Appendix A - Application guidance

This appendix is an integral part of this Standard.

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

Scope

Measurement of interests in controlled entities, associates or joint ventures in separate financial statements (Paragraphs .03(a) and .07)

AG2. 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 the Standard of GRAP on *Separate Financial Statements* (GRAP 34), GRAP 35 and GRAP 36.

AG3. 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 34, GRAP 35 and GRAP 36, in conjunction with the Standards of GRAP on *Impairment of Cash-generating Assets* or *Impairment of Non-cash-generating Assets*.

Financial guarantee contracts (Paragraphs .03(e) and .08)

AG4. Financial guarantees are routinely issued in the public sector for a variety of reasons, and may vary from guaranteeing housing and motor vehicles loans of employees, to guaranteeing bond issues and the debt of public sector entities. Any obligations or possible obligations arising from the issue of financial guarantee contracts are recognised, measured and/or disclosed by the issuer in accordance with GRAP 19.

AG5. Where the issuer of financial guarantee contracts charges a fee for the issue of the guarantee, the fee is accounted for in accordance with GRAP 9.

AG6. The issue of financial guarantee contracts results in exposure to credit risk. As a result, the issuer of financial guarantees applies the disclosure requirements of this Standard as well as the requirements of GRAP 19 in disclosing such instruments. The derecognition principles of this Standard are also applied to financial guarantee contracts.

AG7. Other guarantees issued by an entity, for example performance guarantees, are not financial instruments. These guarantees are accounted for in accordance with GRAP 19, unless the entity is engaged in insurance activities. Where an entity is engaged in insurance activities and such guarantees meet the definition of an insurance contract, it also considers the IFRS Accounting Standard(s) on insurance to account for such guarantees.

Loan commitments (Paragraphs .03(f) and .09)

AG8. An entity may enter into an arrangement to provide a loan to another entity on specified terms. Any obligations or possible obligations arising from the issue of loan commitments are recognised, measured and/or disclosed by the issuer in accordance with GRAP 19.

AG9. Where the issuer of loan commitments charges a fee for the issue of the commitment, the fee is accounted for in accordance with GRAP 9.

AG10. The issue of loan commitments results in exposure to certain financial risks. As a result, the issuer of loan commitments applies the disclosure requirements of this Standard as well as the requirements of GRAP 19 in disclosing such instruments. This Standard is also applied to the derecognition of loan commitments.

Contracts to buy or sell non-financial items (Paragraphs .11 and .12)

AG11. 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 Standard as if they were financial instruments.

AG12. 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.

AG13. 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.

AG14. 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.

Definitions (Paragraphs .13 to .22)

Financial assets, financial liabilities and residual interests

AG15. 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.

AG16. 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).

AG17. 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.

AG18. "Perpetual" debt instruments (such as "perpetual" bonds and debentures) 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.

AG19. 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.

AG20. 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 IFRS Accounting Standard(s) on insurance.

AG21. 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).

AG22. 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.

AG23. 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 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.

AG24. Obligations arise through various means, including contracts, e.g. contracts with suppliers and employees; legislation, e.g. income taxes and social benefits payable; and through an entity's actions, e.g. constructive obligations.

AG25. Accounting for income taxes payable is dealt with in IAS 12.

AG26. Social benefits are provided to beneficiaries as a result of legislation, rather than a contractual arrangement. As a result, these benefits do not meet the definition of a financial liability as they do not arise from contractual arrangements. Entities should apply the Standard of GRAP on *Social Benefits* to account for the provision of social benefits.

AG27. Constructive obligations, as defined in GRAP 19, also do not arise from contracts and are therefore not financial liabilities.

Contractual arrangements

AG28. Assets and liabilities in the public sector arise from 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.

AG29. 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.

AG29A. Contractual arrangements can often be distinguished from statutory (non-contractual) transactions or arrangements as follows:

(a) Contractual arrangements are governed by common law whereas non-contractual transactions or arrangements in the public sector are undertaken in terms of specific legislation.

(b) Parties to a contractual arrangement are willing, whereas parties to non-contractual transactions or arrangements are usually compelled to transact with one another on terms specified in legislation or an equivalent.

(c) The remedies for non-performance differ. In a contractual arrangement, the remedies for non-performance are agreed between the parties and may include termination of the contract. In non-contractual arrangements, the remedy for non-performance is often outlined in specific legislation.

AG30. Non-exchange revenue transactions are initially recognised and measured in accordance with GRAP 23. Where the transaction is contractual and otherwise meets the definition of a financial asset, the principles in this Standard are also applied. Where the transaction is statutory (non-contractual) in nature, an entity applies GRAP 108 rather than this Standard.

AG31. The following examples illustrate paragraphs AG29. and AG30:

(a) an entity may undertake a formal agreement with an international 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) an 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 and subsequently accounts for the receivable using GRAP 108.

AG32. 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.

Categories of financial instruments

AG33. An entity must classify its financial instruments into the following three categories:

(a) financial instruments at fair value, comprising both derivative and non-derivative financial assets and financial liabilities;

(b) financial instruments at amortised cost comprising only non-derivative financial assets and financial liabilities; or

(c) financial instruments at cost, comprising investments in residual interests where the fair value cannot be reliably determined.

An entity considers the application guidance in paragraphs AG34. to AG41. in classifying its financial instruments.

Classification of financial instruments into categories

AG34. In classifying its financial instruments, an entity first considers whether a financial instrument is:

(a) a derivative, either a stand-alone derivative, or a derivative that has been separated from a host contract in accordance with paragraph .19;

(b) a combined instrument that is designated at fair value in accordance with paragraphs .20 and .21. This designation applies only to those combined instruments where the host contract is a financial instrument; or

(c) an instrument held for trading. A financial instrument is held for trading if:

(i) it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or

(ii) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking.

Where an instrument meets any of the three criteria in (a) to (c) above, it is measured at fair value.

AG35. If the instrument does not meet any of the criteria in paragraph AG34., an entity

shall assess whether the instrument is a non-derivative instrument with fixed or determinable payments. Examples of instruments with fixed or determinable payments are investment accounts or deposits held with banks, bank overdrafts, debtors, creditors, bonds issued or held and other debt instruments.

AG36. If the instrument is a non-derivative instrument with fixed or determinable payments, it is measured at amortised cost. An entity may, however, designate non-derivative instruments with fixed or determinable payments at fair value at initial recognition. The designation of such instruments at fair value is done under the following conditions:

(a) the designation is made at initial recognition, on an instrument by instrument basis;

(b) an entity has a free choice of designating non-derivative financial assets with fixed or determinable payments to be measured at fair value. A narrative description of the criteria used to designate financial assets at fair value should however be provided in the accounting policies; and

(c) an entity may only designate non-derivative financial liabilities with fixed or determinable payments at fair value if such a designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise.

AG37. Where the instrument does not have fixed or determinable payments, an entity considers if the instrument is an investment in a residual interest of another entity. If the instrument is an investment in a residual interest of another entity, it is measured at fair value unless its fair value cannot be reliably measured. Where fair value cannot be reliably measured, the investment is measured at cost.

AG38. An entity can only measure investments in residual interests at cost if the fair value of the investment cannot be reliably measured. A presumption exists that either the fair value or the amortised cost can be determined for other instruments. An entity measures investments in residual interests at cost when fair value cannot be reliably measured because no active market exists and using a valuation technique does not provide a reliable measure of fair value (see paragraphs AG110. and AG111.). An investment in an entity whose main objective is to deliver a service rather than to generate a profit or economic benefits is a typical example of an investment in a residual interest that cannot be measured reliably at fair value.

AG39. To the extent that an instrument is not dealt with in paragraphs AG34. to AG38., i.e. it is not a:

(a) derivative;

(b) combined instrument designated at fair value;

(c) an instrument held for trading;

(d) a non-derivative instrument with fixed or determinable payments; or

(e) a residual interest in the net assets of another entity,

it is measured at fair value.

AG40. The following examples illustrate the application of paragraphs AG34. to AG39.

(a) An entity issues bonds with a five year maturity, which includes an embedded derivative. Where an embedded derivative is included in a host contract that is a financial instrument, an entity may designate the combined instrument at fair value on initial recognition.

(b) An entity invests in government bonds with a view to reselling them in the short-term. Since the entity's intention for holding the bonds is to sell them in the short-term, they are measured at fair value.

(c) An entity invests in government bonds to fund certain long-term obligations. The bonds mature in 20 years and provide a fixed return of 10% per annum, payable monthly in arrears. As the bonds are not held for trading and are non-derivative instruments with fixed or determinable payments (the instrument has a fixed maturity date and specified interest payments), they must be measured at amortised cost, unless the entity designates them at fair value on initial recognition.

(d) A department holds a residual interest in the net assets of a major public entity. The department has invested in the public entity to ensure that essential services are provided to the public. As the investment is not a derivative instrument, is not held for trading and does not have fixed or determinable payments, it is measured at fair value. If the fair value of the investment cannot be reliably measured, it is measured at cost.

AG41. Decision tree A outlines the steps to be followed in categorising financial instruments.

Effective interest rate

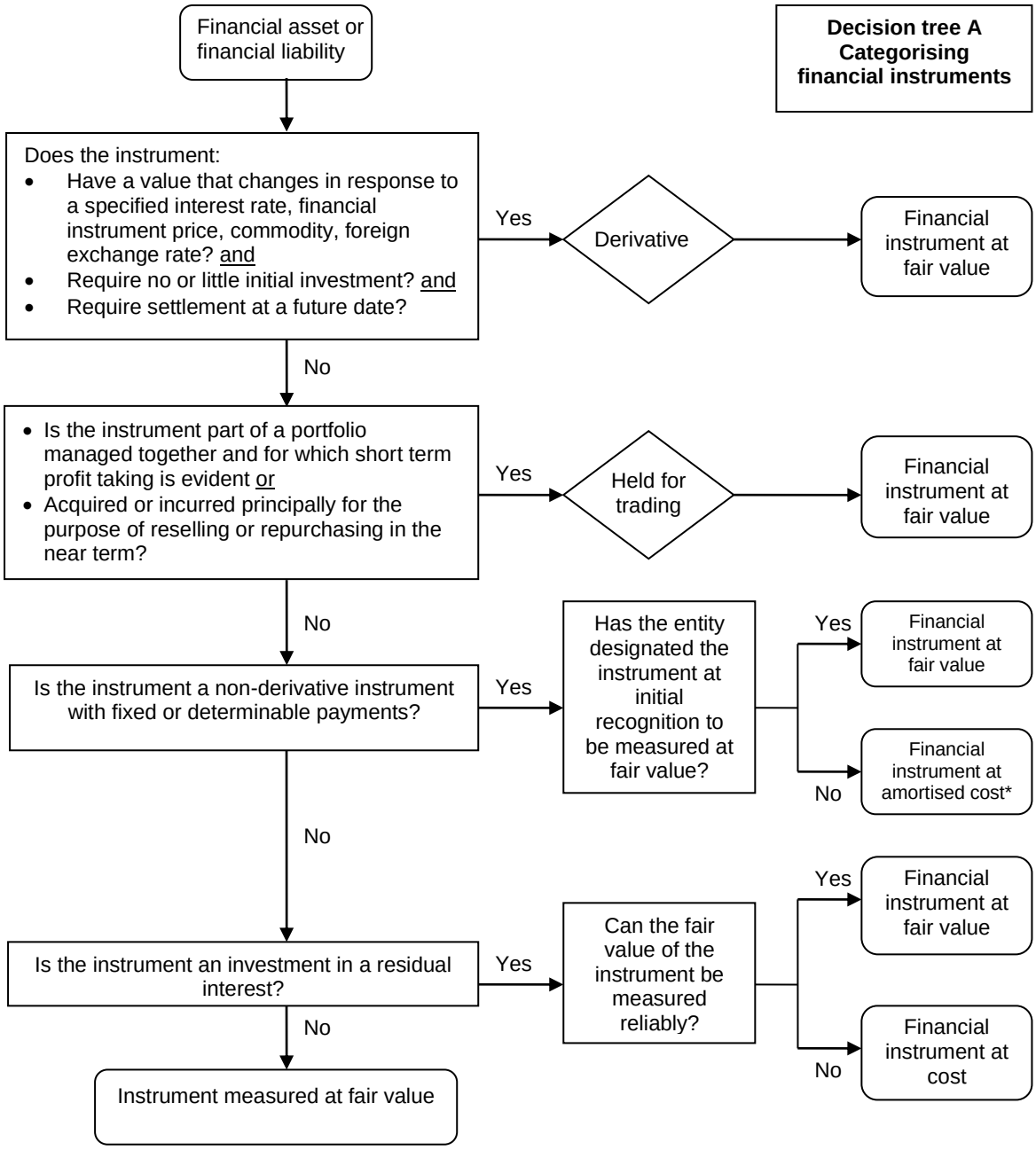
AG42. In some cases financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

AG43. When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate

amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be 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. However, if 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 instrument.

AG44. 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.

AG45. If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as revenue or expense in surplus or deficit.



* An entity assesses if a non-derivative instrument with fixed or determinable payments that is not measured at fair value is a combined instrument using decision tree B.

Derivatives

AG46. Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and accordingly are within the scope of this Standard.

AG47. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Since the terms of the exchange are determined on inception of the derivative instrument, those terms may become either favourable or unfavourable as prices in financial markets change.

AG48. A put or call option to exchange financial assets or financial liabilities gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forego potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability, respectively. The financial instrument underlying an option contract may be any financial asset, including shares in other entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the financial asset under potentially favourable conditions and the writer's obligation to exchange the financial asset under potentially unfavourable conditions are distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and of the writer's obligation are not affected by the likelihood that the option will be exercised.

AG49. Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver R1 million cash in exchange for R1 million face amount of fixed rate government bonds, and the other party (the seller) promises to deliver R1 million face amount of fixed rate government bonds in exchange for R1 million cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above R1 million, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below R1 million, the effect will be the opposite. The purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability)

similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

AG50. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, note issuance facilities and letters of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardised and traded on an exchange.

AG51. 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.

AG52. 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 .11 and .12).

AG53. 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.

AG54. 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.

Residual interests

AG55. 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.

AG56. 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 shows evidence of 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.

Transaction costs

AG57. 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.

Instruments containing embedded derivatives (Paragraphs .18 to .22)

Embedded derivatives

AG58. 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. 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.

AG59. 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.

AG60. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as residual interests (see paragraphs .25 to .35) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

AG61. 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 paragraphs .19(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) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification in terms of this Standard).

(c) An option or automatic provision to extend the remaining term to maturity of a

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

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

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

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

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

(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.

(h) Credit derivatives that are embedded in a host debt instrument and allow one

party (the “beneficiary”) to transfer the credit risk of a particular reference asset, which it may not own, to another party (the “guarantor”) are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

AG62. 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, it is required to separate an embedded derivative (i.e. the indexed principal payment) under paragraph .19 because the host contract is a debt instrument under paragraph AG58. and the indexed principal payment is not closely related to a host debt instrument under paragraph AG61(a). Since the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

AG63. 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 combined instrument at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

AG64. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its 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

AG65. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph .19 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. This voluntary designation is done at initial recognition, on an instrument by instrument basis.

AG66. Such voluntary designation may be used whether paragraph .19 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph .20 would not justify designating the hybrid (combined) instrument as at fair value in the cases set out in paragraphs .20(a) and (b) because doing so would not reduce complexity or increase reliability.

AG67. Where an entity is required to separate an embedded derivative from a host contract but the fair value of the embedded derivative cannot be reliably measured, the combined instrument is designated at fair value. This designation is done on an instrument by instrument basis, either at initial recognition or at subsequent reporting dates if the fair value of the embedded derivative can no longer be measured reliably.

AG68. Decision tree B outlines the application of the principles in this Standard to combined instruments.

Initial recognition

Distinguishing liabilities and residual interests (Paragraphs .25 to .26)

AG69. 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.

AG70. 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;

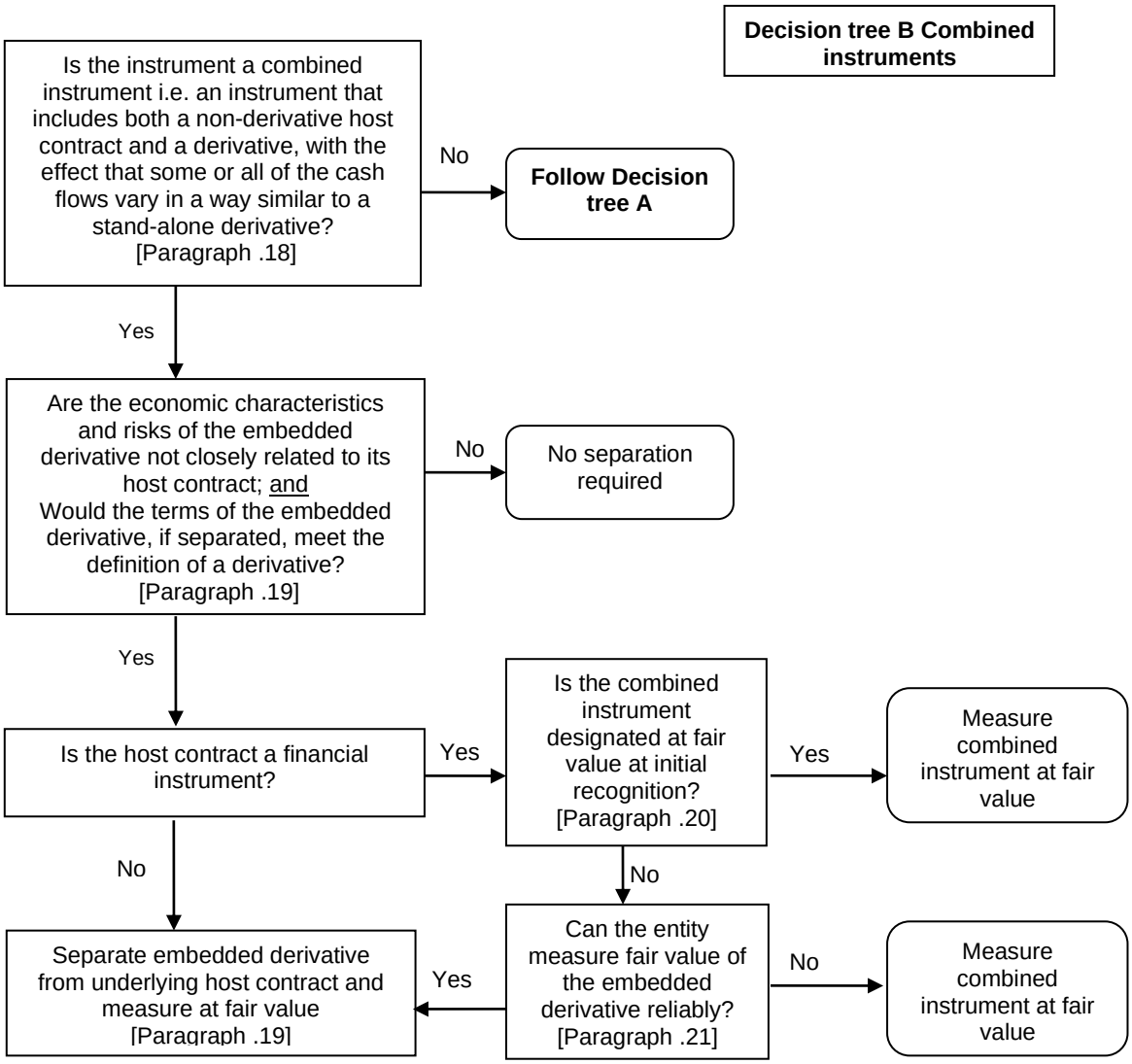
(b) an intention to make distributions in the future;

(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.



Treatment in consolidated financial statements

AG71. In consolidated financial statements, an entity presents non-controlling interest – i.e. the interests of other parties in the net assets and revenue of its controlled entities – in accordance with GRAP 1 and GRAP 35. 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.

Compound financial instruments (Paragraphs .31 to .35)

AG72. Paragraph .25 applies only to issuers of non-derivative compound financial instruments. Paragraph .25 does not deal with compound financial instruments from the perspective of holders. Paragraphs .19 to .22 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.

AG73. 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 .25 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:

- 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.
- The instrument is an embedded option to convert the liability into a residual interest of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. This option has value on initial recognition even when it is out of the money.

AG74. 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.

AG75. 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 .31 to .35.

AG76. 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 loss; and

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

AG77. 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

AG78. As a consequence of the principle in paragraph .23, an entity recognises all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG142.). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph AG143.).

AG79. The following are examples of applying the principle in paragraph .25:

(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 .11 to .12, its net fair value is recognised as an asset or liability on the commitment date (see (c));

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

paragraphs .02 to .12) is recognised as an asset or a liability on the commitment date. 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 .02 to .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.

Initial measurement

Initial measurement of financial assets and financial liabilities

Transaction costs (Paragraph .36)

AG80. 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 .36)

AG81. 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 AG105.). 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 AG103. to AG109.). 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.

AG82. 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.

Determining market interest rates (Paragraph .36)

AG83. 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.

AG84. As a convenience, 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.

AG85. 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 .36)

AG86. 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).

AG87. 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.

AG88. 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 .57 to .64 and AG120. to AG129.).

AG89. 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 .37 to .44)

AG90. Concessionary loans are granted to or received by an entity at below market terms. Examples of concessionary loans granted by entities include loans to other countries, farmers, 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.

AG91. 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.

AG92. 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.

AG93. An entity firstly assesses whether the substance of the concessionary loan is in fact a loan by applying the principles in paragraphs AG69. to AG70. 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.

AG94. 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 AG83. to AG85. and AG100. to AG109. 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 cash receipts using a market related rate of interest for a similar debt instrument with the same terms, maturity, currency and credit risk profile. At initial recognition, an entity analyses the substance of the loan granted or received into its component parts, and accounts for those components using the principles in paragraphs AG95. and AG96.

AG95. Any difference between the fair value of the loan and the transaction price (the loan proceeds) is treated as follows:

(a) where the loan is received by an entity, the difference is accounted for in accordance with GRAP 23; or

(b) where the loan is granted by an entity, the difference is treated as a social benefit in accordance with the *Framework for the Preparation and Presentation of Financial Statements*[2].

AG96. After initial recognition, an entity subsequently measures concessionary loans using the categories defined in paragraph .14.

Subsequent measurement

Subsequent measurement of financial assets

AG97. 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 .45.

Fair value measurement considerations (Paragraphs .45 to .50)

AG98. 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.

AG99. 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

[2] 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*.

value (e.g. for counterparty credit risk) are not included in the term “bid-ask spread”.

Active market: quoted price

AG100. 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.

AG101. 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.

AG102. 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

AG103. 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.

AG104. 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.

AG105. 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.

AG106. 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 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.

AG107. 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.

AG108. 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.

AG109. 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 AG86. to AG89.).

No active market: investments in residual interests

AG110. 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.

AG111. 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, an entity measures such instruments at cost.

Inputs to valuation techniques

AG112. 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 .50.)

(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 (Paragraphs .45 to .47)

AG113. The interest expense or revenue is calculated using the effective interest rate method. This method calculates the rate of interest that is necessary to discount the estimated stream of principal and interest cash flows through the expected life of the financial instrument to equal the amount at initial recognition. The rate is then applied to the carrying amount at each reporting date to determine the interest expense or income for the period. In this way, the interest expense or income is recognised on a level yield to maturity basis.

AG114. Often it will not be necessary to undertake a formal effective interest rate calculation. This may be because:

(a) the instrument is a short duration receivable or payable with no stated interest rate (which is usually measured at original invoice amount); or

(b) the nominal interest rate (e.g. “coupon” rate on a debt instrument) equals the calculated effective interest rate. This will be the case for a fixed rate instrument when:

- there is no premium or discount on initial recognition of the instrument (i.e. the carrying amount on initial recognition is the same as the redemption amount); and
- the instrument carries the same interest rate for the whole term of the

instrument.

It will be the case for a variable rate instrument when there is no premium or discount on initial recognition. With a variable rate financial instrument, the determinable cash flows should be re-estimated to reflect movements in interest paid/received on the instrument. If the variable rate financial instrument was recognised initially at an amount equal to the principal payable/receivable on maturity (i.e. at “par”), this periodic re-estimation does not have a significant effect on the carrying amount of the instrument. Where the variable rate instrument was originated or acquired at a premium or discount on the principal payable/receivable at maturity, however, there may be a significant effect on the carrying amount, since the amortised cost calculations will be affected.

Reclassifications (Paragraphs .51 to .54)

AG115. Reclassifications of financial instruments are not allowed while they are issued or held, except in the circumstances described in paragraphs AG116. to AG118.

AG116. A reclassification is allowed for a combined instrument when, at initial recognition, the embedded derivative was accounted for separately from the host contract but the fair value of the embedded derivative cannot be measured reliably at subsequent reporting dates. In such instances, an entity measures the entire combined instrument at fair value. This may require an entity to reclassify a financial instrument from amortised cost or cost to fair value after initial recognition.

AG117. A reclassification of an investment in residual interests between the fair value 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.

AG118. An entity may also reclassify an instrument from cost to fair value, 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.

Gains and losses (Paragraphs .55 and .56)

AG119. 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. Under GRAP 4, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in surplus or deficit.

Impairment and uncollectibility of financial assets

Financial assets carried at amortised cost (Paragraphs .61 to .63)

AG120. Impairment of a financial asset carried at amortised cost is measured using the

financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan or a receivable are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. If a loan or receivable has a variable interest rate, the discount rate for measuring any impairment loss under paragraph .61 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of a financial instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, except if management does not intend to call up the collateral held. 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 up collateral held it is not included in the estimated future cash flows of the asset.

AG121. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.

AG122. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range (GRAP 19 discusses principles in relation to a "range of outcomes"), taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period.

AG123. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

AG124. Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

AG125. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, inflation, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

AG126. As an example of applying paragraph AG125. an entity may determine, on the basis of historical experience, that one of the main causes of default on consumer debtors is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of consumer debtors may have died in that year, indicating that an impairment loss has occurred on those loans even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these "incurred but not reported" losses. It would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, however, since the necessary loss event (the death of the borrower) has not yet occurred.

AG127. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

AG128. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g. for smaller balance loans or receivables) as long as they are consistent with the requirements in paragraphs .61 to .63 and AG124. to AG127. Any model used would incorporate the effect of the

time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest income after impairment recognition

AG129. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Derecognition

Derecognition of financial assets (Paragraphs .65 to .79)

AG130. Decision tree C illustrates the evaluation of whether a financial asset is derecognised.

Waiver of rights

AG131. 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 .37(a).

AG132. The waiver of debts should be distinguished from debt write-offs 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

AG133. 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).

AG134. 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.

AG135. 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

AG136. 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.

AG137. 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).

AG138. 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

AG139. 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 .76, 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.

AG140. 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 .76, an entity applies the fair value measurement requirements in paragraphs .48 to .50 and AG100. to AG109. in addition to paragraph .76.

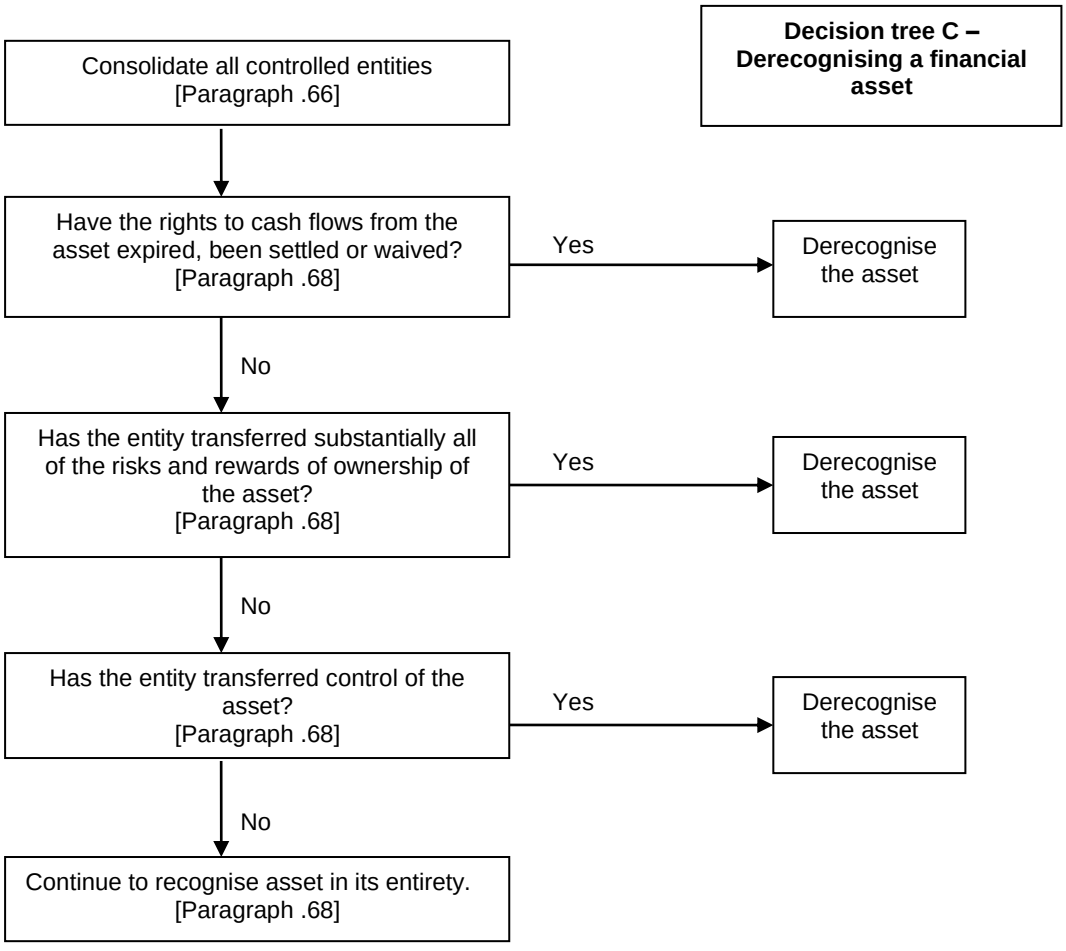
Transfers that do not qualify for derecognition

AG141. The following is an application of the principle outlined in paragraph .78. 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

AG142. 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.

AG143. 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 .80 to .83)

AG144. 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.

AG145. 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.

AG146. 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.

AG147. 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 AG144(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.

AG148. 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 .65 to .79 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.

AG149. For the purpose of paragraph .81, 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.

AG150. 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 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.

Presentation

Interest, dividends or similar distributions, losses and gains (Paragraphs .84 to .91)

AG151. The following example illustrates the application of paragraph .84 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 (Paragraphs .92 to .100)

AG152. To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognised amounts. An entity may have a conditional right to set off recognised amounts, such as in a master netting agreement or in some forms of non-recourse debt. Such rights are enforceable only on the occurrence of some future event, usually a default of the counterparty. Such an arrangement thus does not meet the conditions for offset.

AG153. 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 .92.

Disclosure

Accounting policies (paragraph .103)

AG154. Paragraph .103 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 assets or financial liabilities designated at fair value:

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

(ii) the criteria for designating financial assets at initial recognition; and

(iii) the circumstances under which financial liabilities have been designated at fair value at initial recognition, providing details of the recognition or measurement inconsistency that would have arisen had the liability not been designated at fair value;

(b) when an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:

(i) the criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and

(ii) the criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph .111);

(c) how net gains or net losses on each category of financial instrument are determined (see paragraph .116), for example, whether the net gains or net losses on items at fair value include interest income or income from dividends or similar distributions;

(d) the criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph .116(e)); and

(e) when the terms of financial assets that would otherwise be past due or

impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph .128(d)).

Paragraph .132 of GRAP 1 also requires entities to disclose, along with its 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 .104)

AG155. Paragraph .104 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 .104 are determined by the entity and are thus distinct from the categories of financial instruments specified in the definitions of this Standard (which determine how financial instruments are measured).

AG156. 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.

AG157. 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.

Nature and extent of risks arising from financial instruments (paragraphs .123 to .133)

AG158. The disclosures required by paragraphs .125 to .133 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 .126)

AG159. Paragraph .126(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.

AG160. Paragraph .126(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.

Maximum credit risk exposure (paragraph .128(a))

AG161. Paragraph .128(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 impairment losses.

AG162. 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 (paragraphs .131(a) and (b))

AG163. In accordance with paragraph .126(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 paragraphs .131(a) or (b).

AG164. In preparing the maturity analyses required by paragraph .131(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.

AG165. In complying with paragraphs .131(a) and (b), an entity shall not separate an embedded derivative from a hybrid (combined) financial instrument. For such an instrument, an entity shall apply paragraph .131(a).

AG166. Paragraph .131(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.

AG167. Paragraphs .131(a) and (b) require an entity to disclose maturity analyses for

financial liabilities that show the remaining contractual maturities for some financial liabilities. The following applies 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.

AG168. The contractual amounts disclosed in the maturity analyses as required by paragraphs .131(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.

AG169. Paragraph .131(c) requires an entity to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative disclosures required in paragraphs .131(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.

AG170. Other factors that an entity might consider in providing the disclosure required in paragraph .131(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 (Paragraphs .132 to .133)

AG171. Paragraph .132 encourages, but does not require, an entity to disclose a sensitivity analysis for each 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.

AG172. If 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.

AG173. 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.

AG174. 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

AG175. 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

AG176. 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.

AG177. A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

Other price risk

AG178. 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.

AG179. 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.

AG180. 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.