Appendix A - Application guidance

This appendix is an integral part of this Standard.

Chapter 1 – Objective and scope

AG1.1 This application guidance explains the application of particular aspects of this ~~the~~ Standard.

Scope

Measurement of interests in controlled entities, associates or joint ventures in separate financial statements (Paragraphs 1.3(a) and 1.6)

AG1.2 An entity can either measure investments in controlled entities, associates or joint ventures at cost or at fair value as a financial instrument in its separate financial statements in accordance with GRAP 6, GRAP 7 and GRAP 8.

AG1.3 An entity that elects to measure an investment in a controlled entity, associate or joint venture at fair value as a financial instrument applies this Standard to those investments. Where an entity elects to apply the cost model to such investments in its separate financial statements, it applies GRAP 6, GRAP 7 and GRAP 8, in conjunction with the Standards of GRAP on *Impairment of Cash-generating Assets* or *Impairment of Non-cash-generating Assets*.

Strategic investment in an equity instrument

AG1.4 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 operational relationship with the entity in which the investment is made. The investor or joint venture entity uses the Standards of GRAP on *Investments in Associates* and *Interests in Joint Ventures* to determine whether the equity method of accounting shall be applied to such an investment.

Application to insurers

AG 1.5 This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 1.3(d) excludes because they arise under contracts within the scope of the IFRS Standard(s) on insurance.

Financial guarantee contracts (Paragraph~~s~~ 1.3(d))

AG 1.6 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 1.3(d)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in IFRSs 4 if the risk transferred is significant, the issuer applies this Standard. Paragraph 5.1 requires the issuer to recognise a financial guarantee contract initially at fair value (except for some financial guarantees issued in a non-exchange transaction). 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 6.14 and AG6.12 apply (when a transfer of a financial asset does not qualify for derecognition), the issuer measures it at the higher of:

    (i) the amount determined in accordance with paragraphs 5.17 to 5.35; and

    (ii) the amount initially recognised less, when appropriate, the cumulative amount of revenue recognised in accordance with the principles of GRAP 9 (see paragraph 4.7(c)).

    Paragraphs AG5.28 to AG5.33 provide guidance on the measurement of financial guarantees issued in non-exchange transactions.

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in this Standard, and are not insurance contracts as defined in IFRS. 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 GRAP 9 in determining when it recognises the revenue from the guarantee and from the sale of goods.

Contracts to buy or sell non-financial items (Paragraphs 1.9 to 1.12)

AG1.7 Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g. an option, futures or forward contract on oil) are not financial instruments. Many commodity contracts are of this type. Some are standardised in form and traded on organised markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold, and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity, do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of this ~~the~~ Standard as if they were financial instruments.

AG1.8 A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on credit.

AG1.9 Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, as opposed to payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.

AG1.10 The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

Chapter 2 – Definitions

Definitions (Paragraphs 2.1 to 2.3)

Financial assets, financial liabilities and residual interests

AG2.1 Currency (cash) is a financial asset because it represents a medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

AG2.2 Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

(a) accounts receivable and payable;

(b) notes receivable and payable;

(c) loans receivable and payable; and

(d) bonds receivable and payable.

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

AG2.3 Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.

AG2.4 'Perpetual' debt instruments (such as 'perpetual' bonds and debentures) normally ~~may~~ provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example:

(a) an entity issues a perpetual bond requiring it to make annual payments in perpetuity equal to a stated interest rate of 8% applied to a stated par or principal amount of R1 000. Assuming 8% to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of R1 000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability respectively; and

(b) an entity issues a perpetual bond, with no stated interest and no maturity date. As the issuer has no contractual obligation to pay cash or another financial asset to the holder, the instrument may show evidence of a residual interest in the entity. The holder of the instrument would have a financial asset because it has acquired an interest in the net assets of another entity.

AG2.5 A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of a residual interest.

AG2.6 The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender’s ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of these contingent rights and obligations may be insurance contracts within the scope of the IFRSs on insurance.

AG2.7 Under GRAP 13 a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. An operating lease, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, a finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument (except individual payments currently due and payable).

AG2.8 Physical assets (such as inventories, property, plant and equipment and biological assets), leased assets and intangible assets (such as software) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

AG2.9 Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, most obligations arising from non-exchange revenue transactions with conditions and warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

AG2.10 Liabilities that are not contractual (such as income taxes and social benefits that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes payable is dealt with in IAS 12. Similarly, constructive obligations, as defined in GRAP 19, do not arise from contracts and are not financial liabilities.

Contractual arrangements

AG2.11 Assets and liabilities in the public sector arise out of both contractual and non-contractual arrangements. Assets and liabilities arising out of non-contractual arrangements do not meet the definition of a financial asset or a financial liability.

AG2.12 Contracts, for the purposes of this Standard, are evidenced by the following three criteria:

- contracts involve willing parties entering into an arrangement;
- the terms of the contract create rights and obligations for the parties to the contract, and those rights and obligations need not result in equal performance by each party. For example, a donor funding arrangement creates an obligation for the donor to transfer resources to the recipient in terms of the agreement concluded, and establishes the right of the recipient to receive those resources. These types of arrangements may be contractual even though the recipient did not provide equal consideration in return, i.e. the arrangement does not result in equal performance by the parties; and
- performance and remedy for non-performance are enforceable by law.

AG2.13 Non-contractual, non-exchange revenue transactions are initially recognised and measured in accordance with GRAP 23. If non-exchange revenue transactions are contractual and otherwise meet the definition of a financial asset, the principles in this Standard are also applied. Guidance on the subsequent measurement, derecognition, presentation and disclosure of non-contractual non-exchange revenue transactions will be provided in a Guideline to be issued by the Board.

AG2.14 The following examples illustrate paragraphs AG2.12 and AG2.13:

(a) an entity may undertake a formal agreement with an aid agency to receive funding for one of its programmes. Although the initial recognition and initial measurement of the receivable is dealt with in GRAP 23, it is also a financial asset since the receivable arises from a contract which is to be settled through the receipt of cash. Consequently the subsequent measurement, derecognition, presentation and disclosure requirements of this Standard also apply; and

(b) a reporting entity in the national government collects taxes in terms of legislation. Even though taxes are settled between the taxpayer and the entity in cash, any resulting assets and liabilities are not financial instruments since the transaction is executed in terms of legislation as opposed to a contract. The entity recognises an asset (a receivable for taxes owing to the government) when the taxable event occurs, and measures the asset at fair value in accordance with GRAP 23.

AG2.15 An entity also considers the classification requirements of this Standard in determining whether an inflow of resources received as part of a contractual non-exchange revenue transaction is in substance a liability or a residual interest.

AG2.16 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 R1 000 if six-month JIBAR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

AG2.17 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 1.11 and 1.12). However, this Standard applies to such contracts for an entity's expected purchase, sale or usage requirements if the entity makes a designation in accordance with paragraph 1.10 (see paragraphs 1.9-1.12).

AG2.18 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.

AG2.19 The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Financial assets and financial liabilities held for trading

AG2.20 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.

AG2.21 Financial liabilities held for trading include:

(a) derivative liabilities;

(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.

AG2.22 The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

Purchased or originated credit impaired financial assets

AG2.23 Purchased or originated credit impaired financial assets are those assets that are credit impaired on initial recognition. Financial assets are credit impaired because one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. The definition of 'credit impaired' in paragraph 2.1 outlines a number of events that may indicate that a financial asset is credit impaired. Some of the events may not be relevant in assessing whether a concessionary loan (or investment) is credit impaired at purchase or origination because these loans are generally granted on below market terms to achieve specific social or other policy objectives. For example:

(a) Paragraph (c) refers to concessions that a lender would not otherwise consider being granted to a borrower in financial difficulty. As the purpose of the concessionary loan may be to provide assistance to such a lender through concessionary terms, this criteria may be irrelevant in considering if the loan is credit impaired.

(b) Paragraph (f) outlines that the purchase or origination of a financial asset at a deep discount that reflects incurred credit losses may be an indication that a financial asset is credit impaired. Once an entity has measured a concessionary loan granted by it at fair value on initial recognition, the fair value may reflect a deep discount compared to the original transaction price. This difference however reflects the separation of the loan into its component parts and its measurement at market terms. As a result, this criterion may not be relevant in assessing whether an asset is credit impaired on purchase or origination.

Residual interests

AG2.24 A residual interest is a contract that shows evidence of an interest in the net assets of another entity. The key distinction between a residual interest and a financial liability is that a financial liability requires the payment of cash or another financial asset to another party. A residual interest merely entitles the holder of the interest to a part of the net assets of an entity, and any payments made to the holder are discretionary, e.g. dividends or similar distributions are paid to holders of residual interests at management's discretion.

AG2.25 In the public sector, various forms of contributed capital exist. For example, some public entities may issue shares, while others may have been given capital contributions through the budget process. Where an entity receives capital contributions other than through the issue of shares or other unitised capital, the contribution usually evidences a residual interest of another entity when:

(a) there is a formal designation of the contribution by the parties to the transaction either before or at the time of the contribution; or

(b) there is a formal agreement between the parties specifying that the contribution represents a residual interest of another entity.

Even though a formal transfer of resources may be proven by a designation or formal agreement, an entity assesses the nature of the transfer based on its substance and not merely its legal form.

Chapter 3 – Recognition

Initial recognition (Paragraphs 3.3 to 3.4)

Distinguishing liabilities and residual interests

Treatment of preference shares

AG3.1 Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or a residual interest, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient surpluses or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the owner. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the owners of an intention to redeem the shares.

AG3.2 When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and a residual interest. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are residual interests. The classification of a preference share as a residual interest or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (for example, because of restrictions on paying dividends or similar distributions on the ordinary shares if dividends or similar distributions are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a surplus or deficit for a period; or

(f) an ability or inability of the issuer to influence the amount of its surplus or deficit for the period.

Contractual obligation to deliver cash

AG3.3 In determining whether an instrument is a financial liability or a residual interest, an entity considers the contractual rights and obligations of the instrument and not the intention of the parties. Failure by an entity to enforce the rights and obligations in an arrangement, whether deliberately or erroneously, does not, in itself, change the nature of the transaction. An entity should however consider whether not executing the terms of an arrangement affects their enforceability in terms of law. Consider the following examples:

(a) A controlling entity grants a loan to a controlled entity which requires the repayment of capital and interest at specific dates. The controlling entity fails to enforce collection of outstanding amounts under the terms of the agreement for a period of two years due to a shortcoming in its administrative processes. The failure of the entity to not collect amounts due does not change the nature of the transaction and that the entity classifies the transaction as a financial liability.

(b) A controlling entity grants a loan to a controlled entity which requires the repayment of capital and interest at specific dates. The controlling entity fails to enforce collection of outstanding amounts under the terms of the agreement for a period of ten years due to a shortcoming in its administrative processes. The entity determines that the failure to enforce the terms of the arrangement means that the debt has legally prescribed. Due to the change in legal terms, an entity assesses whether a financial liability still exists.

Contingent settlement provisions

AG3.4 Paragraph 3.9 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is a residual interest.

Treatment in consolidated financial statements

AG3.5 In consolidated financial statements, an entity presents minority interests–i.e. the interests of other parties in the net assets and revenue of its controlled entities–in accordance with GRAP 1 and GRAP 6. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the economic entity and the holders of the instrument in determining whether the economic entity as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a controlled entity in an economic entity issues a financial instrument and a controlling entity or other entity within the economic entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the economic entity may not have discretion over distributions or redemption. Although the controlled entity may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the economic entity and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the economic entity as a whole. To the extent that there is such an obligation the instrument (or component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

Compound financial instruments (Paragraphs 3.10 to 3.14)

AG3.6 Paragraph 3.3 applies only to issuers of non-derivative compound financial instruments. Paragraph 3.3 does not deal with compound financial instruments from the perspective of holders. Paragraphs 4.11 to 4.15 deal with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain features of both financial liabilities and residual interests.

AG3.7 A form of compound financial instrument is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivative features. Paragraph 3.3 requires the issuer of such a financial instrument to present the liability component and the residual interest component separately in the statement of financial position, as follows:

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

(b) The instrument is an embedded option to convert the liability into a residual interest of the issuer. This option has value on initial recognition even when it is out of the money.

AG3.8 On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as a residual interest. The original residual interest component remains as a residual interest (although it may be transferred from one line item within net assets to another). There is no gain or loss on conversion at maturity.

AG3.9 When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and residual interest components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued, in accordance with paragraphs 3.10 to 3.14.

AG3.10 Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

(a) the amount of gain or loss relating to the liability component is recognised in surplus or deficit; and

(b) the amount of consideration relating to the residual interest component is recognised in net assets.

AG3.11 An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in surplus or deficit.

Recognition of financial assets and financial liabilities

AG3.12 As a consequence of the principle in paragraph 3.1, an entity recognises all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively.

AG3.13 The following are examples of applying the principle in paragraph 3.3:

(a) unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive, or a legal obligation to pay cash;

(b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but 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 1.11 to 1.12, its net fair value is recognised as an asset or liability on the commitment date (see (c) below);

(c) a forward contract that is within the scope of this Standard (see paragraphs 1.3 to 1.12) is recognised as an asset or a liability on the commitment date, instead of the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability;

(d) option contracts that are within the scope of this Standard (see paragraphs 1.3 to 1.12) are recognised as assets or liabilities when the holder or writer becomes a party to the contract; and

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

Chapter 4 – Classification

Classification

Classification of financial assets

The entity's management model for managing financial assets

AG4.1 Paragraph 4.1 (a) requires an entity to classify financial assets on the basis of the entity's management model for managing the financial assets, unless paragraph 4.6 applies. An entity assesses whether its financial assets meet the condition in paragraph 4.2(a) on the basis of the management model as determined by the entity's management (as defined in GRAP 24).

AG4.2 An entity's management model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular objective. The entity's management model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one management model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes. Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into sub-portfolios in order to reflect the level at which an entity manages those financial assets. For example, that may be the case if an entity purchases a portfolio of bonds and manages some of the bonds with an objective of collecting contractual cash flows and manages the other bonds with an objective of selling them.

AG4.3 An entity's management model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's management model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the management model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the management model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements (see GRAP 3 on *Accounting Policies, Changes in Accounting Estimates and Errors*) nor does it change the classification of the remaining financial assets held in that management model (i.e. those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the management model assessment. However, when an entity assesses the management model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information.

AG4.4 An entity's management model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the management model. An entity will need to use judgement when it assesses its management model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

(a) how the performance of the management model and the financial assets held within that management model are evaluated and reported to the entity's management;

(b) the risks that affect the performance of the management model (and the financial assets held within that management model) and, in particular, the way in which those risks are managed; and

(c) how managers are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

A management model whose objective is to hold assets in order to collect contractual cash flows

AG4.5 Financial assets that are held within a management model whose objective is to hold assets in order to collect contractual cash flows are managed to realise cash flows by collecting contractual payments over the life of the instrument. That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows (instead of managing the overall return on the portfolio by both holding and selling assets). In determining whether cash flows are going to be realised by collecting the financial assets' contractual cash flows, it is necessary to consider the frequency, value and timing of sales in prior periods, the reasons for those sales and expectations about future sales activity. However sales in themselves do not determine the management model and therefore cannot be considered in isolation. Instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.

AG4.6 Although the objective of an entity's management model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's management model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur or are expected to occur in the future.

AG4.7 The management model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets' credit risk. To determine whether there has been an increase in the assets' credit risk, the entity considers reasonable and supportable information, including forward looking information. Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a management model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a management model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk.

AG4.8 Sales that occur for other reasons, such as sales made to manage credit concentration risk (without an increase in the assets' credit risk), may also be consistent with a management model whose objective is to hold financial assets in order to collect contractual cash flows. In particular, such sales may be consistent with a management model whose objective is to hold financial assets in order to collect contractual cash flows if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to this assessment. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's management model. In addition, sales may be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows.

AG4.9 The following are examples of when the objective of an entity's management model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive. Furthermore, the examples are not intended to discuss all factors that may be relevant to the assessment of the entity's management model nor specify the relative importance of the factors.

Example	Analysis
Example 1	
An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs. The entity performs credit risk management activities with the objective of minimising credit losses. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs. Reports to management focus on the	Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (i.e. the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows. Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy. Infrequent sales resulting from unanticipated funding needs (e.g. in a stress case scenario) also would not contradict that objective, even if such

credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.	sales are significant in value.
Example 2	
An entity's management model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired. If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them. In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.	The objective of the entity's management model is to hold the financial assets in order to collect the contractual cash flows. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (e.g. some of the financial assets are credit impaired at initial recognition). Moreover, the fact that the entity enters into derivatives to modify the cash flows of the portfolio does not in itself change the entity's management model.
Example 3	
An entity has a management model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus	The economic entity originated the loans with the objective of holding them to collect the contractual cash flows. However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial

consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.	statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.

Other management models

AG4.10 Financial assets are measured at fair value through surplus or deficit if they are not held within a management model whose objective is to hold assets to collect contractual cash flows. The following management models result in measurement at fair value through surplus or deficit:

(a) a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and

(b) a management model whose objective is achieved by realising cash flows through the sale of assets.

A management model whose objective is achieved by both collecting contractual cash flows and selling financial assets

AG4.11 An entity may hold financial assets in a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets. In this type of management model, the entity's management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the management model. There are various objectives that may be consistent with this type of management model. For example, the objective of the management model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding. To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.

AG4.12 Compared to a management model whose objective is to hold financial assets to collect contractual cash flows, this management model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the management model's objective instead of being only incidental to it. However, there is no threshold for the frequency or value of sales that must occur in this management model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

AG4.13 The following are examples of when the objective of the entity's management model may be achieved by both collecting contractual cash flows and selling financial assets. This list of examples is not exhaustive. Furthermore, the examples are not intended to describe all the factors that may be relevant to the assessment of the entity's management model nor specify the relative importance of the factors.

Example	Analysis
Example 4	
An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period. The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return.	The objective of the management model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash. In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in

	credit risk). The objective of this contrasting management model is to hold financial assets to collect contractual cash flows.
Example 5	
An entity that pays unemployment benefits holds financial assets in order to fund its liabilities. The entity uses the proceeds from the contractual cash flows on the financial assets to settle its ~~insurance contract~~ liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the entity ~~insurer~~ undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.	The objective of the management model is to fund the liabilities. To achieve this objective, the entity collects contractual cash flows as they come due and sells financial assets to maintain the desired profile of the asset portfolio. Thus both collecting contractual cash flows and selling financial assets are integral to achieving the management model's objective.

A management model whose objective is achieved by realising cash flows through the sale of assets

AG4.14 A management model that results in measurement at fair value through surplus or deficit is one in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. In this case, the entity's objective will typically result in active buying and selling. Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a management model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the management model's objective; instead, it is incidental to it.

AG4.15 A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 4.8(b)) is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. For such portfolios, the collection of contractual cash flows is only incidental to achieving the management model's objective. Consequently, such portfolios of financial assets must be measured at fair value through surplus or deficit.

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

General approach

AG4.16 Paragraph 4.1(b) requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held within a management model whose objective is to hold assets to collect contractual cash flows or within a management model whose objective is achieved by both collecting contractual cash flows and selling financial assets, unless paragraph 4.6 applies. To do so, the condition in paragraph 4.2(b) requires an entity to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

AG4.17 Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs AG4.23 to AG4.27) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices, ~~or~~ commodity prices, a specific profitability or income threshold being reached by the borrower or lender, or the achievement (or otherwise) of specific financial ratios, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

AG4.18 In accordance with paragraph 4.3(a), principal is the fair value of the financial asset at initial recognition. However that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

AG4.19 An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

AG4.20 Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts do not meet the condition in paragraph 4.2(b).

Concessionary loans granted by an entity

AG4.21 Concessionary loans are granted by an entity on below market terms related either to the principal or interest repaid, or both (see paragraph AG5.13). In assessing whether the contractual cash flows of a concessionary loan are solely payments of principal and interest, an entity first applies paragraphs AG5.14 to AG5.24. These paragraphs require an entity to separate a concessionary loan into its relevant components and measure the cash flows using a market related rate of interest for a similar instrument. The effect of applying paragraph AG5.14 to AG5.24 means that the principal appropriately reflects the amounts that will be repaid in the arrangement using a market related rate of interest. An entity then assesses whether the contractual cash flows are solely payments of principal and interest.

AG4.22 As the concessionary loan has effectively been recognised at fair value, the contractual cash flows are likely to reflect solely payments of principal or interest. However, an entity applies judgement to assess if the contractual cash flows after initial recognition are solely payments of principal and interest. Examples of instances when the contractual cash flows may not be solely payments or principal or interest are as follows:

(a) The borrower has the ability to exercise certain options that mean that the loan will not be fully recovered by the lender and/or will not receive full compensation for the interest due. For example, the borrower may suspend payment of the loan and take payment holidays which may not be recovered in full or in part, or interest will not be charged on such payment holidays.

(b) The repayment of principal and/or interest is based on factors that are unrelated to a basic lending arrangement. For example, where principal and/or interest are only repayable when certain conditions are met such as the lender becoming employed, earning a specific level of income, revenue, profitability, defined ratios, production level, etc.

Consideration for the time value of money

AG4.23 Time value of money is the element of interest that provides consideration for only the passage of time. That is, the time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the element provides consideration for only the passage of time, an entity applies judgement and considers relevant factors such as the currency in which the financial asset is denominated and the period for which the interest rate is set.

AG4.24 However, in some cases, the time value of money element may be modified (i.e. imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment.

AG4.25 When assessing a modified time value of money element, the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit risk except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraph 4.2(b). To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. The reason for the interest rate being set in this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.

AG4.26 When assessing a modified time value of money element, an entity must consider factors that could affect future contractual cash flows. For example, if an entity is assessing a bond with a five-year term and the variable interest rate is reset every six months to a five-year rate, the entity cannot conclude that the contractual cash flows are solely payments of principal and interest on the principal amount outstanding simply because the interest rate curve at the time of the assessment is such that the difference between a five-year interest rate and a six-month interest rate is not significant. Instead, the entity must also consider whether the relationship between the five-year interest rate and the six-month interest rate could change over the life of the instrument such that the contractual (undiscounted) cash flows over the life of the instrument could be significantly different from the (undiscounted) benchmark cash flows. However, an entity must consider only reasonably possible scenarios instead of every possible scenario. If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraph 4.2(b) and therefore cannot be measured at amortised cost.

AG4.27 Government or a regulatory authority often sets interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, despite paragraphs AG4.23 to AG4.26, a regulated interest rate shall be considered a proxy for the time value of money element for the purpose of applying the condition in paragraph 4.2(b) if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

Contractual terms that change the timing or amount of contractual cash flows

AG4.28 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk. (See also paragraph AG4.26)

AG4.29 The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

(a) a variable interest rate that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin;

(b) a contractual term that permits the issuer (i.e. the debtor) to prepay a debt instrument or permits the holder (i.e. the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract; and

(c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (i.e. an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

AG4.30 Despite paragraph AG4.28, a financial asset that would otherwise meet the condition in paragraph 4.2(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost (subject to meeting the condition in paragraph 4.2(a) if:

(a) the entity acquires or originates the financial asset at a premium or discount to the contractual par amount;

(b) the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable additional compensation for the early termination of the contract; and

(c) when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

AG4.31 The following examples illustrate contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
Instrument A	
Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.	The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding. However, if the interest payments were indexed to another variable such as the debtor's performance (e.g. the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance results in an

	adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement (see paragraph AG4.17).
Instrument B	
Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month JIBAR for a three-month term or one-month JIBAR for a one-month term.	The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money, for the credit risk associated with the instrument and for other basic lending risks and costs, as well as a profit margin (see paragraph AG4.17). The fact that the JIBAR interest rate is reset during the life of the instrument does not in itself disqualify the instrument. However, if the borrower is able to choose to pay a one-month interest rate that is reset every three months, the interest rate is reset with a frequency that does not match the tenor of the interest rate. Consequently, the time value of money element is modified. Similarly, if an instrument has a contractual interest rate that is based on a term that can exceed the instrument's remaining life (for example, if an instrument with a five-year maturity pays a variable rate that is reset periodically but always reflects a five-year maturity),

	the time value of money element is modified. That is because the interest payable in each period is disconnected from the interest period. In such cases, the entity must qualitatively or quantitatively assess the contractual cash flows against those on an instrument that is identical in all respects except the tenor of the interest rate matches the interest period to determine if the cash flows are solely payments of principal and interest on the principal amount outstanding. (See paragraph AG4.27 for guidance on regulated interest rates.) For example, in assessing a bond with a five-year term that pays a variable rate that is reset every six months but always reflects a five-year maturity, an entity considers the contractual cash flows on an instrument that resets every six months to a six-month interest rate but is otherwise identical. The same analysis would apply if the borrower is able to choose between the lender's various published interest rates (e.g. the borrower can choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate).
Instrument C	
Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.	The contractual cash flows of both: (a) an instrument that has a fixed interest rate; and (b) an instrument that has a variable

	interest rate are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money, for the credit risk associated with the instrument during the term of the instrument and for other basic lending risks and costs, as well as a profit margin. (See paragraph AG4.17). Consequently, an instrument that is a combination of (a) and (b) (e.g. a bond with an interest rate cap) can have cash flows that are solely payments of principal and interest on the principal amount outstanding. Such a contractual term may reduce cash flow variability by setting a limit on a variable interest rate (e.g. an interest rate cap or floor) or increase the cash flow variability because a fixed rate becomes variable.
Instrument D	
Instrument D is a full recourse loan and is secured by collateral.	The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

AG4.32 The following examples illustrate contractual cash flows that are not solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
Instrument E	
Instrument E is a bond that is convertible into a fixed number of equity instruments of the issuer.	The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement (see paragraph AG4.17); i.e. the return is linked to the value of the equity of the issuer.
Instrument F	
Instrument F is a loan that pays an inverse floating interest rate (i.e. the interest rate has an inverse relationship to market interest rates).	The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. The interest amounts are not consideration for the time value of money on the principal amount outstanding.
Instrument G	
Instrument G is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due. Instrument G pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest.	The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding. If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and

	interest on the principal amount outstanding. The fact that Instrument G is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity. Also, the fact that Instrument G is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal amount outstanding. Even if the callable amount includes an amount that reasonably compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding. (See also paragraph AG4.30)

AG4.33 In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.2(b), and 4.3 of this Standard.

AG4.34 This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the condition in paragraph 4.2(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

AG4.35 However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraph 4.2(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraph 4.2(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

AG4.36 A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

AG4.37 In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

Contractually linked instruments

AG4.38 In some types of transactions, an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches.

AG4.39 In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:

(a) the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g. the interest rate on the tranche is not linked to a commodity index);

(b) the underlying pool of financial instruments has the cash flow characteristics set out in paragraphs AG4.41 and AG4.42; and

(c) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, the credit rating of the tranche being assessed for classification is equal to or higher than the credit rating that would apply to a single tranche that funded the underlying pool of financial instruments).

AG4.40 An entity must look through until it can identify the underlying pool of instruments that are creating (instead of passing through) the cash flows. This is the underlying pool of financial instruments.

AG4.41 The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

AG4.42 The underlying pool of instruments may also include instruments that:

(a) reduce the cash flow variability of the instruments in paragraph AG4.41 and, when combined with the instruments in paragraph AG4.41, result in cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g. an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in paragraph AG4.41); or

(b) align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph AG4.41to address differences in and only in:

(i) whether the interest rate is fixed or floating;

(ii) the currency in which the cash flows are denominated, including inflation in that currency; or

(iii) the timing of the cash flows.

AG4.43 If any instrument in the pool does not meet the conditions in either paragraph AG4.41 or paragraph AG4.42, the condition in paragraph AG4.39(b) is not met. In performing this assessment, a detailed instrument-by-instrument analysis of the pool may not be necessary. However, an entity must use judgement and perform sufficient analysis to determine whether the instruments in the pool meet the conditions in paragraphs AG4.41 to AG4.42. (See also paragraph AG4.36 for guidance on contractual cash flow characteristics that have only a de minimis effect.)

AG4.44 If the holder cannot assess the conditions in paragraph AG4.39 at initial recognition, the tranche must be measured at fair value through surplus or deficit. If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the conditions in paragraphs AG4.41 to AG4.42, the tranche does not meet the conditions in paragraph AG4.39 and must be measured at fair value through surplus or deficit. However, if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions in paragraphs AG4.41 to AG4.42, the ability to take possession of such assets shall be disregarded for the purposes of applying this paragraph unless the entity acquired the tranche with the intention of controlling the collateral.

Option to designate a financial asset or financial liability as at fair value through surplus or deficit (Paragraphs 4.1 to 4.8)

AG4.45 Subject to the conditions in paragraphs 4.6 and 4.8 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.

AG4.46 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 13 (b) of GRAP 3 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of designation of a financial liability as at fair value through surplus or deficit, paragraph 4.8 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 4.8, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Designation eliminates or significantly reduces an accounting mismatch

AG4.47 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification. 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 subsequently measured at fair value through surplus or deficit and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through surplus or deficit.

AG4.48 The following example shows 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 4.6 or 4.8(a):

> An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, and 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 (for example, those that are derivatives, or are classified as held for trading).

AG4.49 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.

AG4.50 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 R100 and a number of similar financial assets that sum to R50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of R45) 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.

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

AG4.51 An entity may manage and evaluate the performance of a group of financial liabilities or financial assets and financial liabilities in such a way that measuring that group at fair value through surplus or deficit results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, instead of on the nature of its financial instruments.

AG4.52 For example, an entity may use this condition to designate financial liabilities as at fair value through surplus or deficit if it meets the principle in paragraph 4.8(b) and the entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management.

AG4.53 As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial liabilities as at fair value through surplus or deficit on the basis of this condition shall so designate all eligible financial liabilities that are managed and evaluated together.

AG4.54 Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 4.8(b). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for an entity's Treasury function—as approved by the entity's management—clearly demonstrates that its performance is evaluated on this basis, no further documentation is required to demonstrate compliance with paragraph 4.8(b)

Embedded derivatives (Paragraphs 4.9 to 4.15)

AG4.55 When an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard, paragraph 4.11 requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently at fair value through surplus or deficit.

AG4.56 If a host contract has no stated or predetermined maturity and represents an interest in the net assets of an entity, then its economic characteristics and risks are those of a residual interest, and an embedded derivative would then need to possess characteristics of a residual interest related to the same entity to be regarded as closely related. If the host contract is not a residual interest and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

AG4.57 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.

AG4.58 Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative. However, embedded derivatives that are classified as residual interests (see paragraphs 3.3 to 3.14) are accounted for separately from those classified as assets or liabilities. In addition, if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

AG4.59 The economic characteristics and risks of an embedded derivative are not closely related to the host contract in the following examples. In these examples, assuming the conditions in paragraph 4.11 (b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity, commodity price or index is not closely related to a host debt instrument.

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

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

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

(e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

(i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or

(ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of the lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest differential. The interest rate differential is in excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the residual interest component of a convertible debt instrument in accordance with this Standard.

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

AG4.60 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 4.11 because the host contract is a debt instrument under paragraph AG4.56 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG4.59(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.

AG4.61 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, the effect of separating an embedded derivative and accounting for each component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

AG4.62 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

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

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (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 the Standard of GRAP on *The Effects of Changes in Foreign Exchange Rates* (GRAP 4) requires foreign currency gains and losses on monetary items to be recognised 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 business transactions or external trade).

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

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

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

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

Instruments containing embedded derivatives

AG4.63 As noted in paragraph AG4.55, when an entity becomes a party to a hybrid (contract with a host that is not an asset within the scope of this Standard and with one or more embedded derivatives, paragraph 4.11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value. For that reason this Standard permits entities to designate the entire instrument to be measured at fair value.

AG4.64 Such designation may be used whether paragraph 4.11 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 4.13 would not justify designating the hybrid contract as at fair value in the cases set out in paragraph 4.13(a) and (b) because doing so would not reduce complexity or increase reliability.

Reassessment of embedded derivatives

AG4.65 In accordance with paragraph 4.11, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

AG4.66 Paragraph AG4.65 does not apply to embedded derivatives in contracts acquired in:

(a) a transfer of functions between entities not under common control (as defined in GRAP 106);

(b) transfer of functions between entities under common control as described in the Standard of GRAP on *Transfers of Functions Between Entities Under Common Control;*

(c) a merger as described in the Standard of GRAP on *Mergers;* or

(d) the formation of a joint venture as defined in the Standard of GRAP on *Interests in Joint Ventures*

or their possible reassessment at the date of transfer.

Reclassification of financial assets

Change in management model

AG4.67 Paragraph 4.16 requires an entity to reclassify financial assets if the entity changes its management model for managing those financial assets. Such changes are expected to be very infrequent. Such changes are determined by the entity's management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's management model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated an activity or function. Examples of a change in management model include the following:

(a) A government agency extends loans to small business owners and has a management model to sell the loan portfolios to private entities at a discount due to the long collection cycle of these loans. The entity enters into a long term contract with a third party collection service provider, and the loan portfolios are no longer for sale, and are held to collect the contractual cash flows with the aid of the collections service provider.

(b) A municipality held a portfolio of longer term fixed income securities to collect cash flows in order to finance a planned infrastructure project in the foreseeable future. A change in the municipality's plan resulted in the cancellation of the project and the portfolio is grouped into the regular investment portfolio that is regularly sold to meet its everyday liquidity needs in funding various programmes.

AG4.68 A change in the objective of the entity's management model must be effected before the reclassification date. Using the example in (a) above, if the entity decides on the 15th of February to no longer sell its loan portfolios to private entities it must reclassify all affected financial assets on 1 April (i.e. the first day of the entity's next reporting period). The entity must not sell any of its loans or otherwise engage in activities consistent with its former management model after the 15th of February.

AG4.69 The following are not changes in management model:

(a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).

(b) The temporary disappearance of a particular market for financial assets.

(c) A transfer of financial assets between parts of the entity with different management models.

Investments in residual interests

AG4.70 A reclassification of an investment in residual interests between the fair value through surplus or deficit and cost categories is permitted, but only when an entity can no longer reliably measure the fair value of an investment in a residual interest.

AG4.71 An entity may also reclassify an instrument from cost to fair value through surplus or deficit, because the fair value of the instrument is now available. For example, an entity may not have been able to determine the fair value of an investment in a controlled entity because the controlled entity's objectives were to provide services rather than generate profits. If the objectives of the controlled entity change to provide goods and services at a commercial return, the entity could now determine a fair value based on a valuation technique using the cash flows generated by the entity.

Chapter 5 – Measurement

Initial measurement

Initial measurement of financial assets and financial liabilities

Transaction costs (Paragraph 5.1)

AG5.1 Where an entity subsequently measures financial assets and financial liabilities at fair value, it excludes transaction costs from the amount initially recognised. Where an entity subsequently measures financial assets and financial liabilities at amortised cost or cost, it includes transaction costs in the amount initially recognised.

Determining fair value on initial recognition (Paragraph 5.1)

AG5.2 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 AG5.52). 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 AG5.40 to AG5.46). For example, the fair value of a long-term loan or similar receivable that carries no interest can be estimated as the present value of all future cash receipts discounted at 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, unless it qualifies for recognition as some other type of asset.

AG5.3 If an entity originates a loan that bears an off-market interest rate (e.g. 5% when the market rate for similar loans is 8%), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, i.e. net of the fee it receives. The entity accretes the discount to surplus or deficit using the effective interest rate method.

AG5.4 The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.2, the entity shall account for that instrument at that date as follows:

(a) At the measurement required by paragraph 5.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

(b) In all other cases, at the measurement required by paragraph 5.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

The requirements of this paragraph do not apply to concessionary loans or concessionary investments as outlined in paragraphs AG5.12 to AG5.27.

Determining market interest rates (Paragraph 5.1)

AG5.5 An entity determines a market related interest rate by considering the type of transaction and the counterparty involved. This means that an entity would use a rate for a similar transaction with similar terms, adjusted for the credit risk of the counterparty involved.

AG5.6 As a practical expedient, an entity may consider using the prime lending rate as a basis for determining a market related rate for a group of loans or receivables. For example, the prime lending rate could be used as a basis for determining a market related interest rate for consumer debtors. The prime lending rate would, however, need to be adjusted for any risks specific to those debtors.

AG5.7 Similarly it may be appropriate to use the government bond rate as a basis for determining a market related rate for debts owing to or from other government entities. The government bond rate should, however, match the maturity of the asset or liability, and should be adjusted for any other risk.

Determining material financing transactions (Paragraph 5.1)

AG5.8 The fair value of a short-term receivable or payable on initial recognition is the transaction price unless the terms of the arrangement are not market related, e.g. no interest or a below market rate of interest is charged for any initial credit period granted or received (i.e. the period between the date the receivable or payable is originated and the due date for payment).

AG5.9 Short-term receivables and payables are not discounted where the initial credit period granted or received is consistent with terms used in the public sector, either through established practices or legislation. For example, it is common practice for municipalities to allow consumers a period of time, after issuing an invoice, to settle their water and electricity accounts. Specific legislation may also prescribe credit terms for specific types of transactions or entities, which provide an indication of what appropriate credit terms are for certain transactions and events. Where the initial credit period granted is not in line with practices or legislation in the public sector, the effect of discounting is considered if it is material.

AG5.10 Once the due date for short-term receivables has elapsed and payment is not received, an entity shall consider whether there is any indication that the receivable may be impaired, either because interest is not levied on outstanding amounts (using a market related rate of interest), or because the principal amount may not be collected (see paragraphs 5.17 to 5.35 and AG 5.40 to AG5.115).

AG5.11 The following example illustrate the application of these requirements:

An entity provides goods and services to the public. Payment for these goods and services should be received within 30 days after the invoice date in accordance with legislation. Assume that the value of goods and services provided in one month is R1-million and that, based on past history,

- only 30% of the debtors pay within the 30 days,
- 50% of the debtors pay within 120 days of invoice date,
- 15% of the debtors pay after 120 days but before 210 days of the invoice date, and
- 5% will never pay.

Analysis:

The entity has provided interest free credit to its customers for a period of 30 days. This 30 day credit period is deemed to be appropriate for the entity's operations based on prevailing legislation. It therefore initially recognises R1-million as revenue and a receivable.

After the 30 day interest free credit period has elapsed, an entity shall consider whether late or non-payment by customers is an indication of impairment. The entity shall also consider whether an impairment loss exists if it does not charge a market related rate of interest on the outstanding balance.

Concessionary loans (Paragraphs 5.4 to 5.6)

Overview

AG5.12 Concessionary loans are granted to or received by an entity at below market terms for a number of social or economic reasons. Examples of concessionary loans granted by entities include loans to other countries, emerging businesses to promote economic growth, student loans granted to qualifying students for tertiary education and housing loans granted to low income families. Entities may receive concessionary loans, for example, from development agencies and other government entities.

AG5.13 The terms of concessionary loans are not market-related for a number of reasons:

(a) The loans often provide flexible repayment terms, or contingent repayment terms which are linked to the achievement of certain outcomes, e.g. earning a certain level of income, finding employment, attaining certain financial ratios, etc.

(b) The loans may permit the taking of payment holidays, which are often exercised at the option of the borrower. Interest may or may not be levied during these periods.

(c) The lender may not require the repayment of part or all of the capital advanced.

(d) The interest charged may not be market related, if interest is charged at all.

Analysing the substance of concessionary loans

AG5.14 An entity assesses whether the substance of the concessionary loan is a loan by applying the principles in paragraphs AG3.1 to AG3.2. If an entity has determined that the transaction is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition.

AG5.15 Where an entity grants concessionary loans it shall consider whether part of the consideration granted is a social benefit. Social benefits are defined broadly as cash transfers paid to individuals and households in a non-exchange transaction to protect them against certain social risks. An entity accounts for the components of a concessionary loan granted separately. The loan is recognised as a financial asset, while any social benefit is accounted for in accordance with the *Framework for the Preparation and Presentation of Financial Statements*[1].

AG5.16 Where an entity receives a concessionary loan, it assesses on initial recognition whether part of the consideration received as a concessionary loan comprises a contribution from owners or non-exchange revenue. The entity accounts for the loan as a financial liability and contributions from owners and non-exchange revenue in accordance with GRAP 23.

[1] In June 2017, the Board replaced the *Framework for the Preparation and Presentation of Financial Statements* with the *Conceptual Framework for General Purpose Financial Reporting.*

Determining the fair value of concessionary loans

AG5.17 As concessionary loans are granted or received at below market terms, the transaction price on initial recognition of the loan may not be its fair value. An entity determines the fair value of the loan by using the principles in paragraphs AG5.5 to AG5.7 and paragraphs AG5.37 to AG5.46. Where an entity cannot determine fair value by reference to an active market, it uses a valuation technique. Fair value using a valuation technique would be determined by discounting all future contractual cash receipts using a market related rate of interest for a similar debt instrument with the same terms, maturity, currency and credit risk profile. An entity applies paragraph AG5.18 to determine the fair value of a purchased or originated credit impaired concessionary loan. At initial recognition, an entity analyses the substance of the loan granted or received into its component parts, and accounts for those components separately.

AG5.18 In measuring the fair value of a concessionary loan, an entity considers if the loan is credit impaired on initial recognition (see paragraphs AG2.33, and 5.28 to 5.29). If the loan is credit impaired, an entity measures the instrument at the fair value using the contractual cash flows of the instrument, including the expected credit losses over the life of the instrument, and discounts the cash flows using the credit adjusted effective interest rate. An entity applies paragraph AG5.15 to account for the component parts and recognises the credit losses and social benefit together using the principles in the *Framework for the Preparation and Presentation of Financial Statements*[1].

AG5.19 There is usually a high degree of judgement involved in determining the fair value of concessionary loans because they are often provided to further particular government policies, and as a result, there may be no equivalent market. As a result, an entity applies a valuation technique as outlined in paragraph AG5.40 to AG5.46. These valuation techniques make use of market-inputs as far as possible. When concessionary loans are credit impaired on purchase or origination, the existence of an equivalent market and market data may be unlikely. When a reliable measure of fair value cannot be determined using the techniques in paragraph AG5.40 to AG5.46 for such loans, an entity may apply a practical expedient. An entity may determine the fair value of a purchased or originated credit impaired concessionary loan by estimating the expected cash flows, including credit losses, and discounting the cash flows using a rate that best represents the time value of money.

AG5.20 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.

AG5.21 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 this Standard.

Commitments to provide concessionary loans

AG5.22 Where an entity commits to provide a loan on concessionary terms to another party, it initially measures the loan commitment at fair value in accordance with paragraph 5.1. Where there is no reliable measure of fair value on initial recognition (and subsequently), the entity measures the loan commitment at the value of the loss allowance plus the value of any social benefit provided and is recognised as a social benefit in accordance with the Framework (see paragraphs 5.4 and AG5.28). An entity recognises the loan once it is drawn down (in whole or in part) by the borrower.

AG5.23 When an entity measures a commitment to provide a concessionary loan on the basis described in paragraph AG5.22, it determines the effective interest rate (or credit adjusted effective interest rate) on initial recognition. Subject to paragraphs AG5.54 to AG5.56, this rate is not changed each time there is a draw down on the commitment.

AG5.24 After initial recognition, an entity subsequently measures concessionary loans by applying the classification principles in paragraphs 4.1 to 4.8 as well as the impairment principles in paragraphs AG5.17 to AG5.40 and AG5.60 to AG5.115.

Concessionary investments

AG5.25 In the public sector, investments in residual interests can be used as a way for an entity to provide financing or subsidised funding to another public sector entity. In such a transaction, there is generally a lack of an active market for such investments (i.e. the investment is often not in any unitised capital of the of the entity, and if it is, the instruments are generally unquoted), and there are no or minimal future cash flow expectations from the investment besides a potential redemption by the issuing entity. Cash is provided by the investing entity to the investee generally to further the investee's economic or social objectives. Examples of such investments could include membership in a development bank, or equity investment in another public sector or other entity that provides certain social programmes or services (e.g. subsidised housing, small business assistance, promoting innovation in certain industries, etc.).

AG5.26 At initial recognition of such transactions, an entity analyses the terms of the arrangement and assesses whether the cash provided in full or in part, is in substance a grant or other transfer of resources, with the intention at the outset being provision or receipt of resources by way of a non-exchange transaction. Where the terms of the arrangement are unclear, the transaction is treated as an investment in the residual interest of another entity. However, to the extent that the transaction is a non-exchange transaction, any assets, revenue and/or contribution from owners arising from the transaction is accounted for in accordance with GRAP 23. The entity providing the grant or other transfer of resources recognises any social benefit in accordance with the *Framework for the Preparation and Presentation of Financial Statements*[1].

AG5.27 To the extent that an investment gives rise to a residual interest in the other entity that is in the scope of this Standard, it is recognised initially at fair value in accordance with paragraph 5.1. The investment is measured subsequently in accordance with paragraphs 5.7 to 5.8. If the instrument does not have an active market, the entity shall consider valuation techniques and inputs in AG5.30 to AG5.44 in determining the fair value, and if no reliable measure of fair value is available, at cost in accordance with paragraph 4.5

Valuing financial guarantees issued in a non-exchange transaction

AG5.28 In terms of the requirements of this Standard, financial guarantee contracts issued by an entity, like other financial liabilities, are required to be initially recognised at fair value. The subsequent measurement of financial guarantee contracts is the higher of the amount of the loss allowance determined in accordance with paragraphs 4.7 and the amount initially recognised less, when appropriate, cumulative revenue recognised in accordance with GRAP 9.

AG5.29 In the public sector, guarantees are frequently issued in 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, public-private partnerships, supporting corporate entities at times of economic distress, and guaranteeing the bond issues or debt of entities in other spheres of government or within economic entities. 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 represents a fair value, an entity recognises the financial guarantee at the amount of the consideration (see paragraph AG1.6(a)). Where an entity concludes that the consideration is not a fair value, an entity measures the financial guarantee contract at initial recognition in the same way as if no consideration had been paid.

AG5.30 At initial recognition, where no fee is charged or where the fee charged does not represent fair value, an entity firstly considers whether there are quoted prices available in an active market for directly equivalent financial guarantee contracts. 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 no 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 fulfilment 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.

AG5.31 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 guarantees a bond issue of Agency X. As Agency 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 recognises the financial guarantee at that fair value in the statement of financial position and recognises 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.

AG5.32 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 measures the financial guarantee contract issued initially at the loss allowance in accordance with paragraph 4.7(c).

Valuing loan commitments

AG5.33 In terms of paragraph 5.1, an entity measures loan commitments initially at their fair value. This is most likely to equal any commitment fee charged. As with financial guarantee contracts, if an entity is unable to determine a reliable measure of fair value of the loan commitment on initial recognition, an entity recognises the loan commitment at the loss allowance (see paragraphs AG5.89 and AG5.91). However, if an entity commits to provide a concessionary loan to another party and the fair value of the loan commitment cannot be measured reliably, an entity measures the loan commitment initially at the loss allowance plus the value of the social benefit provided and recognises this amount in accordance with paragraph 5.4.

Subsequent measurement

AG5.34 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 5.9. However, hybrid contracts with hosts that are assets within the scope of this Standard are always measured in accordance with paragraph 4.10.

Fair value measurement considerations (Paragraphs 5.10 to 5.12)

AG5.35 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.

AG5.36 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

AG5.37 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. When they exist they are used to measure the financial asset or financial liability.

AG5.38 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.

AG5.39 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

AG5.40 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.

AG5.41 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.

AG5.42 Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is shown 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.

AG5.43 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 AG5.42~~AG105~~. may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, this Standard requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

AG5.44 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, then 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.

AG5.45 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.

AG5.46 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 (see paragraphs AG5.8 to AG5.11).

No active market: investments in residual interests

AG5.47 The fair value of investments in residual interests that do not have a quoted market price in an active market 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.

AG5.48 There are situations in which the variability in the range of reasonable fair value estimates of investments in residual interests that do not have a quoted market price is likely not to be significant. It may, however, be particularly difficult to determine the fair value of a residual interest of an entity whose main objective is to provide a public service rather than generate cash flows or make a profit. If a fair value cannot be determined for an investment in a residual interest because the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, as a practical expedient, an entity measures such instruments at cost.

Inputs to valuation techniques

AG5.49 An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

(a) *The time value of money (i.e. interest at the basic or risk-free rate).* Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as an interbank rate or prime lending rate, as the benchmark rate. (Since these rates are 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.)

(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) *Prices of equity instruments.* 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 5.12.)

(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.

Amortised cost measurement (Paragraphs 5.13 to 5.16)

Effective interest method

AG5.50 In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in surplus or deficit. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

AG5.51 Fees that are an integral part of the effective interest rate of a financial instrument include:

(a) Origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.

(b) Commitment fees received by the entity to originate a loan and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.

(c) Origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

AG5.52 Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with GRAP 9 include:

(a) fees charged for servicing a loan;

(b) commitment fees to originate a loan when it is unlikely that a specific lending arrangement will be entered into; and

(c) loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

AG5.53 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts that are 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 financial instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects the interest that has accrued on that financial instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e. interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the financial instrument.

AG5.54 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

AG5.55 If an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 5.15 and changes in estimates of credit losses), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit adjusted effective interest rate for purchased or originated credit impaired financial assets). The adjustment is recognised in surplus or deficit as revenue or expense.

AG5.56 In some cases a financial asset is considered credit-impaired at initial recognition because the credit risk is very high, and in the case of a purchase it is acquired at a deep discount. An entity is required to include the initial expected credit losses in the estimated cash flows when calculating the credit-adjusted effective interest rate for financial assets that are considered to be purchased or originated credit-impaired at initial recognition. However, this does not mean that a credit-adjusted effective interest rate should be applied solely because the financial asset has high credit risk at initial recognition.

Transaction costs

AG5.57 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.

Write-off

AG5.58 The legal write-off of debt is usually governed by legislation, regulation or similar means in the public sector. Debts owing to the state are generally written off when all reasonable steps have been taken to recover the debt or it is irrecoverable, or recovery of the debt would be uneconomical, cause undue hardship, or it would be to the advantage of the state to settle the claim. An entity considers substance over form when recognising write-offs.

AG5.59 Write-offs can relate to a financial asset in its entirety or to a portion of it. For example, an entity plans to enforce the collateral on a financial asset and expects to recover no more than 30 per cent of the financial asset from the collateral. If the entity has no reasonable prospects of recovering any further cash flows from the financial asset, it should write off the remaining 70 per cent of the financial asset.

Impairment

Collective and individual assessment basis

AG5.60 In order to meet the objective of recognising lifetime expected credit losses for significant increases in credit risk since initial recognition, it may be necessary to perform the assessment of significant increases in credit risk on a collective basis by considering information that is indicative of significant increases in credit risk on, for example, a group or sub-group of financial instruments. This is to ensure that an entity meets the objective of recognising lifetime expected credit losses when there are significant increases in credit risk, even if evidence of such significant increases in credit risk at the individual instrument level is not yet available.

AG5.61 Lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.

AG5.62 However, depending on the nature of the financial instruments and the credit risk information available for particular groups of financial instruments, an entity may not be able to identify significant changes in credit risk for individual financial instruments before the financial instrument becomes past due. This may be the case for financial instruments, such as concessionary loans to small businesses in a particular sector, for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument until the borrower breaches the contractual terms. If changes in the credit risk for individual financial instruments are not captured before they become past due, a loss allowance based only on credit information at an individual financial instrument level would not faithfully represent the changes in credit risk since initial recognition.

AG5.63 In some circumstances an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime expected credit losses on an individual instrument basis. In that case, lifetime expected credit losses shall be recognised on a collective basis that considers comprehensive credit risk information. This comprehensive credit risk information must incorporate not only past due information but also all relevant credit information, including forward-looking macroeconomic information, in order to approximate the result of recognising lifetime expected credit losses when there has been a significant increase in credit risk since initial recognition on an individual instrument level.

AG5.64 For the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk characteristics. Examples of shared credit risk characteristics may include, but are not limited to, the:

(a) instrument type;

(b) credit risk ratings;

(c) collateral type;

(d) date of initial recognition;

(e) remaining term to maturity;

(f) industry;

(g) geographical location of the borrower; and

(h) the value of collateral relative to the financial asset if it has an impact on the probability of a default occurring.

AG5.65 Paragraph 5.19 requires that lifetime expected credit losses are recognised on all financial instruments for which there has been significant increases in credit risk since initial recognition. In order to meet this objective, if an entity is not able to group financial instruments for which the credit risk is considered to have increased significantly since initial recognition based on shared credit risk characteristics, the entity should recognise lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly. The aggregation of financial instruments to assess whether there are changes in credit risk on a collective basis may change over time as new information becomes available on groups of, or individual, financial instruments.

Timing of recognising lifetime expected credit losses

AG5.66 The assessment of whether lifetime expected credit losses should be recognised is based on significant increases in the likelihood or risk of a default occurring since initial recognition (irrespective of whether a financial instrument has been repriced to reflect an increase in credit risk) instead of on evidence of a financial asset being credit-impaired at the reporting date or an actual default occurring. Generally, there will be a significant increase in credit risk before a financial asset becomes credit-impaired or an actual default occurs.

AG5.67 For loan commitments, an entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default on the contract.

AG5.68 The significance of a change in the credit risk since initial recognition depends on the risk of a default occurring as at initial recognition. Thus, a given change, in absolute terms, in the risk of a default occurring will be more significant for a financial instrument with a lower initial risk of a default occurring compared to a financial instrument with a higher initial risk of a default occurring.

AG5.69 The risk of a default occurring on financial instruments that have comparable credit risk is higher the longer the expected life of the instrument; for example, the risk of a default occurring on an AAA-rated bond with an expected life of 10 years is higher than that on an AAA-rated bond with an expected life of 5 years.

AG5.70 Because of the relationship between the expected life and the risk of a default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of a default occurring over time. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is identical to the risk of a default occurring on that financial instrument when its expected life in a subsequent period is only 5 years, that may indicate an increase in credit risk. This is because the risk of a default occurring over the expected life usually decreases as time passes if the credit risk is unchanged and the financial instrument is closer to maturity. However, for financial instruments that only have significant payment obligations close to the maturity of the financial instrument the risk of a default occurring may not necessarily decrease as time passes. In such a case, an entity should also consider other qualitative factors that would demonstrate whether credit risk has increased significantly since initial recognition.

AG5.71 An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses. An entity may apply different approaches for different financial instruments. An approach that does not include an explicit probability of default as an input per se, such as a credit loss rate approach, can be consistent with the requirements in this Standard, provided that an entity is able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses, such as collateral, and considers the following when making the assessment:

(a) the change in the risk of a default occurring since initial recognition;

(b) the expected life of the financial instrument; and

(c) reasonable and supportable information that is available without undue cost or effort that may affect credit risk.

AG5.72 The methods used to determine whether credit risk has increased significantly on a financial instrument since initial recognition should consider the characteristics of the financial instrument (or group of financial instruments) and the default patterns in the past for comparable financial instruments. Despite the requirement in paragraph

5.24, for financial instruments for which default patterns are not concentrated at a specific point during the expected life of the financial instrument, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring. In such cases, an entity may use changes in the risk of a default occurring over the next 12 months to determine whether credit risk has increased significantly since initial recognition, unless circumstances indicate that a lifetime assessment is necessary.

AG5.73 However, for some financial instruments, or in some circumstances, it may not be appropriate to use changes in the risk of a default occurring over the next 12 months to determine whether lifetime expected credit losses should be recognised. For example, the change in the risk of a default occurring in the next 12 months may not be a suitable basis for determining whether credit risk has increased on a financial instrument with a maturity of more than 12 months when:

(a) the financial instrument only has significant payment obligations beyond the next 12 months;

(b) changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months; or

(c) changes in credit-related factors only have an impact on the credit risk of the financial instrument (or have a more pronounced effect) beyond 12 months.

Determining whether credit risk has increased significantly since initial recognition

AG5.74 When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect the credit risk on a financial instrument in accordance with paragraph 5.32(c). An entity need not undertake an exhaustive search for information when determining whether credit risk has increased significantly since initial recognition.

AG5.75 Credit risk analysis is a multifactor and holistic analysis; whether a specific factor is relevant, and its weight compared to other factors, will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region. An entity shall consider reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed. However, some factors or indicators may not be identifiable on an individual financial instrument level. In such a case, the factors or indicators should be assessed for appropriate portfolios, groups of portfolios or portions of a portfolio of financial instruments to determine whether the requirement in paragraph 5.18 for the recognition of lifetime expected credit losses has been met.

AG5.76 The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

(a) Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

(b) Other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

(c) Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:

(i) the credit spread;

(ii) the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and

(iii) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

(d) An actual or expected significant change in the financial instrument's external credit rating.

(e) An actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies.

(f) Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.

(g) An actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased leverage, liquidity, management problems or changes in the scope of operations or organisational structure (such as the discontinuance of a segment) that results in a significant change in the borrower's ability to meet its debt obligations.

(h) Significant increases in credit risk on other financial instruments of the same borrower.

(i) An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's goods or services because of a shift in technology.

(j) Significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers may have a greater incentive to default on their mortgages.

(k) A significant change in the quality of the guarantee provided by an owner (or an individual's guarantors) if the owner or guarantors) have an incentive and financial ability to prevent default by capital or cash infusion.

(l) Significant changes, such as reductions in financial support from a controlling entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security).

(m) Expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument.

(n) Significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the economic entity (for example, an increase in the expected number or extent of delayed contractual payments).

(o) Changes in the entity's credit management approach in relation to the financial instrument; i.e. based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.

(p) Past due information, including the rebuttable presumption as set out in paragraph 5.26.

AG5.77 In some cases, the qualitative and non-statistical quantitative information available may be sufficient to determine that a financial instrument has met the criterion for the recognition of a loss allowance at an amount equal to lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, i.e. qualitative factors that are not captured through the internal ratings process and a specific internal rating category at the reporting date, taking into consideration the credit risk characteristics at initial recognition, if both types of information are relevant.

More than 30 days past due rebuttable presumption

AG5.78 The rebuttable presumption in paragraph 5.26 is not an absolute indicator that lifetime expected credit losses should be recognised, but is presumed to be the latest point at which lifetime expected credit losses should be recognised even when using forward-looking information (including macroeconomic factors on a portfolio level).

AG5.79 An entity can rebut this presumption. However, it can do so only when it has reasonable and supportable information available that demonstrates that even if contractual payments become more than 30 days past due, this does not represent a significant increase in the credit risk of a financial instrument. For example when non-payment was an administrative oversight, instead of resulting from financial difficulty of the borrower, or the entity has access to historical evidence that demonstrates that there is no correlation between significant increases in the risk of a default occurring and financial assets on which payments are more than 30 days past due, but that evidence does identify such a correlation when payments are more than 60 days past due.

AG5.80 An entity cannot align the timing of significant increases in credit risk and the recognition of lifetime expected credit losses to when a financial asset is regarded as credit-impaired or an entity's internal definition of default.

Financial instruments that have low credit risk at the reporting date

AG5.81 The credit risk on a financial instrument is considered low for the purposes of paragraph 5.25, if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and operational conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the environment within which an entity operates.

AG5.82 To determine whether a financial instrument has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed. An external rating of 'investment grade' is an example of a financial instrument that may be considered as having low credit risk. However, financial instruments are not required to be externally rated to be considered to have low credit risk. They should, however, be considered to have low credit risk from a market participant perspective taking into account all of the terms and conditions of the financial instrument.

AG5.83 Lifetime expected credit losses are not recognised on a financial instrument simply because it was considered to have low credit risk in the previous reporting period and is not considered to have low credit risk at the reporting date. In such a case, an entity shall determine whether there has been a significant increase in credit risk since initial recognition and thus whether lifetime expected credit losses are required to be recognised in accordance with paragraph 5.18.

Modifications

AG5.84 In some circumstances, the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset in accordance with this Standard. When the modification of a financial asset results in the derecognition of the existing financial asset and the subsequent recognition of the modified financial asset, the modified asset is considered a 'new' financial asset for the purposes of this Standard.

AG5.85 Accordingly the date of the modification shall be treated as the date of initial recognition of that financial asset when applying the impairment requirements to the modified financial asset. This typically means measuring the loss allowance at an amount equal to 12-month expected credit losses until the requirements for the recognition of lifetime expected credit losses in paragraph 5.18 are met. However, in some unusual circumstances following a modification that results in derecognition of the original financial asset, there may be evidence that the modified financial asset is credit-impaired at initial recognition, and thus, the financial asset should be recognised as an originated credit-impaired financial asset. This might occur, for example, in a situation in which there was a substantial modification of a distressed asset that resulted in the derecognition of the original financial asset. In such a case, it may be possible for the modification to result in a new financial asset which is credit- impaired at initial recognition.

AG5.86 If the contractual cash flows on a financial asset have been renegotiated or otherwise modified, but the financial asset is not derecognised, that financial asset is not automatically considered to have lower credit risk. An entity shall assess whether there has been a significant increase in credit risk since initial recognition on the basis of all reasonable and supportable information that is available without undue cost or effort. This includes historical and forward-looking information and an assessment of the credit risk over the expected life of the financial asset, which includes information about the circumstances that led to the modification. Evidence that the criteria for the recognition of lifetime expected credit losses are no longer met may include a history of up-to-date and timely payment performance against the modified contractual terms. Typically a borrower would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms.

Measurement of expected credit losses

Expected credit losses

AG5.87 Expected credit losses are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

AG5.88 For financial assets, a credit loss is the present value of the difference between:

(a) the contractual cash flows that are due to an entity under the contract; and

(b) the cash flows that the entity expects to receive.

AG5.89 For undrawn loan commitments, a credit loss is the present value of the difference between:

(a) the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan; and

(b) the cash flows that the entity expects to receive if the loan is drawn down.

AG5.90 An entity's estimate of expected credit losses on loan commitments shall be consistent with its expectations of drawdowns on that loan commitment, i.e. it shall consider the expected portion of the loan commitment that will be drawn down within 12 months of the reporting date when estimating 12-month expected credit losses, and the expected portion of the loan commitment that will be drawn down over the expected life of the loan commitment when estimating lifetime expected credit losses.

AG5.91 Where a loan commitment is provided for a concessionary loan, an entity also considers the requirements in paragraph AG5.33.

AG5.92 For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

AG5.93 For a financial asset that is credit-impaired at the reporting date, but that is not a purchased or originated credit-impaired financial asset, an entity shall measure the expected credit losses as the difference between the asset's gross carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. Any adjustment is recognised in surplus or deficit as an impairment gain or loss.

AG5.94 When measuring a loss allowance for a lease receivable, the cash flows used for determining the expected credit losses should be consistent with the cash flows used in measuring the lease receivable in accordance with GRAP 13.

AG5.95 An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.32. An example of a practical expedient is the calculation of the expected credit losses on receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs AG5.60 to AG5.112) for receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a receivable is past due (for example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90–180 days past due etc.). Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral and type of customer (such as industrial or households).

Definition of default

AG5.96 Paragraph 5.24 requires that when determining whether the credit risk on a financial instrument has increased significantly, an entity shall consider the change in the risk of a default occurring since initial recognition.

AG5.97 When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes shall be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument.

Period over which to estimate expected credit losses

AG5.98 In accordance with paragraph 5.34, the maximum period over which expected credit losses shall be measured is the maximum contractual period over which the entity is exposed to credit risk. For loan commitments and financial guarantee contracts, this is the maximum contractual period over which an entity has a present contractual obligation to extend credit.

AG5.99 However, in accordance with paragraph 5.35, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. In practice lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases, which could be too late to prevent some or all of the expected credit losses. These financial instruments generally have the following characteristics as a result of the nature of the financial instrument, the way in which the financial instruments are managed, and the nature of the available information about significant increases in credit risk:

(a) the financial instruments do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day);

(b) the contractual ability to cancel the contract is not enforced in the normal day-to-day management of the financial instrument and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level; and

(c) the financial instruments are managed on a collective basis.

AG5.100 When determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions, an entity should consider factors such as historical information and experience about:

(a) the period over which the entity was exposed to credit risk on similar financial instruments;

(b) the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and

(c) the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

Probability weighted outcome

AG5.101 The purpose of estimating expected credit losses is neither to estimate a worst-case scenario nor to estimate the best-case scenario. Instead, an estimate of expected credit losses shall always reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs even if the most likely outcome is no credit loss.

AG5.102 Paragraph 5.32(a) requires the estimate of expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. In practice, this may not need to be a complex analysis. In some cases, relatively simple modelling may be sufficient, without the need for a large number of detailed simulations of scenarios. For example, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. In those situations, the expected credit losses shall reflect at least two outcomes in accordance with paragraph 5.33.

AG5.103 For lifetime expected credit losses, an entity shall estimate the risk of a default occurring on the financial instrument during its expected life. 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring. Thus, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months nor the cash shortfalls that are predicted over the next 12 months.

Time value of money

AG5.104 Expected credit losses shall be discounted to the reporting date, not to the expected default or some other date, using the effective interest rate determined at initial recognition or an approximation thereof. If a financial instrument has a variable interest rate, expected credit losses shall be discounted using the current effective interest rate determined in accordance with paragraph AG5.54.

AG5.105 For purchased or originated credit-impaired financial assets (which excludes receivables), expected credit losses shall be discounted using the credit-adjusted effective interest rate determined at initial recognition.

AG5.106 Expected credit losses on lease receivables shall be discounted using the same discount rate used in the measurement of the lease receivable in accordance with GRAP 13.

AG5.107 The expected credit losses on a loan commitment shall be discounted using the effective interest rate, or an approximation thereof, that will be applied when recognising the financial asset resulting from the loan commitment. This is because for the purpose of applying the impairment requirements, a financial asset that is recognised following a draw down on a loan commitment shall be treated as a continuation of that commitment instead of as a new financial instrument. The expected credit losses on the financial asset shall therefore be measured considering the initial credit risk of the loan commitment from the date that the entity became a party to the irrevocable commitment.

AG5.108 Expected credit losses on financial guarantee contracts or on loan commitments for which the effective interest rate cannot be determined shall be discounted by applying a discount rate that reflects the current market assessment of the time value of money and the risks that are specific to the cash flows but only if, and to the extent that, the risks are taken into account by adjusting the discount rate instead of adjusting the cash shortfalls being discounted.

Reasonable and supportable information

AG5.109 For the purpose of this Standard, reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions. Information that is available for financial reporting purposes is considered to be available without undue cost or effort.

AG5.110 An entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument. The degree of judgement that is required to estimate expected credit losses depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement required to estimate expected credit losses increases. The estimate of expected credit losses does not require a detailed estimate for periods that are far in the future—for such periods, an entity may extrapolate projections from available, detailed information.

AG5.111 An entity need not undertake an exhaustive search for information but shall consider all reasonable and supportable information that is available without undue cost or effort and that is relevant to the estimate of expected credit losses, including the effect of expected prepayments. The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, that may be both internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

AG5.112 Historical information is an important anchor or base from which to measure expected credit losses. However, an entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows. In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered. Estimates of changes in expected credit losses should reflect, and be 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 credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience.

AG5.113 When using historical credit loss experience in estimating expected credit losses, it is important that information about historical credit loss rates is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit loss rates were observed. Consequently, the method used shall enable each group of financial assets to be associated with information about past credit loss experience in groups of financial assets with similar risk characteristics and with relevant observable data that reflects current conditions.

AG5.114 Expected credit losses reflect an entity's own expectations of credit losses. However, when considering all reasonable and supportable information that is available without undue cost or effort in estimating expected credit losses, an entity should also consider observable market information about the credit risk of the particular financial instrument or similar financial instruments.

Collateral

AG5.115 For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity, except if management does not intend to call the collateral. For example, an entity may have collateral for debts owing to it, but may choose not to use the collateral if it is likely to cause economic hardship. Where management's intention is not to call the collateral, it is not included in the calculation of the expected shortfalls. When management intends to use the collateral, the estimate of expected cash shortfalls on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral (i.e. the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset in this or other Standards.

Reclassification~~s~~ of financial assets **(Paragraphs 5.37 to 5.41)**

AG5.116 If an entity reclassifies financial assets in accordance with paragraph 4.16, paragraph 5.37 requires that the reclassification is applied prospectively from the reclassification date.

AG5.117 An entity is not required to separately recognise interest revenue or impairment gains or losses for a financial asset measured at fair value through surplus or deficit. Consequently, when an entity reclassifies a financial asset out of the fair value through surplus of deficit measurement category, the effective interest rate is determined on the basis of the fair value of the asset at the reclassification date. In addition, for the purposes of applying paragraphs 5.17 to 5.35 to the financial asset from the reclassification date, the date of the reclassification is treated as the date of initial recognition.

Gains and losses **(Paragraphs 5.42 to 5.46)**

AG5.118 An entity applies GRAP 4 to financial assets and financial liabilities that are monetary items in accordance with that Standard and denominated in a foreign currency. GRAP 4 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in surplus or deficit.

Liabilities designated as at fair value through surplus or deficit

AG5.119 When an entity designates a financial liability as at fair value through surplus or deficit, it must determine whether presenting in the statement of changes in net assets the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in surplus or deficit. An accounting mismatch would be created or enlarged if presenting the effects of changes in the liability's credit risk in the statement of changes in net assets would result in a greater mismatch in surplus or deficit than if those amounts were presented in surplus or deficit.

AG5.120 To make that determination, an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in surplus or deficit by a change in the fair value of another financial instrument measured at fair value through surplus or deficit. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument.

AG5.121 That determination is made at initial recognition and is not reassessed. For practical purposes the entity need not enter into all of the assets and liabilities giving rise to an accounting mismatch at exactly the same time. A reasonable delay is permitted provided that any remaining transactions are expected to occur. An entity must apply consistently its methodology for determining whether presenting in the statement of changes in net assets the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in surplus or deficit. However, an entity may use different methodologies when there are different economic relationships between the characteristics of the liabilities designated as at fair value through surplus or deficit and the characteristics of the other financial instruments. An entity is required to provide qualitative disclosures in the notes to the financial statements about its methodology for making that determination.

AG5.122 If such a mismatch would be created or enlarged, the entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in surplus or deficit. If such a mismatch would not be created or enlarged, the entity is required to present the effects of changes in the liability's credit risk in the statement of changes in net assets.

AG5.123 Amounts presented in the statement of changes in net assets shall not be subsequently transferred to surplus or deficit. However, the entity may transfer the cumulative gain or loss within net assets.

AG5.124 The following example describes a situation in which an accounting mismatch would be created in surplus or deficit if the effects of changes in the credit risk of the liability were presented in the statement of changes in net assets. A development finance institution provides loans to customers and funds those loans by selling bonds with matching characteristics (e.g. amount outstanding, repayment profile, term and currency) in the market. The contractual terms of the loan permit the customer to prepay its loan (i.e. satisfy its obligation to the institution) by buying the corresponding bond at fair value in the market and delivering that bond to the institution. As a result of that contractual prepayment right, if the credit quality of the bond worsens (and, thus, the fair value of the institution's liability decreases), the fair value of the institution's loan asset also decreases. The change in the fair value of the asset reflects the customer's contractual right to prepay the mortgage loan by buying the underlying bond at fair value (which, in this example, has decreased) and delivering the bond to the institution. Consequently, the effects of changes in the credit risk of the liability (the bond) will be offset in surplus or deficit by a corresponding change in the fair value of a financial asset (the loan). If the effects of changes in the liability's credit risk were presented in the statement of changes in net assets there would be an accounting mismatch in surplus or deficit. Consequently, the institution is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in surplus or deficit.

AG5.125 In the example in paragraph AG5.124, there is a contractual linkage between the effects of changes in the credit risk of the liability and changes in the fair value of the financial asset (i.e. as a result of the customer's contractual right to prepay the loan by buying the bond at fair value and delivering the bond to the institution). However, an accounting mismatch may also occur in the absence of a contractual linkage.

AG5.126 For the purposes of applying the requirements in paragraphs 5.43 and 5.44, an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk. An accounting mismatch in surplus or deficit would arise only when the effects of changes in the liability's credit risk are expected to be offset by changes in the fair value of another financial instrument. A mismatch that arises solely as a result of the measurement method (i.e. because an entity does not isolate changes in a liability's credit risk from some other changes in its fair value) does not affect the determination required by paragraphs 5.44 and 5.45. For example, an entity may not isolate changes in a liability's credit risk from changes in liquidity risk. If the entity presents the combined effect of both factors in the statement of changes in net assets, a mismatch may occur because changes in liquidity risk may be included in the fair value measurement of the entity's financial assets and the entire fair value change of those assets is presented in surplus or deficit. However, such a mismatch is caused by measurement imprecision, not the offsetting relationship described in paragraph AG5.120 and, therefore, does not affect the determination required by paragraphs 5.44 and 5.45.

The meaning of 'credit risk'

AG5.127 This Standard defines credit risk as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. The requirement in paragraph 5.44(a) relates to the risk that the issuer will fail to perform on that particular liability. It does not necessarily relate to the creditworthiness of the issuer. For example, if an entity issues a collateralised liability and a non-collateralised liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero.

AG5.128 For the purposes of applying the requirement in paragraph 5.44(a), credit risk is different from asset-specific performance risk. Asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but instead it is related to the risk that a single asset or a group of assets will perform poorly (or not at all).

AG5.129 The following are examples of asset-specific performance risk:

(a) A liability with a unit-linking feature whereby the amount due to investors is contractually determined on the basis of the performance of specified assets. The effect of that unit-linking feature on the fair value of the liability is asset-specific performance risk, not credit risk.

(b) A liability issued by a structured (special purpose) entity with the following characteristics. The entity is legally isolated so the assets in the entity are ring-fenced solely for the benefit of its investors, even in the event of bankruptcy. The entity enters into no other transactions and the assets in the entity cannot be hypothecated. Amounts are due to the entity's investors only if the ring-fenced assets generate cash flows. Thus, changes in the fair value of the liability primarily reflect changes in the fair value of the assets. The effect of the performance of the assets on the fair value of the liability is asset-specific performance risk, not credit risk.

Determining the effects of changes in credit risk

AG5.130 For the purposes of applying the requirement in paragraph 5.44(a) , an entity shall determine the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability either:

(a) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see paragraphs AG5.131 and AG5.132); or

(b) using an alternative method the entity believes more faithfully represents the amount of change in the liability's fair value that is attributable to changes in its credit risk.

AG5.131 Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates.

AG5.132 If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount in paragraph AG5.130(a) can be estimated as follows:

(a) First, the entity computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.

(b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).

The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in the statement of changes in net assets in accordance with paragraph 5.44 (a).

AG5.133 The example in paragraph AG5.132 assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in observed (benchmark) interest rates are not significant. This method would not be appropriate if changes in fair value arising from other factors are significant. In those cases, an entity is required to use an alternative method that more faithfully measures the effects of changes in the liability's credit risk (see paragraph AG5.130(b)). For example, if the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be presented in the statement of changes in net assets in accordance with paragraph 5.44(a).

AG5.134 As with all fair value measurements, an entity's measurement method for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk must make maximum use of relevant observable inputs and minimum use of unobservable inputs.

Chapter 6 - Derecognition

Derecognition of financial assets (Paragraphs 6.1 to 6.15)

AG6.1 Decision tree A—illustrates the evaluation of whether a financial asset is derecognised.

Waiver of rights

AG6.2 An entity may waive its contractual rights to receive cash or other financial assets under existing agreements. Where an entity waives its rights, it shall assess whether or not the waiver is the provision of a social benefit, e.g. to reduce poverty among a certain group of people. Where this waiver results in the provision of a social benefit, an entity classifies and recognises any resulting loss on derecognition of the asset in accordance with paragraph 5.4(a).

AG6.3 The waiver of debts should be distinguished from debt write-offs in paragraph 5.16 for purposes of disclosure in the financial statements. Debts owing to the entity that cannot be collected, usually after following legal processes are often written off; whereas the waiver of debt is the eradication of debt to achieve specific objectives such as to provide free or subsidised water and electricity to low income households.

Evaluation of the transfer of risks and rewards of ownership

AG6.4 Examples of when an entity has transferred substantially all of 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).

AG6.5 Examples of when an entity has retained substantially all of 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.

AG6.6 If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the transfer of control

AG6.7 An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

AG6.8 The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

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

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

  (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (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).

AG6.9 That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. If a put option or guarantee constrains the transferee from selling the transferred asset, however, 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

AG6.10 An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up on 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 6.12, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

AG6.11 In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 6.12, an entity applies the fair value measurement requirements in paragraphs 5.10 to 5.12 and AG5.35 to AG5.46 in addition to paragraph 6.12.

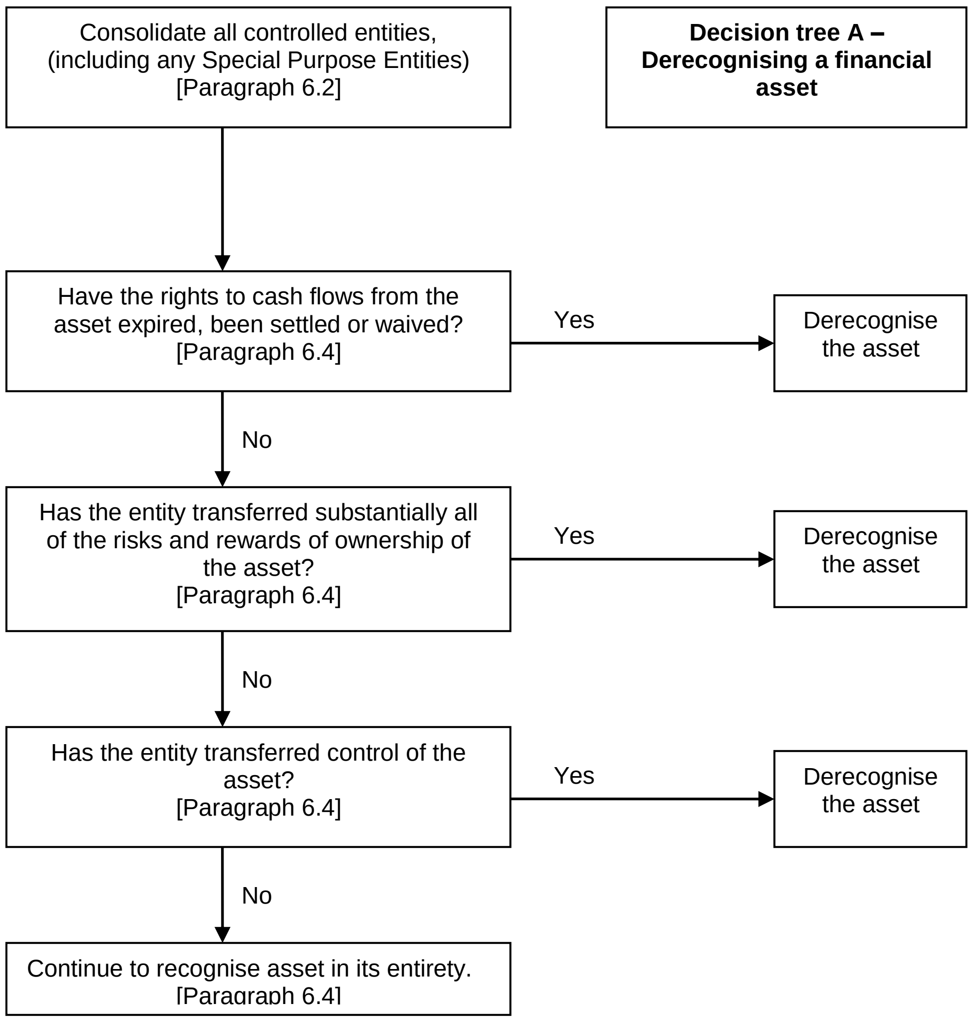
Transfers that do not qualify for derecognition

AG6.12 The following is an application of the principle outlined in paragraph 6.14. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

All transfers

AG6.13 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

AG6.14 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.



Derecognition of financial liabilities (Paragraphs 6.16 to 6.19)

AG6.15 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;

(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); or

(c) waives the debt or it is assumed by another entity by way of a non-exchange transaction. These transactions are accounted for by considering the requirements of this Standard as well as GRAP 23.

AG6.16 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.

AG6.17 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.

AG6.18 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph AG6.15(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.

AG6.19 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 6.1 to 6.15 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.

AG6.20 For the purpose of paragraph 6.17, 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% different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

AG6.21 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:

(a) recognises a new financial liability based on the fair value (or where applicable, the loss allowance) of its obligation for the guarantee; and

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

Chapter 7 - Presentation

Interest, dividends or similar distributions, losses and gains (Paragraph 7.1 to 7.8)

AG7.1 The following example illustrates the application of paragraph 7.1 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends or similar distributions are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognised in surplus or deficit and classified as interest expense. Any dividends or similar distributions paid relate to the residual interest component and, accordingly, are recognised as a distribution of any surplus. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of ordinary shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (e.g. commodity). If any unpaid dividends or similar distributions are added to the redemption amount, however, then the entire instrument is a liability. In such a case, any dividends or similar distributions are classified as interest expense.

Offsetting a financial asset and a financial liability (Paragraph 7.9 to 7.17)

Criterion that an entity 'currently has a legally enforceable right to set off the recognised amounts'(paragraph 7.9(a))

AG7.2 A right of set off may be currently available or it may be contingent on a future event (for example, the right may be triggered or exercisable only on the occurrence of some future event, such as the default, insolvency or bankruptcy of one of the counterparties). Even if the right of set off is not contingent on a future event, it may only be legally enforceable in the normal course of operations, or in the event of default, or in the event of insolvency or bankruptcy, of one or all of the counterparties.

AG7.3 To meet the criterion in paragraph 7.9(a), an entity must currently have a legally enforceable right of set-off. This means that the right of set-off:

(a) must not be contingent on a future event; and

(b) must be legally enforceable in all of the following circumstances:

(i) the normal course of operations;

(ii) the event of default; and

(iii) the event of insolvency or bankruptcy of the entity and all of the counterparties.

AG7.4 The nature and extent of the right of set-off, including any conditions attached to its exercise and whether it would remain in the event of default or insolvency or bankruptcy, may vary. Consequently, it cannot be assumed that the right of set-off is automatically available outside of the normal course of operations. For example, the bankruptcy or insolvency laws may prohibit, or restrict, the right of set-off in the event of bankruptcy or insolvency in some circumstances.

AG7.5 The laws applicable to the relationships between the parties (for example, contractual provisions, the laws governing the contract, or the default, insolvency or bankruptcy laws applicable to the parties) need to be considered to ascertain whether the right of set-off is enforceable in the normal course of operations, in an event of default, and in the event of insolvency or bankruptcy, of the entity and all of the counterparties (as specified in paragraph AG7.3(b)).

Criterion that an entity 'intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously' (paragraph 7.9 (b))

AG7.6 To meet the criterion in paragraph 7.9 (b) an entity must intend either to settle on a net basis or to realise the asset and settle the liability simultaneously. Although the entity may have a right to settle net, it may still realise the asset and settle the liability separately.

AG7.7 If an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion in paragraph 7.9 (b). This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle. For example, a gross settlement system that has all of the following characteristics would meet the net settlement criterion in paragraph 7.9(b):

(a) financial assets and financial liabilities eligible for set-off are submitted at the same point in time for processing;

(b) once the financial assets and financial liabilities are submitted for processing, the parties are committed to fulfil the settlement obligation;

(c) there is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing (unless the processing fails—see (d) below);

(d) assets and liabilities that are collateralised with securities will be settled on a securities transfer or similar system (for example, delivery versus payment), so that if the transfer of securities fails, the processing of the related receivable or payable for which the securities are collateral will also fail (and vice versa);

(e) any transactions that fail, as outlined in (d), will be re-entered for processing until they are settled;

(f) settlement is carried out through the same settlement institution (for example, a settlement bank, a central bank or a central securities depository); and

(g) an intraday credit facility is in place that will provide sufficient overdraft amounts to enable the processing of payments at the settlement date for each of the parties, and it is virtually certain that the intraday credit facility will be honoured if called upon.

AG7.8 This Standard does not provide special treatment for so-called 'synthetic instruments', which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions. Each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented in an entity's statement of financial position on a net basis unless they meet the criteria for offsetting in paragraph 7.9.

Chapter 8 – Disclosure

Accounting policies **(paragraph 8.3)**

AG8.1 Paragraph 8.3 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

(a) for financial liabilities designated at fair value:

(i) the nature of the financial assets or financial liabilities the entity has designated at fair value through surplus or deficit;

(ii) the criteria for so designating financial liabilities on initial recognition; and

(iii) how the entity satisfied the conditions in paragraph 4.84 for such designation;

(b) for financial assets designated as measured at fair value through surplus or deficit:

(i) the nature of the financial assets the entity has designated as measured at fair value through surplus or deficit; and

(ii) how the entity has satisfied the criteria in paragraph 4.6 for such designation;

(c) how net gains or net losses on each category of financial instrument are determined (see paragraph 8.30), for example, whether the net gains or net losses on items at fair value include interest revenue or income from dividends or similar distributions~~;~~

Paragraph .132 of GRAP 1 also requires entities to disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Classes of financial instruments and level of disclosure **(paragraph 8.4)**

AG8.2 Paragraph 8.4 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 8.4 are determined by the entity and are thus distinct from the categories of financial instruments specified in this Standard (which determine how financial instruments are measured).

AG8.3 In determining classes of financial instrument, an entity shall, at a minimum:

(a) distinguish instruments measured at amortised cost and cost from those measured at fair value; and

(b) treat as a separate class or classes those financial instruments outside the scope of this Standard.

AG8.4 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this Standard, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Significance of financial instruments for financial position and performance

Nature and extent of risks arising from financial instruments (paragraphs 8.36 to 8.60)

AG8.5 The disclosures required by paragraphs 8.39 to 8.60 shall be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Quantitative disclosures (paragraph 8.40)

AG8.6 Paragraph 8.40(a) requires disclosures of summary quantitative data about an entity's exposure to risks based on the information provided internally to management of the entity. When an entity uses several methods to manage a risk exposure, the entity shall disclose information using the method or methods that provide the most relevant and reliable information. GRAP 3 discusses relevance and reliability.

AG8.7 Paragraph 8.40(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgement taking into account the circumstances of the entity. Disclosure of concentrations of risk shall include:

(a) a description of how management determines concentrations;

(b) a description of the shared characteristic that identifies each concentration (e.g. counterparty, geographical area, currency or market); and

(c) the amount of the risk exposure associated with all financial instruments sharing that characteristic.

Credit risk management practices

AG8.8 Paragraph 8.47(b) requires the disclosure of information about how an entity has defined default for different financial instruments and the reasons for selecting those definitions. In accordance with paragraph 5.24, the determination of whether lifetime expected credit losses should be recognised is based on the increase in the risk of a default occurring since initial recognition. Information about an entity's definitions of default that will assist users of financial statements in understanding how an entity has applied the expected credit loss requirements may include:

(a) the qualitative and quantitative factors considered in defining default;

(b) whether different definitions have been applied to different types of financial instruments; and

(c) assumptions about the cure rate (i.e. the number of financial assets that return to a performing status) after a default occurred on the financial asset.

AG8.9 To assist users of financial statements in evaluating an entity's restructuring and modification policies, paragraph 8.47 (f)(ii) requires the disclosure of information about how an entity monitors the extent to which the loss allowance on financial assets previously disclosed in accordance with paragraph 8.47 (f)(i) are subsequently measured at an amount equal to lifetime expected credit losses in accordance with paragraph 5.18. Quantitative information that will assist users in understanding the subsequent increase in credit risk of modified financial assets may include information about modified financial assets meeting the criteria in paragraph 8.47 (f)(i) for which the loss allowance has reverted to being measured at an amount equal to lifetime expected credit losses (i.e. a deterioration rate).

AG8.10 Paragraph 8.48 (a) requires the disclosure of information about the basis of inputs and assumptions and the estimation techniques used to apply the impairment requirements. An entity's assumptions and inputs used to measure expected credit losses or determine the extent of increases in credit risk since initial recognition may include information obtained from internal historical information or rating reports and assumptions about the expected life of financial instruments and the timing of the sale of collateral.

Changes in the loss allowance

AG8.11 In accordance with paragraph 8.49, an entity is required to explain the reasons for the changes in the loss allowance during the period. In addition to the reconciliation from the opening balance to the closing balance of the loss allowance, it may be necessary to provide a narrative explanation of the changes. This narrative explanation may include an analysis of the reasons for changes in the loss allowance during the period, including:

(a) the portfolio composition;

(b) the volume of financial instruments purchased or originated; and

(c) the severity of the expected credit losses.

AG8.12 For loan commitments and financial guarantee contracts the loss allowance is recognised as a provision. An entity should disclose information about the changes in the loss allowance for financial assets separately from those for loan commitments and financial guarantee contracts. However, if a financial instrument includes both a loan (i.e. financial asset) and an undrawn commitment (i.e. loan commitment) component and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component, the expected credit losses on the loan commitment should be recognised together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision.

Collateral

AG8.13 Paragraph 8.52 requires the disclosure of information that will enable users of financial statements to understand the effect of collateral and other credit enhancements on the amount of expected credit losses. An entity is neither required to disclose information about the fair value of collateral and other credit enhancements nor is it required to quantify the exact value of the collateral that was included in the calculation of expected credit losses (i.e. the loss given default).

AG8.14 A narrative description of collateral and its effect on amounts of expected credit losses might include information about:

(a) the main types of collateral held as security and other credit enhancements (examples of the latter being guarantees, credit derivatives and netting agreements that do not qualify for offset);

(b) the volume of collateral held and other credit enhancements and its significance in terms of the loss allowance;

(c) the policies and processes for valuing and managing collateral and other credit enhancements;

(d) the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and

(e) information about risk concentrations within the collateral and other credit enhancements.

Credit risk exposure

AG8.15 Paragraph 8.54 requires the disclosure of information about an entity's credit risk exposure and significant concentrations of credit risk at the reporting date. A concentration of credit risk exists when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. An entity should provide information that enables users of financial statements to understand whether there are groups or portfolios of financial instruments with particular features that could affect a large portion of that group of financial instruments such as concentration to particular risks. This could include, for example, geographical, industry or issuer-type concentrations.

AG8.16 The number of credit risk rating grades used to disclose the information in accordance with paragraph 8.54 shall be consistent with the number that the entity reports to management for credit risk management purposes. If past due information is the only borrower-specific information available and an entity uses past due information to assess whether credit risk has increased significantly since initial recognition in accordance with paragraph 5.26, an entity shall provide an analysis by past due status for those financial assets.

AG8.17 When an entity has measured expected credit losses on a collective basis, the entity may not be able to allocate the gross carrying amount of individual financial assets or the exposure to credit risk on loan commitments and financial guarantee contracts to the credit risk rating grades for which lifetime expected credit losses are recognised. In that case, an entity should apply the requirement in paragraph 8.54 to those financial instruments that can be directly allocated to a credit risk rating grade and disclose separately the gross carrying amount of financial instruments for which lifetime expected credit losses have been measured on a collective basis.

Maximum credit risk exposure (paragraphs 8.52(a) and 8.56(a))

AG8.18 Paragraph 8.52(a) and 8.56(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:

(a) any amounts offset; and

(b) any loss allowance recognised.

AG8.19 Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:

(a) granting loans and receivables to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets;

(b) entering into derivative contracts, e.g. foreign exchange contracts, interest rate swaps and credit derivatives. When the resulting asset is measured at fair value, the maximum exposure to credit risk at the end of the reporting period will equal the carrying amount;

(c) granting financial guarantees. In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability; and

(d) making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognised as a liability.

Quantitative liquidity disclosures (paragraph 8.58(a))

AG8.20 In accordance with paragraph 8.40(a) an entity discloses summary quantitative data about its exposure to liquidity risk on the basis of the information provided internally to management. An entity shall explain how those data are determined. If the outflows of cash (or another financial asset) included in those data could either:

(a) occur significantly earlier than indicated in the data; or

(b) be for significantly different amounts from those indicated in the data (e.g. for a derivative that is included in the data on a net settlement basis but for which the counterparty has the option to require gross settlement),

the entity shall state that fact and provide quantitative information that enables users of its financial statements to evaluate the extent of this risk unless that information is included in the contractual maturity analyses required by paragraph 8.58(a) or (b).

AG8.21 In preparing the maturity analyses required by paragraph 8.59 (a), an entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

(a) not later than one month;

(b) later than one month and not later than three months;

(c) later than three months and not later than one year; and

(d) later than one year and not later than five years.

AG8.22 In complying with paragraph 8.58(a) and (b), an entity shall not separate an embedded derivative from a hybrid contract. For such an instrument, an entity shall apply paragraph 8.58(a).

AG8.23 Paragraph 8.58(b) requires an entity to disclose a quantitative maturity analysis for derivative financial liabilities that shows remaining contractual maturities if the contractual maturities are essential for an understanding of the timing of the cash flows. For example, this would be the case for:

(a) an interest rate swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability; and

(b) all loan commitments.

AG8.24 Paragraph 8.58(a) and (b) requires an entity to disclose maturity analyses for financial liabilities that show the remaining contractual maturities for some financial liabilities. In this disclosure.

(a) when a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (e.g. demand deposits) are included in the earliest time band;

(b) when an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down; and

(c) for issued financial guarantee contracts the maximum amount of the guarantee is allocated to the earliest period in which the guarantee could be called.

AG8.25 The contractual amounts disclosed in the maturity analyses as required by paragraph 8.58(a) and (b) are the contractual undiscounted cash flows e.g.:

(a) gross finance lease obligations (before deducting finance charges);

(b) prices specified in forward agreements to purchase financial assets for cash;

(c) net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged;

(d) contractual amounts to be exchanged in a derivative financial instrument (e.g. a currency swap) for which gross cash flows are exchanged; and

(e) gross loan commitments.

Such undiscounted cash flows differ from the amount included in the statement of financial position because the amount in that statement is based on discounted cash flows. When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the end of the reporting period. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the end of the period.

AG8.26 Paragraph 8.58(c) requires an entity to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative disclosures required in paragraph 8.58(a) and (b). An entity shall disclose a maturity analysis of financial assets it holds for managing liquidity risk (e.g. financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities), if that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk.

AG8.27 Other factors that an entity might consider in providing the disclosure required in paragraph 8.58(c) include, but are not limited to, whether the entity:

(a) has committed borrowing facilities (e.g. commercial paper facilities) or other lines of credit (e.g. stand-by credit facilities) that it can access to meet liquidity needs;

(b) has very diverse funding sources;

(c) has significant concentrations of liquidity risk in either its assets or its funding sources;

(d) has internal control processes and contingency plans for managing liquidity risk;

(e) has instruments that include accelerated repayment terms (e.g. on the downgrade of the entity's credit rating);

(f) has instruments that could require the posting of collateral (e.g. margin calls for derivatives);

(g) has instruments that allows the entity to choose whether it settles its financial liabilities by delivering cash (or another financial asset) or by delivering its own shares; or

(h) has instruments that are subject to master netting agreements.

Market risk (Paragraph 8.59 to 8.60)

AG8.28 Paragraph 8.59 requires an entity to disclose a sensitivity analysis for each significant type of market risk to which the entity is exposed. An entity decides how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. For example:

(a) an entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading; and

(b) an entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

If an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information.

AG8.29 When an entity prepares a sensitivity analysis, it should show the effect on surplus or deficit of reasonably possible changes in the relevant risk variable (e.g. prevailing market interest rates, currency rates, equity prices or commodity prices). For this purpose:

(a) entities do not need to determine what the surplus or deficit for the period would have been if relevant risk variables had been different. Instead, entities disclose the effect on surplus or deficit at the end of the reporting period assuming that a reasonably possible change in the relevant risk variable had occurred at the end of the reporting period and had been applied to the risk exposures in existence at that date. For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on surplus or deficit (i.e. interest expense) for the current year if interest rates had varied by reasonably possible amounts; and

(b) entities do not need to disclose the effect on surplus or deficit for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

AG8.30 In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:

(a) the economic environments in which it operates. A reasonably possible change should not include remote or 'worst case' scenarios or 'stress tests'. Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable. For example, assume that interest rates are 5% and an entity determines that a fluctuation in interest rates of ±50 basis points is reasonably possible. It would disclose the effect on surplus or deficit if interest rates were to change to 4.5% or 5.5%. In the next period, interest rates have increased to 5.5%. The entity continues to believe that interest rates may fluctuate by ±50 basis points (i.e. that the rate of change in interest rates is stable). The entity would disclose the effect on surplus or deficit if interest rates were to change to 5 % or 6%. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ±50 basis points, unless there is evidence that interest rates have become significantly more volatile; and

(b) the time frame over which it is making the assessment. The sensitivity analysis shall show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

AG8.31 Where an entity presents a sensitivity analysis, it should provide sensitivity analyses for the whole of its operations, but may provide different types of sensitivity analysis for different classes of financial instruments.

Interest rate risk

AG8.32 Interest rate risk arises on interest-bearing financial instruments recognised in the statement of financial position (e.g. loans and receivables and debt instruments issued) and on some financial instruments not recognised in the statement of financial position (e.g. some loan commitments).

Currency risk

AG8.33 Currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency in which they are measured. For the purpose of this Standard, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.

AG8.34 A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

Other price risk

AG8.35 Other price risk arises on financial instruments because of changes in, for instance, commodity prices or equity prices. An entity might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.

AG8.36 Two examples of financial instruments that give rise to equity price risk are (a) a holding of equity instruments in another entity and (b) an investment in a trust that in turn holds investments in equity instruments. Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

AG8.37 Financial instruments that an entity classifies as residual interests are not remeasured. Surplus or deficit is not affected by the equity price risk of those instruments. Accordingly, no sensitivity analysis is required.

Offsetting financial assets and financial liabilities

Scope

AG8.38 The disclosures in paragraphs 8.15 to 8.18 are required for all recognised financial instruments that are set off in accordance with paragraph 7.9. In addition, financial instruments are within the scope of the disclosure requirements in paragraphs 8.15 to 8.18 if they are subject to an enforceable master netting arrangement or similar agreement that covers similar financial instruments and transactions, irrespective of whether the financial instruments are set off in accordance with paragraph 7.9.

AG8.39 The similar agreements referred to in paragraphs 8.14 and AG8.38 include derivative clearing agreements, global master repurchase agreements, global master securities lending agreements, and any related rights to financial collateral. The similar financial instruments and transactions referred to in paragraph AG8.39 include derivatives, sale and repurchase agreements, reverse sale and repurchase agreements, securities borrowing, and securities lending agreements. Examples of financial instruments that are not within the scope of paragraph 8.14 are loans and customer deposits at the same institution (unless they are set off in the statement of financial position), and financial instruments that are subject only to a collateral agreement.

Disclosure of quantitative information for recognised financial assets and recognised financial liabilities within the scope of paragraph 8.14 (paragraph 8.16)

AG8.40 Financial instruments disclosed in accordance with paragraph 8.16 may be subject to different measurement requirements (for example, a payable related to a repurchase agreement may be measured at amortised cost, while a derivative will be measured at fair value). An entity shall include instruments at their recognised amounts and describe any resulting measurement differences in the related disclosures.

Disclosure of the gross amounts of recognised financial assets and recognised financial liabilities within the scope of paragraph 8.14 (paragraph 8.16(a))

AG8.41 The amounts required by paragraph 8.16(a) relate to recognised financial instruments that are set off in accordance with paragraph 7.9. The amounts required by paragraph 8.16(a) also relate to recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement irrespective of whether they meet the offsetting criteria. However, the disclosures required by paragraph 8.16(a) do not relate to any amounts recognised as a result of collateral agreements that do not meet the offsetting criteria in paragraph 7.9. Instead, such amounts are required to be disclosed in accordance with paragraph 8.16(d).

Disclosure of the amounts that are set off in accordance with the criteria in paragraph 7.9 (paragraph 8.16(b))

AG8.42 Paragraph 8.16(b) requires that entities disclose the amounts set off in accordance with paragraph 7.9 when determining the net amounts presented in the statement of financial position. The amounts of both the recognised financial assets and the recognised financial liabilities that are subject to set-off under the same arrangement will be disclosed in both the financial asset and financial liability disclosures. However, the amounts disclosed (in, for example, a table) are limited to the amounts that are subject to set-off. For example, an entity may have a recognised derivative asset and a recognised derivative liability that meet the offsetting criteria in paragraph 7.9. If the gross amount of the derivative asset is larger than the gross amount of the derivative liability, the financial asset disclosure table will include the entire amount of the derivative asset (in accordance with paragraph 8.16(a)) and the entire amount of the derivative liability (in accordance with paragraph 8.16(b)).

However, while the financial liability disclosure table will include the entire amount of the derivative liability (in accordance with paragraph 8.16(a)), it will only include the amount of the derivative asset (in accordance with paragraph 8.16(b)) that is equal to the amount of the derivative liability.

Disclosure of the net amounts presented in the statement of financial position (paragraph 8.16(c))

AG8.43 If an entity has instruments that meet the scope of these disclosures (as specified in paragraph 8.14), but that do not meet the offsetting criteria in paragraph 7.9, the amounts required to be disclosed by paragraph 8.16(c) would equal the amounts required to be disclosed by paragraph 8.16(a).

AG8.44 The amounts required to be disclosed by paragraph 8.16(c) must be reconciled to the individual line item amounts presented in the statement of financial position. For example, if an entity determines that the aggregation or disaggregation of individual financial statement line item amounts provides more relevant information, it must reconcile the aggregated or disaggregated amounts disclosed in paragraph 8.16(c) back to the individual line item amounts presented in the statement of financial position.

Disclosure of the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 8.16(b) (paragraph 8.16(d))

AG8.45 Paragraph 8.16(d) requires that entities disclose amounts that are subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in paragraph 8.16(b). Paragraph 8.16(d)(i) refers to amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in paragraph 7.9 (for example, current rights of set-off that do not meet the criterion in paragraph 7.9(b), or conditional rights of set-off that are enforceable and exercisable only in the event of default, or only in the event of insolvency or bankruptcy of any of the counterparties).

AG8.46 Paragraph 8.16(d)(ii) refers to amounts related to financial collateral, including cash collateral, both received and pledged. An entity shall disclose the fair value of those financial instruments that have been pledged or received as collateral. The amounts disclosed in accordance with paragraph 8.16(d)(ii) should relate to the actual collateral received or pledged and not to any resulting payables or receivables recognised to return or receive back such collateral.

Limits on the amounts disclosed in paragraph 8.16(d) (paragraph 8.17)

AG8.47 When disclosing amounts in accordance with paragraph 8.16 (d), an entity must take into account the effects of over-collateralisation by financial instrument. To do so, the entity must first deduct the amounts disclosed in accordance with paragraph 8.16 (d)(i) from the amount disclosed in accordance with paragraph 8.16(c). The entity shall then limit the amounts disclosed in accordance with paragraph 8.16(d)(ii) to the remaining amount in paragraph 8.16(c) for the related financial instrument. However, if rights to collateral can be enforced across financial instruments, such rights can be included in the disclosure provided in accordance with paragraph 8.17.

Description of the rights of set-off subject to enforceable master netting arrangements and similar agreements (paragraph 8.18)

AG8.48 An entity shall describe the types of rights of set-off and similar arrangements disclosed in accordance with paragraph 8.16(d), including the nature of those rights. For example, an entity shall describe its conditional rights. For instruments subject to rights of set-off that are not contingent on a future event but that do not meet the remaining criteria in paragraph 7.9, the entity shall describe the reason(s) why the criteria are not met. For any financial collateral received or pledged, the entity shall describe the terms of the collateral agreement (for example, when the collateral is restricted).

Disclosure by type of financial instrument or by counterparty

AG8.49 The quantitative disclosures required by paragraph 8.16(a)–(e) may be grouped by type of financial instrument or transaction (for example, derivatives, repurchase and reverse repurchase agreements or securities borrowing and securities lending agreements).

AG8.50 Alternatively, an entity may group the quantitative disclosures required by paragraph 8.16 (a)–(c) by type of financial instrument, and the quantitative disclosures required by paragraph 8.16 (c)–(e) by counterparty. If an entity provides the required information by counterparty, the entity is not required to identify the counterparties by name. However, designation of counterparties (Counterparty A, Counterparty B, Counterparty C, etc.) shall remain consistent from year to year for the years presented to maintain comparability. Qualitative disclosures shall be considered so that further information can be given about the types of counterparties. When disclosure of the amounts in paragraph 8.16(c)–(e) is provided by counterparty, amounts that are individually significant in terms of total counterparty amounts shall be separately disclosed and the remaining individually insignificant counterparty amounts shall be aggregated into one line item.

Other

AG8.51 The specific disclosures required by paragraphs 8.16 to 8.18 are minimum requirements. To meet the objective in paragraph 8.15 an entity may need to supplement them with additional (qualitative) disclosures, depending on the terms of the enforceable master netting arrangements and related agreements, including the nature of the rights of set-off, and their effect or potential effect on the entity's financial position.