with updated estimates of expected interest cash inflows (e.g., in a table that looks like Schedule II). As long as expected interest cash inflows exceed hedged interest cash inflows, the entity may compare the cumulative change in the fair value of the hedged cash inflows with the cumulative change in the fair value of the hedging instrument to compute actual hedge effectiveness. If there are insufficient expected interest cash inflows, there will be ineffectiveness. It is measured by comparing the cumulative change in the fair value of the expected interest cash flows to the extent they are less than the hedged cash flows with the cumulative change in the fair value of the hedging instrument.

Describing the Designation of the Hedging Relationship

As mentioned previously, there are various matters that should be specified in the designation of the hedging relationship that complicate the description of the designation but are necessary to limit ineffectiveness to be recognized for accounting purposes and to avoid unnecessary systems

changes and bookkeeping. The example that follows describes the designation more fully and identifies additional aspects of the designation not apparent from the previous illustrations.

Example Designation
Hedging Objective The hedging objective is to eliminate the risk of interest rate fluctuations over the hedging period, which is the life of the interest rate swap, and in effect obtain a fixed interest rate during this period that is equal to the fixed interest rate on the interest rate swap.
Type of Hedge Cash flow hedge. *Hedging Instrument* The receive-fixed, pay-variable swaps are designated as the hedging instrument. They hedge the cash flow exposure to interest rate risk. repricing of the swap hedges a three-month portion of the interest cash inflows that results from: The forecast reinvestment or repricing of the principal amounts shown in Schedule V. Unrelated investments or repricings that occur after the repricing dates on the swap over its life and involve different borrowers or lenders.
The Hedged Item—General The hedged item is a portion of the gross interest cash inflows that will result from the reinvestment or repricing of the cash flows identified in Schedule V and are expected to occur within the periods shown on such schedule. The portion of the interest cash inflow that is being hedged has three components: The principal component giving rise to the interest cash inflow and the period in which it occurs; The interest rate component; and The time component or period covered by the hedge.

Example Designation

The Hedged Item—The Principal Component

The portion of the interest cash inflows being hedged is the amount that results from the first portion of the principal amounts being invested or repriced in each period:

That is equal to the sum of the notional amounts of the received-fixed, pay-variable interest rate swaps that are designated as hedging instruments and outstanding in the period of the reinvestment or repricing, and

That corresponds to the first principal amounts of cash flow exposures that are invested or repriced at or after the repricing dates of the interest rate swaps.

The Hedged Item—The Interest Rate Component

The portion of the interest rate change that is being hedged is the change in both of the following:

The credit component of the interest rate being paid on the principal amount invested or repriced that is equal to the credit risk inherent in the interest rate swap. It is that portion of the interest rate on the investment that is equal to the interest index of the interest rate swap, such as LIBOR; and

The yield curve component of the interest rate that is equal to the repricing period on the interest rate swap designated as the hedging instrument.

The Hedged Item—The Hedged Period

The period of the exposure to interest rate changes on the portion of the cash flow exposures being hedged is:

The period from the designation date to the repricing date of the interest rate swap that occurs within the quarterly period in which, but not before, the forecast transactions occur; and

Its effects for the period after the forecast transactions occur equal to the repricing interval of the interest rate swap.

It is important to recognize that the swaps are not hedging the cash flow risk for a single investment over its entire life. The swaps are designated as hedging the

cash flow risk from different principal investments and repricings that are made in each repricing period of the swaps over their entire term. The swaps hedge only the interest accruals that occur in the first period following the reinvestment. They are hedging the cash flow impact resulting from a change in interest rates that occurs up to the repricing of the swap. The exposure to changes in rates for the period from the repricing of the swap to the date of the hedged reinvestment of cash inflows or repricing of variable rate assets is not hedged. When the swap is repriced, the interest rate on the swap is fixed until the next repricing date and the accrual of the net swap settlements is determined. Any changes in interest rates after that date that affect the amount of the interest cash inflow are no longer hedged for accounting purposes.

Designation Objectives

Systems Considerations

Many of the tracking and bookkeeping requirements are eliminated by designating each repricing of an interest rate swap as hedging the cash flow risk from forecast reinvestments of cash inflows and repricings of variable rate assets for only a portion of the lives of the related assets. Much tracking and bookkeeping would be necessary if the swaps were instead designated as hedging the cash flow risk from forecast principal investments and repricings of variable rate assets over the entire lives of these assets.

This type of designation avoids keeping track of gains and losses recognized in net assets/equity after the forecast transactions occur (IPSAS 29.108 and IPSAS 29.109) because the portion of the cash flow risk being hedged is that portion that will be recognized in surplus or deficit in the period immediately following the forecast transactions that corresponds with the periodic net cash settlements on the swap. If the hedge were to cover the entire life of the assets being acquired, it would be necessary to associate a specific interest rate swap with the asset being acquired. If a forecast transaction is the acquisition of a fixed rate instrument, the fair value of the swap that hedged that transaction would be recognized in surplus or deficit to adjust the interest revenue on the asset when the interest revenue is recognized. The swap would then have to be terminated or redesignated in another hedging relationship. If a forecast transaction is the acquisition of a variable rate asset, the swap would continue in the hedging relationship but it would have to be tracked back to the asset acquired so that any fair value amounts on the swap recognized in net assets/equity could be recognized in surplus or deficit upon the subsequent sale of the asset.

It also avoids the necessity of associating with variable rate assets any portion of the fair value of the swaps that is recognized in net assets/equity. Accordingly, there is no portion of the fair value of the swap that is recognized in net assets/equity that should be recognized in surplus or deficit when a forecast

transaction occurs or upon the sale of a variable rate asset.

This type of designation also permits flexibility in deciding how to reinvest cash flows when they occur. Since the hedged risk relates only to a single period that corresponds with the repricing period of the interest rate swap designated as the hedging instrument, it is not necessary to determine at the designation date whether the cash flows will be reinvested in fixed rate or variable rate assets or to specify at the date of designation the life of the asset to be acquired.

Effectiveness Considerations

Ineffectiveness is greatly reduced by designating a specific portion of the cash flow exposure as being hedged.

- Ineffectiveness due to credit differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the cash flow risk being hedged as the risk attributable to changes in the interest rates that correspond with the rates inherent in the swap, such as the AA rate curve. This type of designation prevents changes resulting from changes in credit spreads from being considered as ineffectiveness.
- Ineffectiveness due to duration differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the interest rate risk being hedged as the risk relating to changes in the portion of the yield curve that corresponds with the period in which the variable rate leg of the interest rate swap is repriced.
- Ineffectiveness due to interest rate changes that occur between the repricing date of the interest rate swap and the date of the forecast transactions is eliminated by simply not hedging that period of time. The period from the repricing of the swap and the occurrence of the forecast transactions in the period immediately following the repricing of the swap is left unhedged. Therefore, the difference in dates does not result in ineffectiveness.

Accounting Considerations

The ability to qualify for hedge accounting using the methodology described here is founded on provisions in IPSAS 29 and on interpretations of its requirements. Some of those are described in the answer to Question F.6.2 Hedge Accounting Considerations when Interest Rate Risk is Managed on a Net Basis. Some additional and supporting provisions and interpretations are identified below.

Hedging a Portion of the Risk Exposure

The ability to identify and hedge only a portion of the cash flow risk exposure resulting from the reinvestment of cash flows or repricing of variable rate

instruments is found in IPSAS 29.90 as interpreted in the answers to Questions F.6.2 Issue (k) and F.2.17 Partial Term Hedging.

Hedging Multiple Risks with a Single Instrument

The ability to designate a single interest rate swap as a hedge of the cash flow exposure to interest rates resulting from various reinvestments of cash inflows or repricings of variable rate assets that occur over the life of the swap is founded on IPSAS 29.85 as interpreted in the answer to Question F.1.12 Hedges of More Than One Type of Risk.

Hedging Similar Risks in a Portfolio

The ability to specify the forecast transaction being hedged as a portion of the cash flow exposure to interest rates for a portion of the duration of the investment that gives rise to the interest payment without specifying at the designation date the expected life of the instrument and whether it pays a fixed or variable rate is founded on the answer to Question F.6.2 Issue (l), which specifies that the items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged.

Hedge Terminations

The ability to de-designate the forecast transaction (the cash flow exposure on an investment or repricing that will occur after the repricing date of the swap) as being hedged is provided for in IPSAS 29.112 dealing with hedge terminations. While a portion of the forecast transaction is no longer being hedged, the interest rate swap is not de-designated, and it continues to be a hedging instrument for the remaining transactions in the series that have not occurred. For example, assume that an interest rate swap having a remaining life of one year has been designated as hedging a series of three quarterly reinvestments of cash flows. The next forecast cash flow reinvestment occurs in three months. When the interest rate swap is repriced in three months at the then current variable rate, the fixed rate and the variable rate on the interest rate swap become known and no longer provide hedge protection for the next three months. If the next forecast transaction does not occur until three months and ten days, the ten-day period that remains after the repricing of the interest rate swap is not hedged.

F.6.4 Hedge Accounting: Premium or Discount on Forward Exchange Contract

A forward exchange contract is designated as a hedging instrument, for example, in a hedge of a net investment in a foreign operation. Is it permitted to amortize the discount or premium on the forward exchange contract to surplus or deficit over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortized to surplus or deficit under IPSAS 29. Derivatives are always measured at fair value in the statement of financial position. The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognized in surplus or deficit unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a foreign operation, in which case the effective portion of the gain or loss is recognized in net assets/equity. In that case, the amounts recognized in net assets/equity are recognized in surplus or deficit when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under IPSAS 29.84(b), the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are recognized in surplus or deficit.

F.6.5 IPSAS 29 and IPSAS 4 Fair Value Hedge of Asset Measured at Cost

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does IPSAS 29 require the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions in IPSAS 29.98 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

Section G: Other

G.1 *Disclosure of Changes in Fair Value*

IPSAS 29 requires financial assets classified as available-for-sale (AFS) and financial assets and financial liabilities at fair value through surplus or deficit to be remeasured to fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through surplus or deficit are recognized in surplus or deficit, and fair value changes for AFS assets are recognized in net assets/equity. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

IPSAS 30.23 requires items of revenue, expense and gains and losses to be

disclosed. This disclosure requirement encompasses items of revenue, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of fair value changes, distinguishing between changes that are recognized in surplus or deficit and changes that are recognized in net assets/equity. Further breakdown is provided of changes that relate to:

(a) AFS assets, showing separately the amount of gain or loss recognized in net assets/equity during the period and the amount that was recognized in surplus for deficit for the period;

(b) Financial assets or financial liabilities at fair value through surplus or deficit, showing separately those fair value changes on financial assets or financial liabilities (i) designated as such upon initial recognition and (ii) classified as held for trading in accordance with IPSAS 29; and

(c) Hedging instruments.

IPSAS 30 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that in accordance with IPSAS 29 it categorizes as held for trading, but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, IPSAS 30.10 requires disclosure of the carrying amounts of financial assets or financial liabilities at fair value through surplus or deficit, showing separately: (i) those designated as such upon initial recognition and (ii) those held for trading in accordance with IPSAS 29.

G.2 *IPSAS 29 and IPSAS 2 Hedge Accounting: Statements of Cash Flows*

How should cash flows arising from hedging instruments be classified in statements of cash flows?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in IPSAS 2 has not been updated to reflect IPSAS 29, the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments under IPSAS 29.

Illustrative Examples

These examples accompany, but are not part of, IPSAS 29.

Hedging Interest Rate Risk for a Portfolio of Assets and Liabilities

IE1. On January 1, 20X1 Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.

IE2. For risk management purposes, Entity A analyzes the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (i.e., it has 60 separate monthly time periods).[5] The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.

IE3. This example deals only with the repricing time period expiring in three months' time, i.e., the time period maturing on March 31, 20X1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of CU100 million and liabilities of CU80 million into this time period. All of the liabilities are repayable on demand.

IE4. Entity A decides, for risk management purposes, to hedge the net position of CU20 million and accordingly enters into an interest rate swap[6] on January 1, 20X1, to pay a fixed rate and receive London Interbank Offered Rate (LIBOR), with a notional principal amount of CU20 million and a fixed life of three months.

IE5. This example makes the following simplifying assumptions:

(a) The coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;

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

[6] This example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

(b) The coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and

(c) The interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap).

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

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

	Jan 1, 20X1	**Jan 31, 20X1**	**Feb 1, 20X1**	**Feb 28, 20X1**	**Mar 31, 20X1**
Fair value (asset) (CU)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

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

	Jan 1, 20X1	**Jan 31, 20X1**	**Feb 1, 20X1**	**Feb 28, 20X1**	**Mar 31, 20X1**
Fair value (liability) (CU)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting Treatment

IE9. On January 1, 20X1, Entity A designates as the hedged item an amount of CU20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (i.e., the CU20 million of assets) that is attributable to changes in LIBOR. It also

complies with the other designation requirements set out in paragraphs 98(d) and AG162 of the Standard.

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

End of Month 1 (January 31, 20X1)

IE11. On January 31, 20X1 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as CU96 million.

IE12. The fair value of the designated interest rate swap with a notional principal of CU20 million is (CU47,408)[7] (the swap is a liability).

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

(a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 percent (CU20 million ÷ CU100 million).

(b) Second, it applies this percentage (20 percent) to its revised estimate of the amount in that time period (CU96 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU19.2 million.

(c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU19.2 million) that is attributable to changes in LIBOR. This is CU45,511 (CU47,408[8] × (CU19.2 million ÷ CU20 million)).

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

Dr		Cash	CU172,097	
	Cr	Surplus or deficit (interest revenue)[9]		CU172,097
To recognize the interest received on the hedged amount (CU19.2 million).				

[7] See paragraph IE8.

[8] i.e., CU20,047,408 – CU 20,000,000, see paragraph IE7.

[9] This example does not show how amounts of interest revenue and interest expense are calculated.

Dr		Surplus or deficit (interest expense)	CU179,268	
	Cr	Surplus or deficit (interest revenue)		CU179,268
	Cr	Cash		Nil
To recognize the interest received and paid on the swap designated as the hedging instrument.				

Dr		Surplus or deficit (loss)	CU47,408	
	Cr	Derivative liability		CU47,408
To recognize the change in the fair value of the swap.				

Dr		Separate line item in the statement of financial position	CU45,511	
	Cr	Surplus or deficit (gain)		CU45,511
To recognize the change in the fair value of the hedged amount.				

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

Beginning of Month 2

IE16. On February 1, 20X1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold 81/3 percent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual

assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

IE17. On this basis, Entity A computes that it has sold 81/3 percent of the assets allocated to the three-month time period, i.e., CU8 million (81/3 percent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.[10] On derecognition of the assets, Entity A also removes from the separate line item in the statement of financial position an amount that represents the change in the fair value of the hedged assets that it has now sold. This is 81/3 percent of the total line item balance of CU45,511, i.e., CU3,793.

IE18. Entity A makes the following accounting entries to recognize the sale of the asset and the removal of part of the balance in the separate line item in the statement of financial position:

Dr		Cash	CU8,018,400	
	Cr	Asset		CU8,000,000
	Cr	Separate line item in the statement of financial position		CU3,793
	Cr	Surplus or deficit (gain)		CU14,607
To recognize the sale of the asset at fair value and to recognize a gain on sale				

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

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

IE20. Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument CU8 million or 40 percent of the notional amount of the original swap with a remaining life of two months and a fair value of CU18,963.[11] It also complies with the other designation requirements in paragraphs 98(a) and AG162 of the Standard. The CU12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognized in surplus or deficit, or is designated as the hedging instrument in a different hedge.[12]

IE21. As at February 1, 20X1 and after accounting for the sale of assets, the separate line item in the statement of financial position is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6[13] million of assets. However, as at February 1, 20X1, Entity A is hedging only CU8 million of assets that have a cumulative change in fair value of CU18,963.[14] The remaining separate line item in the statement of financial position of CU22,755[15] relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortizes this amount over the remaining life of the time period, i.e., it amortizes CU22,755 over two months.

IE22. Entity A determines that it is not practicable to use a method of amortization based on a recalculated effective yield and hence uses a straight-line method.

End of Month 2 (February 28, 20X1)

IE23. On February 28, 20X1 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of CU8 million is (CU9,518)[16] (the swap is a liability). Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at February 28, 20X1 as CU8,009,518.[17]

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[10] The amount realized on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in IE7.

[11] CU47,408 × 40 percent.

[12] The entity could instead enter into an offsetting swap with a notional principle of CU12 million to adjust its position and designate as the hedging instrument all CU20 million of the existing swap and all CU12 million of the new offsetting swap.

[13] CU19.2 million – (8⅓ × CU19.2 million).

[14] CU41,718 × (CU8 million/CU17.6 million).

[15] CU41,718 – CU18,963.

[16] CU23,795 [see paragraph IE8] × (CU8 million/CU20 million).

[17] CU20,023,795 [see paragraph IE7] × (CU8 million/CU20 million).

IE24. Entity A makes the following accounting entries relating to the hedge in this time period:

Dr		Cash	CU71,707	
	Cr	Surplus or deficit (interest revenue)		CU71,707
To recognize the interest received on the hedged amount (CU8 million).				

Dr		Surplus or deficit (interest expense)	CU71,707	
	Cr	Surplus or deficit(interest revenue)		CU62,115
	Cr	Cash		CU9,592
To recognize the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).				
Dr		Derivative liability	CU9,445	
	Cr	Surplus or deficit (gain)		CU9,445
To recognize the change in the fair value of the portion of the swap designated as the hedging instrument (CU8 million) (CU9,518 – CU18,963).				

Dr		Surplus or deficit (loss)	CU9,445	
	Cr	Separate line item in the statement of financial position		CU9,445
To recognize the change in the fair value of the hedged amount (CU8,009,518 –				

CU8,018,963).

IE25. The net effect on surplus or deficit (excluding interest revenue and interest expense) is nil reflecting that the hedge is fully effective.

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

Dr		Surplus or deficit (loss)	CU11,378	
	Cr	Separate line item in the statement of financial position		CU11,378 (a)
To recognize the amortization charge for the period. (a) CU22,755 ÷ 2				

End of Month 3

IE27. During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On March 31, 20X1 the assets and the swap mature and all balances are recognized in surplus or deficit.

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

Dr		Cash	CU8,071,707	
	Cr	Asset (statement of financial position)		CU8,000,000
	Cr	Surplus or deficit (interest revenue)		CU71,707
To recognize the interest and cash received on maturity of the hedged amount (CU8 million).				

Dr		Surplus or deficit (interest expense)	CU71,707	
	Cr	Surplus or deficit (interest revenue)		CU62,115
	Cr	Cash		CU9,592
To recognize the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).				

Dr		Derivative liability	CU9,518	
	Cr	Surplus or deficit (gain)		CU9,518
To recognize the expiry of the portion of the swap designated as the hedging instrument (CU8 million).				

Dr		Surplus or deficit (loss)	CU9,518	
	Cr	Separate line item in the statement of financial position		CU9,518
To remove the remaining line item balance on expiry of the time period.				

IE29. The net effect on surplus or deficit (excluding interest revenue and interest expense) is nil reflecting that the hedge is fully effective.

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

Dr		Surplus or deficit (loss)	CU11,377	

	Cr	Separate line item in the statement of financial position		CU11,377[(a)]
To recognize the amortization charge for the period.				
(a) CU22,755 ÷ 2				

Summary

IE31. The tables below summarize:

(a) Changes in the separate line item in the statement of financial position;

(b) The fair value of the derivative;

(c) The surplus or deficit effect of the hedge for the entire three-month period of the hedge; and

(d) Interest revenue and interest expense relating to the amount designated as hedged.

Description	**Jan 1, 20X1**	**Jan 31, 20X1**	**Feb 1, 20X1**	**Feb 28, 20X1**	**Mar 31, 20X1**
	CU	**CU**	**CU**	**CU**	**CU**
Amount of asset hedged	**20,000,000**	**19,200,000**	**8,000,000**	**8,000,000**	**8,000,000**
(a) **Changes in the separate line item in the statement of financial position**					
Brought forward:					
Balance to be amortized	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518

Description	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
	CU	CU	CU	CU	CU
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortization	Nil	Nil	Nil	(11,378)	(11,377)
Carried forward:					
Balance to be amortized	**Nil**	**Nil**	**22,755**	**11,377**	**Nil**
Remaining balance	**Nil**	**45,511**	**18,963**	**9,518**	**Nil**
(b) **The fair value of the derivative**					
CU20,000,000	Nil	47,408	–	–	–
CU12,000,000	Nil	–	28,445	No longer designated as the hedging instrument.	
CU8,000,000	Nil	–	18,963	9,518	Nil
Total	**Nil**	**47,408**	**47,408**	**9,518**	**Nil**
(c) **Effect of the hedge on surplus or deficit**					
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative	Nil	(47,408)	N/A	9,445	9,518

Description	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
	CU	CU	CU	CU	CU
fair value					
Net effect	**Nil**	**(1,897)**	**N/A**	**Nil**	**Nil**
Amortization	**Nil**	**Nil**	**N/A**	**(11,378)**	**(11,377)**
In addition, there is a gain on sale of assets of CU14,607 at February 1, 20X1.					
(d) **Interest revenue and interest expense relating to the amount designated as hedged**					
Interest revenue					
– on the asset	Nil	172,097	N/A	71,707	71,707
– on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
– on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

Disposal of a Foreign Operation

IE32. This example illustrates the application of paragraphs C12 and C13 of Appendix C in connection with the amount recognized in surplus or deficit on the disposal of a foreign operation.

Background

IE33. This example assumes the economic entity structure set out in the application guidance and that Entity D used a USD borrowing in Entity A to hedge the EUR/USD risk of the net investment in Entity C in Entity D's consolidated financial statements. Entity D uses the step-by-step method of consolidation. Assume the hedge was fully effective and the full USD/EUR accumulated change in the value of the hedging instrument before disposal of Entity C is €24 million (gain). This is matched exactly by the fall in value of the net investment in Entity C, when measured

against the functional currency of Entity D (euro).

IE34. If the direct method of consolidation is used, the fall in the value of Entity D's net investment in Entity C of €24 million would be reflected totally in the foreign currency translation reserve relating to Entity C in Entity D's consolidated financial statements. However, because Entity D uses the step-by-step method, this fall in the net investment value in Entity C of €24 million would be reflected both in Entity B's foreign currency translation reserve relating to Entity C and in Entity D's foreign currency translation reserve relating to Entity B.

IE35. The aggregate amount recognized in the foreign currency translation reserve in respect of Entities B and C is not affected by the consolidation method. Assume that using the direct method of consolidation, the foreign currency translation reserves for Entities B and C in Entity D's consolidated financial statements are €62 million gain and €24 million loss respectively; using the step-by-step method of consolidation those amounts are €49 million gain and €11 million loss respectively.

Reclassification

IE36. When the investment in Entity C is disposed of, IPSAS 29 requires the full €24 million gain on the hedging instrument to be recognized in surplus or deficit. Using the step-by-step method, the amount to be recognized in surplus or deficit in respect of the net investment in Entity C would be only €11 million loss. Entity D could adjust the foreign currency translation reserves of both Entities B and C by €13 million in order to match the amounts reclassified in respect of the hedging instrument and the net investment as would have been the case if the direct method of consolidation had been used, if that was its accounting policy. An entity that had not hedged its net investment could make the same reclassification.

Receipt of a Concessionary Loan

IE37. A local authority receives loan funding to the value of CU5 million from an international development agency to build primary healthcare clinics over a period of 5 years. The agreement stipulates that loan should be repaid over the 5 year period as follows:

Year 1: no capital repayments

Year 2: 10% of the capital

Year 3: 20% of the capital

Year 4: 30% of the capital

Year 5: 40% of the capital

Interest is paid annually in arrears, at a rate of 5% per annum on the outstanding balance of the loan. A market related rate of interest for a similar transaction is 10%.

IE38. The entity has received a concessionary loan of CU5 million, which will be repaid at 5% below the current market interest rate. The difference between the proceeds of the loan and the present value of the contractual payments in terms of the loan agreement, discounted using the market related rate of interest, is recognized as non-exchange revenue.

IE39. The journal entries to account for the concessionary loan are as follows:

1. On initial recognition, the entity recognizes the following (assuming that the entity subsequently measures concessionary loan at amortized cost):

Dr		Bank	5,000,000	
	Cr	Loan (refer to Table 2 below)		4,215,450
	Cr	Liability or non-exchange revenue		784,550

Recognition of the receipt of the loan at fair value

IPSAS 23 is considered in recognizing either a liability or revenue for the off-market portion of the loan. Paragraph IG54 of that Standard provides journal entries for the recognition and measurement of the off-market portion of the loan deemed to be non-exchange revenue.

2. Year 1: The entity recognizes the following:

Dr		Interest (refer to Table 3 below)	421,545	
	Cr	Loan		421,545

Recognition of interest using the effective interest method (CU4,215,450 × 10%)

Dr		Loan (refer to Table 1 below)	250,000	
	Cr	Bank		250,000
Recognition of interest paid on outstanding balance (CU5m × 5%)				

3. Year 2: The entity recognizes the following:				
Dr		Interest	438,700	
	Cr	Loan		438,700
Recognition of interest using the effective interest method (CU4,386,995 × 10%)				
Dr		Loan	750,000	
	Cr	Bank		750,000
Recognition of interest paid on outstanding balance (CU5m × 5% + CU500,000 capital repaid)				

4. Year 3: The entity recognizes the following:				
Dr		Interest	407,569	
	Cr	Loan		407,569
Recognition of interest using the effective interest method (CU4,075,695 × 10%)				
Dr		Loan	1,225,000	
	Cr	Bank		1,225,000

Recognition of interest paid on outstanding balance (CU4.5m × 5% + CU1m capital repaid)

5. Year 4: The entity recognizes the following:				
Dr		Interest	325,826	
	Cr	Loan		325,826
Recognition of interest using the effective interest method (CU 3,258,264 × 10%)				
Dr		Loan	1,675,000	
	Cr	Bank		1,675,000
Recognition of interest paid on outstanding balance (CU3.5m × 5% + CU1.5m capital repaid)				

6. Year 5: The entity recognizes the following:				
Dr		Interest	190,909	
	Cr	Loan		190,909
Recognition of interest using the effective interest method (CU1,909,091 × 10%)				
Dr		Loan	2,100,000	
	Cr	Bank		2,100,000
Recognition of interest paid on outstanding balance (CU2m × 5% + CU2m capital repaid)				

Calculations:

Table 1: Amortization Schedule (Using Contractual Repayments at 5% Interest)

	Year 0 CU	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital	5,000,000	5,000,000	5,000,000	4,500,000	3,500,000	2,000,000
Interest	–	250,000	250,000	225,000	175,000	100,000
Payments	–	(250,000)	(750,000)	(1,225,000)	(1,675,000)	(2,100,000)
Balance	**5,000,000**	**5,000,000**	**4,500,000**	**3,500,000**	**2,000,000**	–

Table 2: Discounting Contractual Cash Flows (Based on a Market Rate of 10%)

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital balance	5,000,000	4,500,000	3,500,000	2,000,000	–
Interest payable	250,000	250,000	225,000	175,000	100,000
Total payments (capital and interest)	250,000	750,000	1,225,000	1,675,000	2,100,000
Present value of payments	227,272	619,835	920,360	1,144,048	1,303,935
Total present value of					4,215,450

payments					
Proceeds received					5,000,000
Less: Present value of outflows (fair value of loan on initial recognition)					4,215,450
Off-market portion of loan to be recognized as non-exchange revenue					784,550

Table 3: Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1 CU	**Year 2 CU**	**Year 3 CU**	**Year 4 CU**	**Year 5 CU**
Capital	4,215,450	4,386,995	4,075,695	3,258,264	1,909,091
Interest accrual	421,545	438,700	407,569	325,827	190,909
Interest and capital payments	250,000	750,000	1,225,000	1,675,000	2,100,000
Balance	4,386,995	4,075,695	3,258,264	1,909,091	–

Payment of a Concessionary Loan

IE40. The department of education makes low interest loans available to qualifying students on flexible repayment terms as a means of promoting university education.

IE41. The department advanced CU250 million to various students at the beginning of the financial year, with the following terms and conditions:

- Capital is repaid as follows:

Year 1 to 3: no capital repayments

Year 4: 30% capital to be repaid

Year 5: 30% capital to be repaid

Year 6: 40% capital to be repaid

- Interest is calculated at 6% interest on the outstanding loan balance, and is paid annually in arrears. Assume the market rate of interest for a similar loan is 11.5%.

IE42. The journal entries to account for the concessionary loan are as follows (assuming the entity subsequently measures the concessionary loan at amortized cost):

1.	On initial recognition, the entity recognizes the following:			
Dr		Loan	199,345,480	
Dr		Expense	50,654,520	
	Cr	Bank		250,000,000

2.	Year 1: The entity recognizes the following			
Dr		Loan	22,924,730	
	Cr	Interest revenue		22,924,730
Interest accrual using the effective interest method CU199,345,480 × 11.5%				
Dr		Bank	15,000,000	
	Cr	Loan		15,000,000
Interest payment of CU250m × 6%				

3. Year 2: The entity recognizes the following:				
Dr		Loan	23,836,074	
	Cr	Interest revenue		23,836,074
Interest accrual using the effective interest method CU207,270,210 × 11.5%				
Dr		Bank	15,000,000	
	Cr	Loan		15,000,000
Interest payment of CU250m × 6%				

4. Year 3: The entity recognizes the following:				
Dr		Loan	24,852,223	
	Cr	Interest revenue		24,852,223
Interest accrual using the effective interest method CU216,106,284 × 11.5%				
Dr		Bank	15,000,000	
	Cr	Loan		15,000,000

5. Year 4: The entity recognizes the following:				
Dr		Loan	25,985,228	
	Cr	Interest revenue		25,985,228

Interest accrual using the effective interest method CU225,958,228 × 11.5%				
Dr		Bank	90,000,000	
	Cr	Loan		90,000,000
Interest payment of CU250m × 6% + CU75m capital repaid				

6. Year 5: The entity recognizes the following:				
Dr		Loan	18,623,530	
	Cr	Interest revenue		18,623,530
Interest accrual using the effective interest method CU161,943,735 × 11.5%				
Dr		Bank	85,500,000	
	Cr	Loan		85,500,000
Interest payment of CU175m × 6% + CU75m capital repaid				

7. Year 6: The entity recognizes the following:				
Dr		Loan	10,932,735	
	Cr	Interest revenue		10,932,735
Interest accrual using the effective interest method CU95,067,265 × 11.5%				
Dr		Bank	106,000,000	
	Cr	Loan		106,000,000

Recognition of capital repaid

Calculations

Table 1: Amortization Schedule (Using Contractual Repayments at 6% Interest)

	Year 0 CU'000	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000	Year 6 CU'000
Capital	250,000	250,000	250,000	250,000	250,000	250,000	250,000
Interest	–	15,000	15,000	15,000	15,000	10,500	6,000
Payments	–	15,000	15,000	15,000	90,000	85,500	106,000
Balance	**250,000**	**250,000**	**250,000**	**250,000**	**175,000**	**100,000**	**–**

Table 2: Discounting Contractual Cash Flows (Based on a Market Rate of 11.5%)

	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000	Year 6 CU'000
Capital balance	250,000	250,000	250,000	175,000	100,000	–
Interest payable	15,000	15,000	15,000	15,000	10,500	6,000
Total payments (capital and interest)	15,000	15,000	15,000	90,000	85,500	106,000
Present value of payments	13,452,915	12,065,394	10,820,981	58,229,497	49,612,576	55,164,117

Total present value of payments	199,345,480
Proceeds paid	250,000,000
Less: Present value of outflows (fair value of loan on initial recognition)	199,345,480
Off-market portion of loan to be recognized as expense	50,654,520

Table 3: Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU	Year 6 CU
Capital	199,345,480	207,270,210	216,106,284	225,958,228	161,943,735	95,067,265
Interest accrual	22,924,730	23,836,074	24,852,223	25,985,228	18,623,530	10,932,735
Interest and capital payments	15,000,000	15,000,000	15,000,000	90,000,000	85,500,000	106,000,000
Balance	207,270,210	216,106,284	225,958,228	161,943,735	95,067,265	–

Financial Guarantee Contract Provided at Nominal Consideration

IE43. Entity C is a major motor vehicle manufacturer in Jurisdiction A. On January 1, 201V Government A (the issuer) enters into a financial guarantee contract with Entity B (the holder) to reimburse Entity B against the financial effects of default by Entity C (the debtor) for a 30 year loan of 50 million Currency Units (CUs) repayable in two equal instalments of 25 million CUs in 201X and 204Z. Entity C provides nominal consideration of 30,000 CUs to Government A. Prior to entering into negotiation with Government A, Entity C had approached a number of other entities to issue a guarantee, but none of these entities was

prepared to issue such a guarantee. There are no recent examples of financial guarantee contracts in the motor manufacturing sector of the economy in Jurisdiction A or in neighbouring Jurisdictions D & E. Government A concludes that it cannot use a valuation technique as the use of a valuation technique does not provide a reliable measure of fair value. Government A therefore determines to measure the financial guarantee contract in accordance with IPSAS 19.

IE44. On December, 31 201V, having reviewed the financial position and performance of Entity C, Government A determines that there is no present obligation to Entity B in respect of the financial guarantee contract. Government A does not recognize a liability in its statement of financial position. Government A makes the disclosures relating to fair value and credit risk in IPSAS 30, *Financial Instruments: Disclosures* in respect of the financial guarantee contract. It also discloses a contingent liability of 50 million CUs in accordance with IPSAS 19. In its statement of financial performance Government A recognizes revenue of 1,000 CUs in respect of the nominal consideration payable by Entity C.

IE45. In 201Z there has been a further downturn in the motor manufacturing sector affecting Entity C. Entity C is seeking bankruptcy protection and has defaulted on the first repayment of principal, although it has met its obligations for interest payments. Government A determines that Entity C is unlikely to recover, but negotiations are advanced with a potential acquirer (Entity D), which will restructure Entity C. Entity D has indicated that it will assume responsibility for the final instalment of the loan with Entity B, but not the initial instalment. Government A recognizes an expense and liability for 25 million CUs and discloses a contingent liability of 25 million CUs.

Interaction Between Measurement Requirements of IPSAS 23 and IPSAS 29

Background

IE46. An individual donates shares in listed entity X to public sector entity A on January 1, 20X8. At that date, the shares in entity X have a fair value of CU1,000,000. At December 31, 20X8, the fair value of the shares is CU900,000. As part of the arrangement, entity A incurs the transfer duty to have the shares transferred into its name. These costs amount to CU10,000.

IE47. Listed entity X provides telecommunications infrastructure and related services to the public. During 20X9, new technology was introduced into the telecommunications industry, making the infrastructure and equipment used by entity X almost obsolete. This resulted in a

permanent decline in the value of listed entity X. The value of the impairment loss as at December 31, 20X9 is CU700,000. Entity A has a policy of accounting for investments in shares as an available-for-sale financial asset. Assume that the arrangement is a contractual arrangement, no present obligations arise from the donation and that the entity's reporting period ends on December 31, 20X8.

Analysis

IE48. As entity A received the shares as a donation, it uses IPSAS 23 to initially recognize the shares acquired and the related non-exchange revenue. However, because entity A has acquired a financial asset, it considers the initial measurement requirements of IPSAS 23 and IPSAS 29.

IE49. IPSAS 23 prescribes that assets acquired as part of a non-exchange revenue transaction are initially measured at fair value, while IPSAS 29 prescribes that financial assets are initially measured at fair value and, depending on their classification, transaction costs may or may not be included. As the entity has a policy of accounting for investments in shares as available-for-sale financial assets, the transaction costs of CU10,000 are added to the value of the shares of CU1,000,000 on initial measurement.

IE50. The subsequent measurement and derecognition of the shares is addressed in IPSAS 29. The entity classifies investments in shares as available-for-sale financial assets which means that the shares are measured at a fair value with any subsequent changes in fair value recognized in net assets/equity. Impairment losses are however recognized in surplus or deficit in the period in which they occur.

The journal entries at initial acquisition and at the reporting dates are as follows:

1. Acquisition of shares through donation				
Dr		Available-for-sale financial asset (investment in entity X)	1,010,000	
	Cr	Non-exchange revenue		1,000,000
	Cr	Bank (Transfer costs paid)		10,000

2. Subsequent measurement at December 31, 20X8				
Dr		Net assets/equity (fair value adjustment of investment)	110,000	
	Cr	Available-for-sale financial asset (investment in entity X)		110,000

3. Subsequent measurement at December 31, 20X9				
Dr		Impairment loss (surplus or deficit)	700,000	
	Cr	Available-for-sale financial asset		700,000

Comparison with IAS 39

IPSAS 29, *Financial Instruments: Recognition and Measurement* is drawn primarily from IAS 39, *Financial Instruments: Recognition and Measurement* (including amendments up to December 31, 2008 as well as amendments made by the IASB to IAS 39 as part of its *Improvements to IFRSs* in April 2009). The main differences between IPSAS 29 and IAS 39 are as follows:

- IPSAS 29 contains additional application guidance to deal with concessionary loans and financial guarantee contracts entered into at nil or nominal consideration. IAS 39 does not deal with these areas.
- In certain instances, IPSAS 29 uses different terminology from IAS 39. The most significant examples are the use of the terms "statement of financial performance" and "net assets/equity." The equivalent terms in IAS 39 are "statement of comprehensive income or separate income statement (if presented)" and "equity."
- IPSAS 29 does not distinguish between "revenue" and "income." IAS 39 distinguishes between "revenue and "income," with "income" having a broader meaning than the term "revenue."
- Principles from IFRIC 9, *Reassessment of Embedded Derivatives* and IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* have been included as authoritative appendices to IPSAS 29. The IASB issues IFRICs as separate documents.

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