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**STATUTORY BOARD  
FINANCIAL  
REPORTING STANDARD**

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**SB-FRS 109**

## **Financial Instruments**

This version of SB-FRS 109 does **not** include amendments that are effective for annual periods beginning **after** 1 January 2018.

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Statutory Board Financial Reporting Standard 109 *Financial Instruments* (SB-FRS 109) is set out in paragraphs 1.1–7.3.2 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the SB-FRS. SB-FRS 109 should be read in the context of its objective, the *Preface to Statutory Board Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. SB-FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

## Introduction

### Reasons for issuing SB-FRS 109

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- IN1 SB-FRS 109 *Financial Instruments* sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. This Standard replaces SB-FRS 39 *Financial Instruments: Recognition and Measurement*.
- IN2 Many users of financial statements and other interested parties found the requirements in SB-FRS 39 difficult to understand, apply and interpret. They called for the development of a new Standard for the financial reporting of financial instruments that was principle-based and less complex. Although SB-FRS 39 was amended several times to clarify requirements, add guidance and eliminate internal inconsistencies, a fundamental reconsideration of the reporting for financial instruments had not been previously undertaken.
- IN3 [Not used]
- IN4 [Not used]

### Main features of the SB-FRS

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- IN5 [Not used]
- IN6 [Not used]

### Classification and measurement

- IN7 Financial assets are classified on the basis of the business model within which they are held and their contractual cash flow characteristics. SB-FRS 109 introduces a 'fair value through other comprehensive income' measurement category for particular simple debt instruments. Based on feedback from interested parties, including many insurance companies, this is the most relevant measurement basis for financial assets that are held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
- IN8 Most of the requirements for financial liabilities are carried forward unchanged from SB-FRS 39. However, the requirements related to the fair value option for financial liabilities are changed to address own credit risk. Those improvements respond to consistent feedback from users of financial statements and others that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. Entities are permitted to early apply the requirements related to the fair value option for financial liabilities without applying the other requirements of SB-FRS 109 at the same time.

### Impairment methodology

- IN9 SB-FRS 109 contains the impairment requirements relating to the accounting for an entity's expected credit losses on its financial assets and commitments to extend credit. Those requirements eliminate the threshold that was in SB-FRS 39 for the recognition of credit losses. Under the impairment approach in SB-FRS 109 it is no longer necessary for a credit event to have occurred before credit losses are recognised. Instead, an entity always accounts for expected credit losses, and changes in those expected credit losses. The amount of expected credit losses is updated at each reporting date to reflect changes in credit risk since initial recognition and, consequently, more timely information is provided about expected credit losses.

## Hedge accounting

- IN10 SB-FRS 109 also contains new requirements on hedge accounting. These requirements align hedge accounting more closely with risk management, establish a more principle-based approach to hedge accounting and address inconsistencies and weaknesses in the hedge accounting model in SB-FRS 39. However, specific accounting for open portfolios or macro hedging is not addressed and would be discussed in a separate project. Consequently, the exception in SB-FRS 39 for a fair value hedge of an interest rate exposure of a portfolio of financial assets or financial liabilities continues to apply. Entities are also provided with an accounting policy choice between applying the hedge accounting requirements of SB-FRS 109 or continuing to apply the existing hedge accounting requirements in SB-FRS 39 for all hedge accounting.

## Other requirements

- IN11 SB-FRS 109 retains the requirements in SB-FRS 39 for the derecognition of financial assets and financial liabilities.
- IN12 [Not used]
- IN13 [Not used]

# Statutory Board Financial Reporting Standard 109

## *Financial Instruments*

### Chapter 1 Objective

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

### Chapter 2 Scope

- 2.1 This Standard shall be applied by all entities to all types of financial instruments except:
- (a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with SB-FRS 110 *Consolidated Financial Statements*, SB-FRS 27 *Separate Financial Statements* or SB-FRS 28 *Investments in Associates and Joint Ventures*. However, in some cases, SB-FRS 110, SB-FRS 27 or SB-FRS 28 require or permit an entity to account for an interest in a subsidiary, associate or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in SB-FRS 32 *Financial Instruments: Presentation*.
  - (b) rights and obligations under leases to which SB-FRS 17 *Leases* applies. However:
    - (i) lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of this Standard;
    - (ii) finance lease payables recognised by a lessee are subject to the derecognition requirements of this Standard; and
    - (iii) derivatives that are embedded in leases are subject to the embedded derivatives requirements of this Standard.
  - (c) employers' rights and obligations under employee benefit plans, to which SB-FRS 19 *Employee Benefits* applies.
  - (d) financial instruments issued by the entity that meet the definition of an equity instrument in SB-FRS 32 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of SB-FRS 32. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a).
  - (e) rights and obligations arising under (i) an insurance contract as defined in SB-FRS 104 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract, or (ii) a contract that is within the scope of SB-FRS 104 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of SB-FRS 104 if the derivative is not itself a contract within the scope of SB-FRS 104. Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or SB-FRS 104 to such financial guarantee contracts

(see paragraphs B2.5–B2.6). The issuer may make that election contract by contract, but the election for each contract is irrevocable.

- (f) any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of SB-FRS 103 *Business Combinations* at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.
  - (g) loan commitments other than those loan commitments described in paragraph 2.3. However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan commitments are subject to the derecognition requirements of this Standard.
  - (h) financial instruments, contracts and obligations under share-based payment transactions to which SB-FRS 102 *Share-based Payment* applies, except for contracts within the scope of paragraphs 2.4–2.7 of this Standard to which this Standard applies.
  - (i) rights to payments to reimburse the entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with SB-FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*, or for which, in an earlier period, it recognised a provision in accordance with SB-FRS 37.
  - (j) rights and obligations within the scope of SB-FRS 115 *Revenue from Contracts with Customers* that are financial instruments, except for those that SB-FRS 115 specifies are accounted for in accordance with this Standard.
- 2.2 The impairment requirements of this Standard shall be applied to those rights that SB-FRS 115 specifies are accounted for in accordance with this Standard for the purposes of recognising impairment gains or losses.
- 2.3 The following loan commitments are within the scope of this Standard:
- (a) loan commitments that the entity designates as financial liabilities at fair value through profit or loss (see paragraph 4.2.2). An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.
  - (b) loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).
  - (c) commitments to provide a loan at a below-market interest rate (see paragraph 4.2.1(d)).
- 2.4 This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with paragraph 2.5.

- 2.5 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, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from not recognising that contract because it is excluded from the scope of this Standard (see paragraph 2.4).**
- 2.6 There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:
- (a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
  - (b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
  - (c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
  - (d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 2.4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

- 2.7 A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 2.6(a) or 2.6(d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

## **Chapter 3 Recognition and derecognition**

### **3.1 Initial recognition**

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- 3.1.1 An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument (see paragraphs B3.1.1 and B3.1.2). When an entity first recognises a financial asset, it shall classify it in accordance with paragraphs 4.1.1–4.1.5 and measure it in accordance with paragraphs 5.1.1–5.1.3. When an entity first recognises a financial liability, it shall classify it in accordance with paragraphs 4.2.1 and 4.2.2 and measure it in accordance with paragraph 5.1.1.**



## Regular way purchase or sale of financial assets

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

## 3.2 Derecognition of financial assets

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- 3.2.1 In consolidated financial statements, paragraphs 3.2.2–3.2.9, B3.1.1, B3.1.2 and B3.2.1–B3.2.17 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with SB-FRS 110 and then applies those paragraphs to the resulting group.

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

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

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

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

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

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

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

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

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

- (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
- (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
- (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in SB-FRS 7 *Statement of Cash Flows*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

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

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

- (ii) **if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 3.2.16).**

- 3.2.7 The transfer of risks and rewards (see paragraph 3.2.6) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (eg because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its *fair value* at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 3.2.5).
- 3.2.8 Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison are made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.
- 3.2.9 Whether the entity has retained control (see paragraph 3.2.6(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

## **Transfers that qualify for derecognition**

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

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

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

shall be recognised in profit or loss.

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

### **Transfers that do not qualify for derecognition**

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

### **Continuing involvement in transferred assets**

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

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

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

## **All transfers**

- 3.2.22** If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability (see paragraph 42 of SB-FRS 32).
- 3.2.23** If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:
- (a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (eg as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

- (b) If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.
- (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.
- (d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.

### **3.3 Derecognition of financial liabilities**

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

## **Chapter 4 Classification**

### **4.1 Classification of financial assets**

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- 4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:
  - (a) the entity's business model for managing the financial assets and
  - (b) the contractual cash flow characteristics of the financial asset.
- 4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:
  - (a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

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

4.1.2A A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:

- (a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

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

4.1.3 For the purpose of applying paragraphs 4.1.2(b) and 4.1.2A(b):

- (a) principal is the fair value of the financial asset at initial recognition. Paragraph B4.1.7B provides additional guidance on the meaning of principal.
- (b) interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. Paragraphs B4.1.7A and B4.1.9A–B4.1.9E provide additional guidance on the meaning of interest, including the meaning of the time value of money.

4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5–5.7.6).

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

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

## 4.2 Classification of financial liabilities

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4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost, except for:

- (a) *financial liabilities at fair value through profit or loss*. Such liabilities, including *derivatives* that are liabilities, shall be subsequently measured at fair value.
- (b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 3.2.15 and 3.2.17 apply to the measurement of such financial liabilities.

- (c) ***financial guarantee contracts.*** After initial recognition, an issuer of such a contract shall (unless paragraph 4.2.1(a) or (b) applies) subsequently measure it at the higher of:
- (i) the amount of the ***loss allowance*** determined in accordance with Section 5.5 and
  - (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of SB-FRS 115.
- (d) **commitments to provide a loan at a below-market interest rate.** An issuer of such a commitment shall (unless paragraph 4.2.1(a) applies) subsequently measure it at the higher of:
- (i) the amount of the **loss allowance** determined in accordance with Section 5.5 and
  - (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, the cumulative amount of income recognised in accordance with the principles of SB-FRS 115.
- (e) **contingent consideration recognised by an acquirer in a business combination to which SB-FRS 103 applies.** Such contingent consideration shall subsequently be measured at fair value with changes recognised in profit or loss.

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

- 4.2.2 An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either:
- (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32); or
  - (b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in SB-FRS 24 *Related Party Disclosures*), for example, the entity’s board of directors and chief executive officer (see paragraphs B4.1.33–B4.1.36).

## **4.3 Embedded derivatives**

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



## Hybrid contracts with financial asset hosts

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

## Other hybrid contracts

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

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

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

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

- (a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or
- (b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

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

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

## 4.4 Reclassification

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- 4.4.1 When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1–4.1.4. See paragraphs 5.6.1–5.6.7, B4.4.1–B4.4.3 and B5.6.1–B5.6.2 for additional guidance on reclassifying financial assets.

**4.4.2 An entity shall not reclassify any financial liability.**

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

- (a) an item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;
- (b) an item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and
- (c) changes in measurement in accordance with Section 6.7.

**Chapter 5 Measurement****5.1 Initial measurement**

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**5.1.1 Except for trade receivables within the scope of paragraph 5.1.3, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.**

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

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

5.1.3 Despite the requirement in paragraph 5.1.1, at initial recognition, an entity shall measure trade receivables at their transaction price (as defined in SB-FRS 115) if the trade receivables do not contain a significant financing component in accordance with SB-FRS 115 (or when the entity applies the practical expedient in accordance with paragraph 63 of SB-FRS 115).

**5.2 Subsequent measurement of financial assets**

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**5.2.1 After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 4.1.1–4.1.5 at:**

- (a) **amortised cost;**
- (b) **fair value through other comprehensive income; or**
- (c) **fair value through profit or loss.**

**5.2.2 An entity shall apply the impairment requirements in Section 5.5 to financial assets that are measured at amortised cost in accordance with paragraph 4.1.2 and to financial assets that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A.**

**5.2.3 An entity shall apply the hedge accounting requirements in paragraphs 6.5.8–6.5.14 (and, if applicable, paragraphs 89–94 of SB-FRS 39 *Financial Instruments: Recognition and Measurement* for the fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial asset that is designated as a hedged item.<sup>1</sup>**

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<sup>1</sup> In accordance with paragraph 7.2.21, an entity may choose as its accounting policy to continue to apply the hedge accounting requirements in SB-FRS 39 instead of the requirements in Chapter 6 of this Standard. If an entity has made this election, the references in this Standard to particular hedge accounting requirements in Chapter 6 are not relevant. Instead the entity applies the relevant hedge accounting requirements in SB-FRS 39.

## 5.3 Subsequent measurement of financial liabilities

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- 5.3.1 After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 4.2.1–4.2.2.
- 5.3.2 An entity shall apply the hedge accounting requirements in paragraphs 6.5.8–6.5.14 (and, if applicable, paragraphs 89–94 of SB-FRS 39 for the fair value hedge accounting for a portfolio hedge of interest rate risk) to a financial liability that is designated as a hedged item.

## 5.4 Amortised cost measurement

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### Financial assets

#### Effective interest method

- 5.4.1 Interest revenue shall be calculated by using the *effective interest method* (see Appendix A and paragraphs B5.4.1–B5.4.7). This shall be calculated by applying the *effective interest rate* to the *gross carrying amount of a financial asset* except for:
- (a) *purchased or originated credit-impaired financial assets*. For those financial assets, the entity shall apply the *credit-adjusted effective interest rate* to the *amortised cost of the financial asset* from initial recognition.
  - (b) financial assets that are not purchased or originated credit-impaired financial assets but subsequently have become *credit-impaired financial assets*. For those financial assets, the entity shall apply the effective interest rate to the amortised cost of the financial asset in subsequent reporting periods.
- 5.4.2 An entity that, in a reporting period, calculates interest revenue by applying the effective interest method to the amortised cost of a financial asset in accordance with paragraph 5.4.1(b), shall, in subsequent reporting periods, calculate the interest revenue by applying the effective interest rate to the gross carrying amount if the credit risk on the financial instrument improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to an event occurring after the requirements in paragraph 5.4.1(b) were applied (such as an improvement in the borrower's credit rating).

#### Modification of contractual cash flows

- 5.4.3 When the contractual cash flows of a financial asset are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a *modification gain or loss* in profit or loss. The gross carrying amount of the financial asset shall be recalculated as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. Any costs or fees incurred adjust the carrying amount of the modified financial asset and are amortised over the remaining term of the modified financial asset.

#### Write-off

- 5.4.4 An entity shall directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof. A write-off constitutes a derecognition event (see paragraph B3.2.16(r)).

## 5.5 Impairment

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### Recognition of expected credit losses

#### General approach

- 5.5.1** An entity shall recognise a *loss allowance for expected credit losses* on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a contract asset or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d).
- 5.5.2 An entity shall apply the impairment requirements for the recognition and measurement of a loss allowance for financial assets that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However, the loss allowance shall be recognised in other comprehensive income and shall not reduce the carrying amount of the financial asset in the statement of financial position.
- 5.5.3** Subject to paragraphs 5.5.13–5.5.16, at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.
- 5.5.4 The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.
- 5.5.5** Subject to paragraphs 5.5.13–5.5.16, if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to *12-month expected credit losses*.
- 5.5.6 For loan commitments and financial guarantee contracts, the date that the entity becomes a party to the irrevocable commitment shall be considered to be the date of initial recognition for the purposes of applying the impairment requirements.
- 5.5.7 If an entity has measured the loss allowance for a financial instrument at an amount equal to lifetime expected credit losses in the previous reporting period, but determines at the current reporting date that paragraph 5.5.3 is no longer met, the entity shall measure the loss allowance at an amount equal to 12-month expected credit losses at the current reporting date.
- 5.5.8 An entity shall recognise in profit or loss, as an *impairment gain or loss*, the amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with this Standard.

#### Determining significant increases in credit risk

- 5.5.9 At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition.

- 5.5.10 An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date (see paragraphs B5.5.22–B5.5.24).
- 5.5.11 If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on *past due* information when determining whether credit risk has increased significantly since initial recognition. However, when information that is more forward-looking than past due status (either on an individual or a collective basis) is not available without undue cost or effort, an entity may use past due information to determine whether there have been significant increases in credit risk since initial recognition. Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due. When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

### **Modified financial assets**

- 5.5.12 If the contractual cash flows on a financial asset have been renegotiated or modified and the financial asset was not derecognised, an entity shall assess whether there has been a significant increase in the credit risk of the financial instrument in accordance with paragraph 5.5.3 by comparing:
- (a) the risk of a default occurring at the reporting date (based on the modified contractual terms); and
  - (b) the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms).

### **Purchased or originated credit-impaired financial assets**

- 5.5.13 **Despite paragraphs 5.5.3 and 5.5.5, at the reporting date, an entity shall only recognise the cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance for purchased or originated credit-impaired financial assets.**
- 5.5.14 At each reporting date, an entity shall recognise in profit or loss the amount of the change in lifetime expected credit losses as an impairment gain or loss. An entity shall recognise favourable changes in lifetime expected credit losses as an impairment gain, even if the lifetime expected credit losses are less than the amount of expected credit losses that were included in the estimated cash flows on initial recognition.

### **Simplified approach for trade receivables, contract assets and lease receivables**

- 5.5.15 **Despite paragraphs 5.5.3 and 5.5.5, an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for:**
- (a) **trade receivables or contract assets that result from transactions that are within the scope of SB-FRS 115, and that:**
    - (i) **do not contain a significant financing component in accordance with SB-FRS 115 (or when the entity applies the practical expedient in accordance with paragraph 63 of SB-FRS 115); or**
    - (ii) **contain a significant financing component in accordance with SB-FRS 115, if the entity chooses as its accounting policy to measure the loss allowance**

**at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all such trade receivables or contract assets but may be applied separately to trade receivables and contract assets.**

- (b) lease receivables that result from transactions that are within the scope of SB-FRS 17, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all lease receivables but may be applied separately to finance and operating lease receivables.**

5.5.16 An entity may select its accounting policy for trade receivables, lease receivables and contract assets independently of each other.

## **Measurement of expected credit losses**

**5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:**

- (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;**
- (b) the time value of money; and**
- (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.**

5.5.18 When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

5.5.19 The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.

5.5.20 However, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For such financial instruments, and only those financial instruments, the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

## **5.6 Reclassification of financial assets**

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**5.6.1 If an entity reclassifies financial assets in accordance with paragraph 4.4.1, it shall apply the reclassification prospectively from the *reclassification date*. The entity shall not restate any previously recognised gains, losses (including impairment gains or losses) or interest. Paragraphs 5.6.2–5.6.7 set out the requirements for reclassifications.**

**5.6.2 If an entity reclassifies a financial asset out of the amortised cost measurement category and into the fair value through profit or loss measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.**

**5.6.3 If an entity reclassifies a financial asset out of the fair value through profit or loss measurement category and into the amortised cost measurement category, its fair value**

at the reclassification date becomes its new gross carrying amount. (See paragraph B5.6.2 for guidance on determining an effective interest rate and a loss allowance at the reclassification date.)

- 5.6.4 If an entity reclassifies a financial asset out of the amortised cost measurement category and into the fair value through other comprehensive income measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph B5.6.1.)
- 5.6.5 If an entity reclassifies a financial asset out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category, the financial asset is reclassified at its fair value at the reclassification date. However, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date. As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortised cost. This adjustment affects other comprehensive income but does not affect profit or loss and therefore is not a reclassification adjustment (see SB-FRS 1 *Presentation of Financial Statements*). The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. (See paragraph B5.6.1.)
- 5.6.6 If an entity reclassifies a financial asset out of the fair value through profit or loss measurement category and into the fair value through other comprehensive income measurement category, the financial asset continues to be measured at fair value. (See paragraph B5.6.2 for guidance on determining an effective interest rate and a loss allowance at the reclassification date.)
- 5.6.7 If an entity reclassifies a financial asset out of the fair value through other comprehensive income measurement category and into the fair value through profit or loss measurement category, the financial asset continues to be measured at fair value. The cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment (see SB-FRS 1) at the reclassification date.

## 5.7 Gains and losses

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- 5.7.1 A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless:
- (a) it is part of a hedging relationship (see paragraphs 6.5.8–6.5.14 and, if applicable, paragraphs 89–94 of SB-FRS 39 for the fair value hedge accounting for a portfolio hedge of interest rate risk);
  - (b) it is an investment in an equity instrument and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5;
  - (c) it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's *credit risk* in other comprehensive income in accordance with paragraph 5.7.7; or
  - (d) it is a financial asset measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A and the entity is required to recognise some changes in fair value in other comprehensive income in accordance with paragraph 5.7.10.
- 5.7.1A *Dividends* are recognised in profit or loss only when:

- (a) the entity's right to receive payment of the dividend is established;
- (b) it is probable that the economic benefits associated with the dividend will flow to the entity; and
- (c) the amount of the dividend can be measured reliably.

**5.7.2** A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 6.5.8–6.5.14 and, if applicable, paragraphs 89–94 of SB-FRS 39 for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognised in profit or loss when the financial asset is derecognised, reclassified in accordance with paragraph 5.6.2, through the amortisation process or in order to recognise impairment gains or losses. An entity shall apply paragraphs 5.6.2 and 5.6.4 if it reclassifies financial assets out of the amortised cost measurement category. A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 6.5.8–6.5.14 and, if applicable, paragraphs 89–94 of SB-FRS 39 for the fair value hedge accounting for a portfolio hedge of interest rate risk) shall be recognised in profit or loss when the financial liability is derecognised and through the amortisation process. (See paragraph B5.7.2 for guidance on foreign exchange gains or losses.)

**5.7.3** A gain or loss on financial assets or financial liabilities that are hedged items in a hedging relationship shall be recognised in accordance with paragraphs 6.5.8–6.5.14 and, if applicable, paragraphs 89–94 of SB-FRS 39 for the fair value hedge accounting for a portfolio hedge of interest rate risk.

**5.7.4** If an entity recognises financial assets using settlement date accounting (see paragraphs 3.1.2, B3.1.3 and B3.1.6), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets measured at amortised cost. For assets measured at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate in accordance with paragraph 5.7.1. The trade date shall be considered the date of initial recognition for the purposes of applying the impairment requirements.

## Investments in equity instruments

**5.7.5** At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is neither *held for trading* nor contingent consideration recognised by an acquirer in a business combination to which SB-FRS 103 applies. (See paragraph B5.7.3 for guidance on foreign exchange gains or losses.)

**5.7.6** If an entity makes the election in paragraph 5.7.5, it shall recognise in profit or loss dividends from that investment in accordance with paragraph 5.7.1A.

## Liabilities designated as at fair value through profit or loss

**5.7.7** An entity shall present a gain or loss on a financial liability that is designated as at fair value through profit or loss in accordance with paragraph 4.2.2 or paragraph 4.3.5 as follows:

- (a) The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income (see paragraphs B5.7.13–B5.7.20), and



- (b) the remaining amount of change in the fair value of the liability shall be presented in profit or loss

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

- 5.7.8 If the requirements in paragraph 5.7.7 would create or enlarge an accounting mismatch in profit or loss, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.
- 5.7.9 Despite the requirements in paragraphs 5.7.7 and 5.7.8, an entity shall present in profit or loss all gains and losses on loan commitments and financial guarantee contracts that are designated as at fair value through profit or loss.

## **Assets measured at fair value through other comprehensive income**

- 5.7.10 A gain or loss on a financial asset measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A shall be recognised in other comprehensive income, except for impairment gains or losses (see Section 5.5) and foreign exchange gains and losses (see paragraphs B5.7.2–B5.7.2A), until the financial asset is derecognised or reclassified. When the financial asset is derecognised the cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment (see SB-FRS 1). If the financial asset is reclassified out of the fair value through other comprehensive income measurement category, the entity shall account for the cumulative gain or loss that was previously recognised in other comprehensive income in accordance with paragraphs 5.6.5 and 5.6.7. Interest calculated using the effective interest method is recognised in profit or loss.
- 5.7.11 As described in paragraph 5.7.10, if a financial asset is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A, the amounts that are recognised in profit or loss are the same as the amounts that would have been recognised in profit or loss if the financial asset had been measured at amortised cost.

## **Chapter 6 Hedge accounting**

### **6.1 Objective and scope of hedge accounting**

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- 6.1.1 The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5). This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect.
- 6.1.2 An entity may choose to designate a hedging relationship between a hedging instrument and a hedged item in accordance with paragraphs 6.2.1–6.3.7 and B6.2.1–B6.3.25. For hedging relationships that meet the qualifying criteria, an entity shall account for the gain or loss on the hedging instrument and the hedged item in accordance with paragraphs 6.5.1–6.5.14 and B6.5.1–B6.5.28. When the hedged item is a group of items, an entity shall comply with the additional requirements in paragraphs 6.6.1–6.6.6 and B6.6.1–B6.6.16.
- 6.1.3 For a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only for such a hedge), an entity may apply the hedge accounting requirements

in SB-FRS 39 instead of those in this Standard. In that case, the entity must also apply the specific requirements for the fair value hedge accounting for a portfolio hedge of interest rate risk and designate as the hedged item a portion that is a currency amount (see paragraphs 81A, 89A and AG114–AG132 of SB-FRS 39).

## 6.2 Hedging instruments

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### Qualifying instruments

- 6.2.1** A derivative measured at fair value through profit or loss may be designated as a hedging instrument, except for some written options (see paragraph B6.2.4).
- 6.2.2** A non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income in accordance with paragraph 5.7.7. For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5.
- 6.2.3** For hedge accounting purposes, only contracts with a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments.

### Designation of hedging instruments

- 6.2.4** A qualifying instrument must be designated in its entirety as a hedging instrument. The only exceptions permitted are:
- (a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value (see paragraphs 6.5.15 and B6.5.29–B6.5.33);
  - (b) separating the forward element and the spot element of a forward contract and designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element; similarly, the foreign currency basis spread may be separated and excluded from the designation of a financial instrument as the hedging instrument (see paragraphs 6.5.16 and B6.5.34–B6.5.39); and
  - (c) a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.
- 6.2.5** An entity may view in combination, and jointly designate as the hedging instrument, any combination of the following (including those circumstances in which the risk or risks arising from some hedging instruments offset those arising from others):
- (a) derivatives or a proportion of them; and
  - (b) non-derivatives or a proportion of them.
- 6.2.6** However, a derivative instrument that combines a written option and a purchased option (for example, an interest rate collar) does not qualify as a hedging instrument if it is, in effect, a net written option at the date of designation (unless it qualifies in accordance with paragraph B6.2.4). Similarly, two or more instruments (or proportions of them) may be jointly designated

as the hedging instrument only if, in combination, they are not, in effect, a net written option at the date of designation (unless it qualifies in accordance with paragraph B6.2.4).

## 6.3 Hedged items

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### Qualifying items

**6.3.1** A hedged item can be a recognised asset or liability, an unrecognised *firm commitment*, a *forecast transaction* or a net investment in a foreign operation. The hedged item can be:

- (a) a single item; or
- (b) a group of items (subject to paragraphs 6.6.1–6.6.6 and B6.6.1–B6.6.16).

A hedged item can also be a component of such an item or group of items (see paragraphs 6.3.7 and B6.3.7–B6.3.25).

**6.3.2** The hedged item must be reliably measurable.

**6.3.3** If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

**6.3.4** An aggregated exposure that is a combination of an exposure that could qualify as a hedged item in accordance with paragraph 6.3.1 and a derivative may be designated as a hedged item (see paragraphs B6.3.3–B6.3.4). This includes a forecast transaction of an aggregated exposure (ie uncommitted but anticipated future transactions that would give rise to an exposure and a derivative) if that aggregated exposure is highly probable and, once it has occurred and is therefore no longer forecast, is eligible as a hedged item.

**6.3.5** For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting entity can be designated as hedged items. Hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group, except for the consolidated financial statements of an investment entity, as defined in SB-FRS 110, where transactions between an investment entity and its subsidiaries measured at fair value through profit or loss will not be eliminated in the consolidated financial statements.

**6.3.6** However, as an exception to paragraph 6.3.5, the foreign currency risk of an intragroup monetary item (for example, a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with SB-FRS 21 *The Effects of Changes in Foreign Exchange Rates*. In accordance with SB-FRS 21, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

### Designation of hedged items

**6.3.7** An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. An entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow

variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

- (a) only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component), provided that, based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable (see paragraphs B6.3.8–B6.3.15). Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (a one-sided risk).
- (b) one or more selected contractual cash flows.
- (c) components of a nominal amount, ie a specified part of the amount of an item (see paragraphs B6.3.16–B6.3.20).

## 6.4 Qualifying criteria for hedge accounting

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

- (a) **the hedging relationship consists only of eligible hedging instruments and eligible hedged items.**
- (b) **at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the *hedge ratio*).**
- (c) **the hedging relationship meets all of the following hedge effectiveness requirements:**
  - (i) **there is an economic relationship between the hedged item and the hedging instrument (see paragraphs B6.4.4–B6.4.6);**
  - (ii) **the effect of credit risk does not dominate the value changes that result from that economic relationship (see paragraphs B6.4.7–B6.4.8); and**
  - (iii) **the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs B6.4.9–B6.4.11).**

## 6.5 Accounting for qualifying hedging relationships

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**6.5.1 An entity applies hedge accounting to hedging relationships that meet the qualifying criteria in paragraph 6.4.1 (which include the entity's decision to designate the hedging relationship).**

**6.5.2 There are three types of hedging relationships:**

- (a) **fair value hedge:** a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.
- (b) **cash flow hedge:** a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.
- (c) **hedge of a net investment in a foreign operation as defined in SB-FRS 21.**

6.5.3 If the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5, the hedged exposure referred to in paragraph 6.5.2(a) must be one that could affect other comprehensive income. In that case, and only in that case, the recognised hedge ineffectiveness is presented in other comprehensive income.

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

6.5.5 If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio (see paragraph 6.4.1(c)(iii)) but the risk management objective for that designated hedging relationship remains the same, an entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again (this is referred to in this Standard as ‘rebalancing’—see paragraphs B6.5.7–B6.5.21).

6.5.6 An entity shall discontinue hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable). This includes instances when the hedging instrument expires or is sold, terminated or exercised. For this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such a replacement or rollover is part of, and consistent with, the entity’s documented risk management objective. Additionally, for this purpose there is not an expiration or termination of the hedging instrument if:

- (a) as a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a ‘clearing organisation’ or ‘clearing agency’) or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as a counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties the requirement in this subparagraph is met only if each of those parties effects clearing with the same central counterparty.
- (b) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.

Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship).

- 6.5.7 An entity shall apply:
- (a) paragraph 6.5.10 when it discontinues hedge accounting for a fair value hedge for which the hedged item is (or is a component of) a financial instrument measured at amortised cost; and
  - (b) paragraph 6.5.12 when it discontinues hedge accounting for cash flow hedges.

## **Fair value hedges**

**6.5.8 As long as a fair value hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship shall be accounted for as follows:**

- (a) the gain or loss on the hedging instrument shall be recognised in profit or loss (or other comprehensive income, if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5).**
- (b) the hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss. If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A, the hedging gain or loss on the hedged item shall be recognised in profit or loss. However, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5, those amounts shall remain in other comprehensive income. When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.**

6.5.9 When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or the liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognised in the statement of financial position.

6.5.10 Any adjustment arising from paragraph 6.5.8(b) shall be amortised to profit or loss if the hedged item is a financial instrument (or a component thereof) measured at amortised cost. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The amortisation is based on a recalculated effective interest rate at the date that amortisation begins. In the case of a financial asset (or a component thereof) that is a hedged item and that is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A, amortisation applies in the same manner but to the amount that represents the cumulative gain or loss previously recognised in accordance with paragraph 6.5.8(b) instead of by adjusting the carrying amount.

## **Cash flow hedges**

**6.5.11 As long as a cash flow hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship shall be accounted for as follows:**

- (a) the separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of the following (in absolute amounts):**
  - (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and**

- (ii) the cumulative change in fair value (present value) of the hedged item (ie the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.
- (b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (ie the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.
- (c) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss.
- (d) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:
  - (i) if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see SB-FRS 1) and hence it does not affect other comprehensive income.
  - (ii) for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see SB-FRS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).
  - (iii) however, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment (see SB-FRS 1).

6.5.12 When an entity discontinues hedge accounting for a cash flow hedge (see paragraphs 6.5.6 and 6.5.7(b)) it shall account for the amount that has been accumulated in the cash flow hedge reserve in accordance with paragraph 6.5.11(a) as follows:

- (a) if the hedged future cash flows are still expected to occur, that amount shall remain in the cash flow hedge reserve until the future cash flows occur or until paragraph 6.5.11(d)(iii) applies. When the future cash flows occur, paragraph 6.5.11(d) applies.
- (b) if the hedged future cash flows are no longer expected to occur, that amount shall be immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see SB-FRS 1). A hedged future cash flow that is no longer highly probable to occur may still be expected to occur.

## **Hedges of a net investment in a foreign operation**

6.5.13 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see SB-FRS 21), shall be accounted for similarly to cash flow hedges:

- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognised in other comprehensive income (see paragraph 6.5.11); and
- (b) the ineffective portion shall be recognised in profit or loss.

**6.5.14** The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment (see SB-FRS 1) in accordance with paragraphs 48–49 of SB-FRS 21 on the disposal or partial disposal of the foreign operation.

## Accounting for the time value of options

**6.5.15** When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option (see paragraph 6.2.4(a)), it shall account for the time value of the option as follows (see paragraphs B6.5.29–B6.5.33):

- (a) an entity shall distinguish the time value of options by the type of hedged item that the option hedges (see paragraph B6.5.29):
  - (i) a transaction related hedged item; or
  - (ii) a time-period related hedged item.
- (b) the change in fair value of the time value of an option that hedges a transaction related hedged item shall be recognised in other comprehensive income to the extent that it relates to the hedged item and shall be accumulated in a separate component of equity. The cumulative change in fair value arising from the time value of the option that has been accumulated in a separate component of equity (the 'amount') shall be accounted for as follows:
  - (i) if the hedged item subsequently results in the recognition of a non-financial asset or a non-financial liability, or a firm commitment for a non-financial asset or a non-financial liability for which fair value hedge accounting is applied, the entity shall remove the amount from the separate component of equity and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see SB-FRS 1) and hence does not affect other comprehensive income.
  - (ii) for hedging relationships other than those covered by (i), the amount shall be reclassified from the separate component of equity to profit or loss as a reclassification adjustment (see SB-FRS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, when a forecast sale occurs).
  - (iii) however, if all or a portion of that amount is not expected to be recovered in one or more future periods, the amount that is not expected to be recovered shall be immediately reclassified into profit or loss as a reclassification adjustment (see SB-FRS 1).
- (c) the change in fair value of the time value of an option that hedges a time-period related hedged item shall be recognised in other comprehensive income to the extent that it relates to the hedged item and shall be accumulated in a separate component of equity. The time value at the date of designation of the option as a hedging instrument, to the extent that it relates to the hedged item, shall be amortised on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss (or other comprehensive income, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5). Hence, in each



reporting period, the amortisation amount shall be reclassified from the separate component of equity to profit or loss as a reclassification adjustment (see SB-FRS 1). However, if hedge accounting is discontinued for the hedging relationship that includes the change in intrinsic value of the option as the hedging instrument, the net amount (ie including cumulative amortisation) that has been accumulated in the separate component of equity shall be immediately reclassified into profit or loss as a reclassification adjustment (see SB-FRS 1).

## **Accounting for the forward element of forward contracts and foreign currency basis spreads of financial instruments**

- 6.5.16 When an entity separates the forward element and the spot element of a forward contract and designates as the hedging instrument only the change in the value of the spot element of the forward contract, or when an entity separates the foreign currency basis spread from a financial instrument and excludes it from the designation of that financial instrument as the hedging instrument (see paragraph 6.2.4(b)), the entity may apply paragraph 6.5.15 to the forward element of the forward contract or to the foreign currency basis spread in the same manner as it is applied to the time value of an option. In that case, the entity shall apply the application guidance in paragraphs B6.5.34–B6.5.39.

## **6.6 Hedges of a group of items**

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### **Eligibility of a group of items as the hedged item**

- 6.6.1 A group of items (including a group of items that constitute a net position; see paragraphs B6.6.1–B6.6.8) is an eligible hedged item only if:
- (a) it consists of items (including components of items) that are, individually, eligible hedged items;
  - (b) the items in the group are managed together on a group basis for risk management purposes; and
  - (c) in the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group so that offsetting risk positions arise:
    - (i) it is a hedge of foreign currency risk; and
    - (ii) the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume (see paragraphs B6.6.7–B6.6.8).

### **Designation of a component of a nominal amount**

- 6.6.2 A component that is a proportion of an eligible group of items is an eligible hedged item provided that designation is consistent with the entity's risk management objective.
- 6.6.3 A layer component of an overall group of items (for example, a bottom layer) is eligible for hedge accounting only if:
- (a) it is separately identifiable and reliably measurable;
  - (b) the risk management objective is to hedge a layer component;
  - (c) the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not significantly affected by which particular items from the overall group form part of the hedged layer);

- (d) for a hedge of existing items (for example, an unrecognised firm commitment or a recognised asset) an entity can identify and track the overall group of items from which the hedged layer is defined (so that the entity is able to comply with the requirements for the accounting for qualifying hedging relationships); and
- (e) any items in the group that contain prepayment options meet the requirements for components of a nominal amount (see paragraph B6.3.20).

## Presentation

- 6.6.4 For a hedge of a group of items with offsetting risk positions (ie in a hedge of a net position) whose hedged risk affects different line items in the statement of profit or loss and other comprehensive income, any hedging gains or losses in that statement shall be presented in a separate line from those affected by the hedged items. Hence, in that statement the amount in the line item that relates to the hedged item itself (for example, revenue or cost of sales) remains unaffected.
- 6.6.5 For assets and liabilities that are hedged together as a group in a fair value hedge, the gain or loss in the statement of financial position on the individual assets and liabilities shall be recognised as an adjustment of the carrying amount of the respective individual items comprising the group in accordance with paragraph 6.5.8(b).

## Nil net positions

- 6.6.6 When the hedged item is a group that is a nil net position (ie the hedged items among themselves fully offset the risk that is managed on a group basis), an entity is permitted to designate it in a hedging relationship that does not include a hedging instrument, provided that:
- (a) the hedge is part of a rolling net risk hedging strategy, whereby the entity routinely hedges new positions of the same type as time moves on (for example, when transactions move into the time horizon for which the entity hedges);
  - (b) the hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity uses eligible hedging instruments to hedge the net risk (ie when the net position is not nil);
  - (c) hedge accounting is normally applied to such net positions when the net position is not nil and it is hedged with eligible hedging instruments; and
  - (d) not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes, because the accounting would not recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

## 6.7 Option to designate a credit exposure as measured at fair value through profit or loss

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### Eligibility of credit exposures for designation at fair value through profit or loss

- 6.7.1 If an entity uses a credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or a part of, a financial instrument (credit exposure) it may designate that financial instrument to the extent that it is so managed (ie all or a proportion of it) as measured at fair value through profit or loss if:
- (a) the name of the credit exposure (for example, the borrower, or the holder of a loan commitment) matches the reference entity of the credit derivative ('name matching'); and

- (b) the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

An entity may make this designation irrespective of whether the financial instrument that is managed for credit risk is within the scope of this Standard (for example, an entity may designate loan commitments that are outside the scope of this Standard). The entity may designate that financial instrument at, or subsequent to, initial recognition, or while it is unrecognised. The entity shall document the designation concurrently.

## Accounting for credit exposures designated at fair value through profit or loss

- 6.7.2 If a financial instrument is designated in accordance with paragraph 6.7.1 as measured at fair value through profit or loss after its initial recognition, or was previously not recognised, the difference at the time of designation between the carrying amount, if any, and the fair value shall immediately be recognised in profit or loss. For financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A, the cumulative gain or loss previously recognised in other comprehensive income shall immediately be reclassified from equity to profit or loss as a reclassification adjustment (see SB-FRS 1).
- 6.7.3 An entity shall discontinue measuring the financial instrument that gave rise to the credit risk, or a proportion of that financial instrument, at fair value through profit or loss if:
- (a) the qualifying criteria in paragraph 6.7.1 are no longer met, for example:
- (i) the credit derivative or the related financial instrument that gives rise to the credit risk expires or is sold, terminated or settled; or
- (ii) the credit risk of the financial instrument is no longer managed using credit derivatives. For example, this could occur because of improvements in the credit quality of the borrower or the loan commitment holder or changes to capital requirements imposed on an entity; and
- (b) the financial instrument that gives rise to the credit risk is not otherwise required to be measured at fair value through profit or loss (ie the entity's business model has not changed in the meantime so that a reclassification in accordance with paragraph 4.4.1 was required).
- 6.7.4 When an entity discontinues measuring the financial instrument that gives rise to the credit risk, or a proportion of that financial instrument, at fair value through profit or loss, that financial instrument's fair value at the date of discontinuation becomes its new carrying amount. Subsequently, the same measurement that was used before designating the financial instrument at fair value through profit or loss shall be applied (including amortisation that results from the new carrying amount). For example, a financial asset that had originally been classified as measured at amortised cost would revert to that measurement and its effective interest rate would be recalculated based on its new gross carrying amount on the date of discontinuing measurement at fair value through profit or loss.

## Chapter 7 Effective date and transition

### 7.1 Effective date

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- 7.1.1 An entity shall apply this Standard for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity elects to apply this Standard early, it must disclose that fact and apply all of the requirements in this Standard at the same time (but see also paragraphs 7.1.2 and 7.2.21). It shall also, at the same time, apply the amendments in Appendix C.

7.1.2 Despite the requirements in paragraph 7.1.1, for annual periods beginning before 1 January 2018, an entity may elect to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 without applying the other requirements in this Standard. If an entity elects to apply only those paragraphs, it shall disclose that fact and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of SB-FRS 107 *Financial Instruments: Disclosures* (as amended by SB-FRS 109). (See also paragraphs 7.2.2 and 7.2.15.)

7.1.3 [Not used]

7.1.4 [Not used]

## 7.2 Transition

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7.2.1 An entity shall apply this Standard retrospectively, in accordance with SB-FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 7.2.4–7.2.26. This Standard shall not be applied to items that have already been derecognised at the date of initial application.

7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1 and 7.2.3–7.2.26, the date of initial application is the date when an entity first applies those requirements of this Standard and must be the beginning of a reporting period after the issue of this Standard. Depending on the entity's chosen approach to applying SB-FRS 109, the transition can involve one or more than one date of initial application for different requirements.

### Transition for classification and measurement (Chapters 4 and 5)

7.2.3 At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraphs 4.1.2(a) or 4.1.2A(a) on the basis of the facts and circumstances that exist at that date. The resulting classification shall be applied retrospectively irrespective of the entity's business model in prior reporting periods.

7.2.4 If, at the date of initial application, it is impracticable (as defined in SB-FRS 8) for an entity to assess a modified time value of money element in accordance with paragraphs B4.1.9B–B4.1.9D on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the requirements related to the modification of the time value of money element in paragraphs B4.1.9B–B4.1.9D. (See also paragraph 42R of SB-FRS 107.)

7.2.5 If, at the date of initial application, it is impracticable (as defined in SB-FRS 8) for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraph B4.1.12(c) on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph B4.1.12. (See also paragraph 42S of SB-FRS 107.)

7.2.6 If an entity measures a hybrid contract at fair value in accordance with paragraphs 4.1.2A, 4.1.4 or 4.1.5 but the fair value of the hybrid contract had not been measured in comparative reporting periods, the fair value of the hybrid contract in the comparative reporting periods shall be the sum of the fair values of the components (ie the non-derivative host and the embedded derivative) at the end of each comparative reporting period if the entity restates prior periods (see paragraph 7.2.15).

7.2.7 If an entity has applied paragraph 7.2.6 then at the date of initial application the entity shall recognise any difference between the fair value of the entire hybrid contract at the date of initial

application and the sum of the fair values of the components of the hybrid contract at the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the reporting period that includes the date of initial application.

7.2.8 At the date of initial application an entity may designate:

- (a) a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.1.5; or
- (b) an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5.

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

7.2.9 At the date of initial application an entity:

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

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

7.2.10 At the date of initial application, an entity:

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

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

7.2.11 If it is impracticable (as defined in SB-FRS 8) for an entity to apply retrospectively the effective interest method, the entity shall treat:

- (a) the fair value of the financial asset or the financial liability at the end of each comparative period presented as the gross carrying amount of that financial asset or the amortised cost of that financial liability if the entity restates prior periods; and
- (b) the fair value of the financial asset or the financial liability at the date of initial application as the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of initial application of this Standard.

7.2.12 If an entity previously accounted at cost (in accordance with SB-FRS 39), for an investment in an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) (or for a derivative asset that is linked to and must be settled by delivery of such an equity instrument) it shall measure that instrument at fair value at the date of initial application. Any difference between the previous carrying amount and the fair value

shall be recognised in the opening retained earnings (or other component of equity, as appropriate) of the reporting period that includes the date of initial application.

- 7.2.13 If an entity previously accounted for a derivative liability that is linked to, and must be settled by, delivery of an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input) at cost in accordance with SB-FRS 39, it shall measure that derivative liability at fair value at the date of initial application. Any difference between the previous carrying amount and the fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application.
- 7.2.14 At the date of initial application, an entity shall determine whether the treatment in paragraph 5.7.7 would create or enlarge an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of initial application. This Standard shall be applied retrospectively on the basis of that determination.
- 7.2.14A At the date of initial application, an entity is permitted to make the designation in paragraph 2.5 for contracts that already exist on the date but only if it designates all similar contracts. The change in the net assets resulting from such designations shall be recognised in retained earnings at the date of initial application.
- 7.2.15 Despite the requirement in paragraph 7.2.1, an entity that adopts the classification and measurement requirements of this Standard (which include the requirements related to amortised cost measurement for financial assets and impairment in Sections 5.4 and 5.5) shall provide the disclosures set out in paragraphs 42L–42O of SB-FRS 107 but need not restate prior periods. The entity may restate prior periods if, and only if, it is possible without the use of hindsight. If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application. However, if an entity restates prior periods, the restated financial statements must reflect all of the requirements in this Standard. If an entity's chosen approach to applying SB-FRS 109 results in more than one date of initial application for different requirements, this paragraph applies at each date of initial application (see paragraph 7.2.2). This would be the case, for example, if an entity elects to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in accordance with paragraph 7.1.2 before applying the other requirements in this Standard.
- 7.2.16 If an entity prepares interim financial reports in accordance with SB-FRS 34 *Interim Financial Reporting* the entity need not apply the requirements in this Standard to interim periods prior to the date of initial application if it is impracticable (as defined in SB-FRS 8).

### **Impairment (Section 5.5)**

- 7.2.17 An entity shall apply the impairment requirements in Section 5.5 retrospectively in accordance with SB-FRS 8 subject to paragraphs 7.2.15 and 7.2.18–7.2.20.
- 7.2.18 At the date of initial application, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that a financial instrument was initially recognised (or for loan commitments and financial guarantee contracts at the date that the entity became a party to the irrevocable commitment in accordance with paragraph 5.5.6) and compare that to the credit risk at the date of initial application of this Standard.
- 7.2.19 When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:
- (a) the requirements in paragraphs 5.5.10 and B5.5.22–B5.5.24; and
  - (b) the rebuttable presumption in paragraph 5.5.11 for contractual payments that are more than 30 days past due if an entity will apply the impairment requirements by identifying

significant increases in credit risk since initial recognition for those financial instruments on the basis of past due information.

- 7.2.20 If, at the date of initial application, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, an entity shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial instrument is low credit risk at a reporting date, in which case paragraph 7.2.19(a) applies).

### **Transition for hedge accounting (Chapter 6)**

- 7.2.21 When an entity first applies this Standard, it may choose as its accounting policy to continue to apply the hedge accounting requirements of SB-FRS 39 instead of the requirements in Chapter 6 of this Standard. An entity shall apply that policy to all of its hedging relationships. An entity that chooses that policy shall also apply INT SB-FRS 116 *Hedges of a Net Investment in a Foreign Operation* without the amendments that conform that Interpretation to the requirements in Chapter 6 of this Standard.
- 7.2.22 Except as provided in paragraph 7.2.26, an entity shall apply the hedge accounting requirements of this Standard prospectively.
- 7.2.23 To apply hedge accounting from the date of initial application of the hedge accounting requirements of this Standard, all qualifying criteria must be met as at that date.
- 7.2.24 Hedging relationships that qualified for hedge accounting in accordance with SB-FRS 39 that also qualify for hedge accounting in accordance with the criteria of this Standard (see paragraph 6.4.1), after taking into account any rebalancing of the hedging relationship on transition (see paragraph 7.2.25(b)), shall be regarded as continuing hedging relationships.
- 7.2.25 On initial application of the hedge accounting requirements of this Standard, an entity:
- (a) may start to apply those requirements from the same point in time as it ceases to apply the hedge accounting requirements of SB-FRS 39; and
  - (b) shall consider the hedge ratio in accordance with SB-FRS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship, if applicable. Any gain or loss from such a rebalancing shall be recognised in profit or loss.
- 7.2.26 As an exception to prospective application of the hedge accounting requirements of this Standard, an entity:
- (a) shall apply the accounting for the time value of options in accordance with paragraph 6.5.15 retrospectively if, in accordance with SB-FRS 39, only the change in an option's intrinsic value was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.
  - (b) may apply the accounting for the forward element of forward contracts in accordance with paragraph 6.5.16 retrospectively if, in accordance with SB-FRS 39, only the change in the spot element of a forward contract was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. In addition, if an entity elects retrospective application of this accounting, it shall be applied to all hedging relationships that qualify for this election (ie on transition this election is not available on a hedging-relationship-by-hedging-relationship basis). The accounting for foreign currency basis spreads (see paragraph 6.5.16) may be applied retrospectively for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.

- (c) shall apply retrospectively the requirement of paragraph 6.5.6 that there is not an expiration or termination of the hedging instrument if:
  - (i) as a consequence of laws or regulations, or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties; and
  - (ii) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty.

7.2.27 [Not used]

7.2.28 [Not used]

### **7.3 Withdrawal of INT SB-FRS 109**

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7.3.1 This Standard supersedes INT SB-FRS 109 *Reassessment of Embedded Derivatives* and incorporates the requirements previously set out in paragraphs 5 and 7 of INT SB-FRS 109. As a consequential amendment, SB-FRS 101 *First-time Adoption of Financial Reporting Standards* incorporates the requirements previously set out in paragraph 8 of INT SB-FRS 109.

7.3.2 [Not used]



## Appendix A

### Defined terms

*This appendix is an integral part of the Standard.*

<b>12-month expected credit losses</b>	The portion of <b>lifetime expected credit losses</b> that represent the <b>expected credit losses</b> that result from default events on a financial instrument that are possible within the 12 months after the reporting date.
<b>amortised cost of a financial asset or financial liability</b>	The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the <b>effective interest method</b> of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any <b>loss allowance</b> .
<b>contract assets</b>	Those rights that SB-FRS 115 <i>Revenue from Contracts with Customers</i> specifies are accounted for in accordance with this Standard for the purposes of recognising and measuring impairment gains or losses.
<b>credit-impaired financial asset</b>	<p>A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:</p> <ul style="list-style-type: none"> <li>(a) significant financial difficulty of the issuer or the borrower;</li> <li>(b) a breach of contract, such as a default or <b>past due</b> event;</li> <li>(c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;</li> <li>(d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;</li> <li>(e) the disappearance of an active market for that financial asset because of financial difficulties; or</li> <li>(f) the purchase or origination of a financial asset at a deep discount that reflects the incurred <b>credit losses</b>.</li> </ul>

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

<b>credit loss</b>	The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original <b>effective interest rate</b> (or <b>credit-adjusted effective interest rate</b> for <b>purchased or originated credit-impaired financial assets</b> ). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.
<b>credit-adjusted effective interest rate</b>	The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the <b>amortised cost of a financial asset</b> that is a <b>purchased or originated credit-impaired financial asset</b> . When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and <b>expected credit losses</b> . The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), <b>transaction costs</b> , and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
<b>derecognition</b>	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
<b>derivative</b>	A financial instrument or other contract within the scope of this Standard with all three of the following characteristics. <ul style="list-style-type: none"> <li>(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').</li> <li>(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.</li> <li>(c) it is settled at a future date.</li> </ul>
<b>dividends</b>	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital.
<b>effective interest method</b>	The method that is used in the calculation of the <b>amortised cost of a financial asset or a financial liability</b> and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

<b>effective interest rate</b>	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the <b>gross carrying amount of a financial asset</b> or to the <b>amortised cost of a financial liability</b> . When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the <b>expected credit losses</b> . The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), <b>transaction costs</b> , and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).
<b>expected credit losses</b>	The weighted average of <b>credit losses</b> with the respective risks of a default occurring as the weights.
<b>financial guarantee contract</b>	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
<b>financial liability at fair value through profit or loss</b>	A financial liability that meets one of the following conditions. <ul style="list-style-type: none"> <li>(a) it meets the definition of <b>held for trading</b>.</li> <li>(b) upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5.</li> <li>(c) it is designated either upon initial recognition or subsequently as at fair value through profit or loss in accordance with paragraph 6.7.1.</li> </ul>
<b>firm commitment</b>	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
<b>forecast transaction</b>	An uncommitted but anticipated future transaction.
<b>gross carrying amount of a financial asset</b>	The <b>amortised cost of a financial asset</b> , before adjusting for any <b>loss allowance</b> .
<b>hedge ratio</b>	The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.
<b>held for trading</b>	A financial asset or financial liability that: <ul style="list-style-type: none"> <li>(a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;</li> <li>(b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or</li> <li>(c) is a <b>derivative</b> (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).</li> </ul>

<b>impairment gain or loss</b>	Gains or losses that are recognised in profit or loss in accordance with paragraph 5.5.8 and that arise from applying the impairment requirements in Section 5.5.
<b>lifetime expected credit losses</b>	The <b>expected credit losses</b> that result from all possible default events over the expected life of a financial instrument.
<b>loss allowance</b>	The allowance for <b>expected credit losses</b> on financial assets measured in accordance with paragraph 4.1.2, lease receivables and <b>contract assets</b> , the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A and the provision for expected credit losses on loan commitments and <b>financial guarantee contracts</b> .
<b>modification gain or loss</b>	The amount arising from adjusting the <b>gross carrying amount of a financial asset</b> to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original <b>effective interest rate</b> (or the original <b>credit-adjusted effective interest rate</b> for <b>purchased or originated credit-impaired financial assets</b> ) or, when applicable, the revised <b>effective interest rate</b> calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the <b>expected credit losses</b> , unless the financial asset is a <b>purchased or originated credit-impaired financial asset</b> , in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original <b>credit-adjusted effective interest rate</b> .
<b>past due</b>	A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.
<b>purchased or originated credit-impaired financial asset</b>	Purchased or originated financial asset(s) that are <b>credit-impaired</b> on initial recognition.
<b>reclassification date</b>	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.
<b>regular way purchase or sale</b>	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.
<b>transaction costs</b>	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

The following terms are defined in paragraph 11 of SB-FRS 32, Appendix A of SB-FRS 107, Appendix A of SB-FRS 113 or Appendix A of SB-FRS 115 and are used in this Standard with the meanings specified in SB-FRS 32, SB-FRS 107, SB-FRS 113 or SB-FRS 115:

- (a) credit risk;<sup>2</sup>
- (b) equity instrument;

<sup>2</sup> This term (as defined in SB-FRS 107) is used in the requirements for presenting the effects of changes in credit risk on liabilities designated as at fair value through profit or loss (see paragraph 5.7.7).

- (c) fair value;
- (d) financial asset;
- (e) financial instrument;
- (f) financial liability;
- (g) transaction price.

## Appendix B

### Application guidance

*This appendix is an integral part of the Standard.*

#### Scope (Chapter 2)

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- B2.1 Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.) If those contracts are not within the scope of SB-FRS 104 *Insurance Contracts*, they are within the scope of this Standard.
- B2.2 This Standard does not change the requirements relating to employee benefit plans that comply with SB-FRS 26 *Accounting and Reporting by Retirement Benefit Plans* and royalty agreements based on the volume of sales or service revenues that are accounted for under SB-FRS 115 *Revenue from Contracts with Customers*.
- B2.3 Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor or joint venturer entity uses SB-FRS 28 *Investments in Associates and Joint Ventures* to determine whether the equity method of accounting shall be applied to such an investment.
- B2.4 This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2.1(e) excludes because they arise under contracts within the scope of SB-FRS 104.
- B2.5 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2.1(e)):
- (a) Although a financial guarantee contract meets the definition of an insurance contract in SB-FRS 104 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts, the issuer may elect to apply either this Standard or SB-FRS 104 to such financial guarantee contracts. If this Standard applies, paragraph 5.1.1 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 3.2.15–3.2.23 and B3.2.12–B3.2.17 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:
    - (i) the amount determined in accordance with Section 5.5; and
    - (ii) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of SB-FRS 115 (see paragraph 4.2.1(c)).
  - (b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in this

Standard, and are not insurance contracts as defined in SB-FRS 104. Such guarantees are derivatives and the issuer applies this Standard to them.

- (c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies SB-FRS 115 in determining when it recognises the revenue from the guarantee and from the sale of goods.

B2.6 Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.

## Recognition and derecognition (Chapter 3)

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### Initial recognition (Section 3.1)

B3.1.1 As a consequence of the principle in paragraph 3.1.1, an entity recognises all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph B3.2.14). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph B3.2.15).

B3.1.2 The following are examples of applying the principle in paragraph 3.1.1:

- (a) Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
- (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, instead, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard in accordance with paragraphs 2.4–2.7, its net fair value is recognised as an asset or a liability on the commitment date (see paragraph B4.1.30(c)). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or a liability after the inception of the hedge (see paragraphs 6.5.8(b) and 6.5.9).
- (c) A forward contract that is within the scope of this Standard (see paragraph 2.1) is recognised as an asset or a liability on the commitment date, instead of on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.
- (d) Option contracts that are within the scope of this Standard (see paragraph 2.1) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

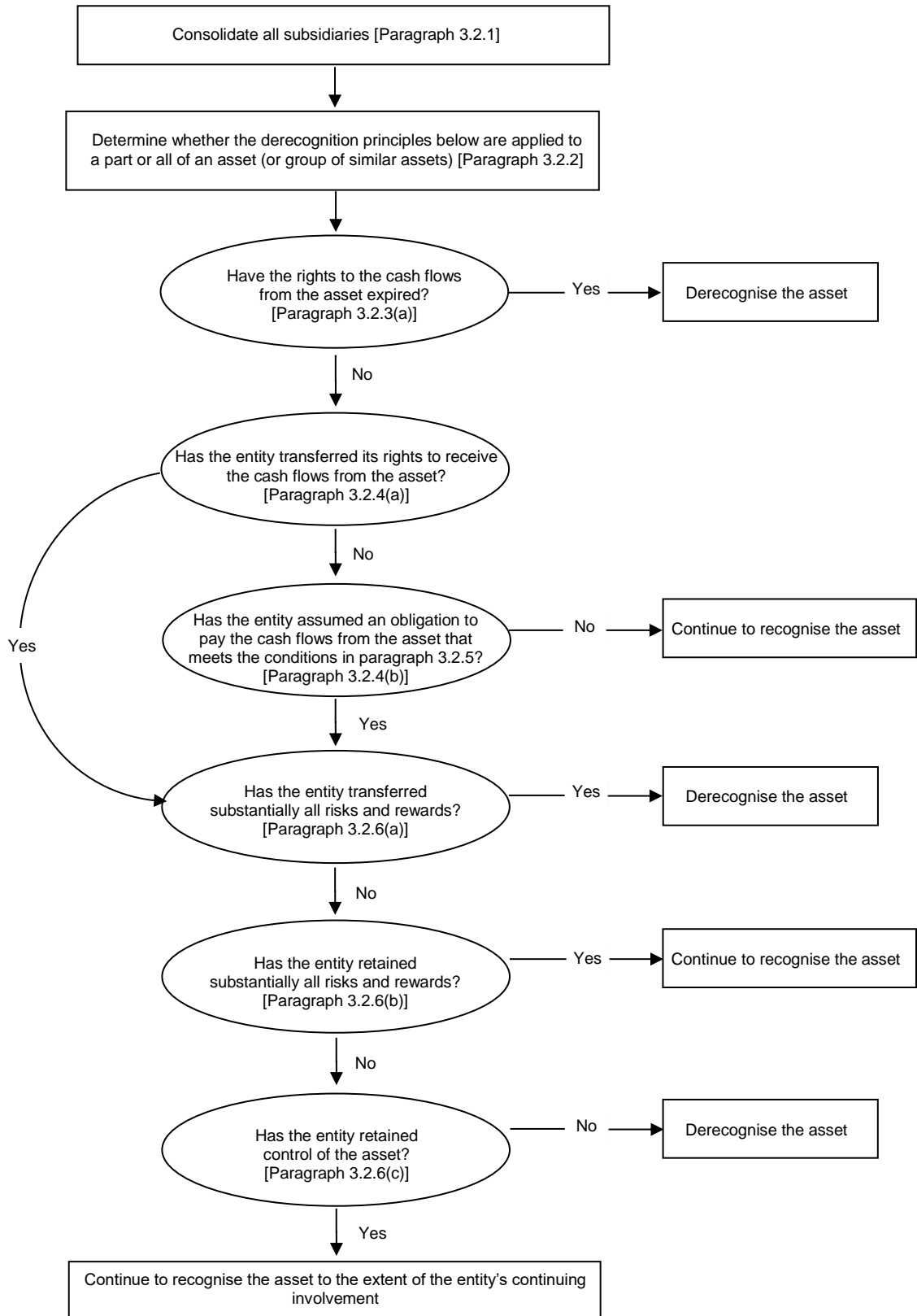
## Regular way purchase or sale of financial assets

- B3.1.3 A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs B3.1.5 and B3.1.6. An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with this Standard. For this purpose assets that are mandatorily measured at fair value through profit or loss form a separate classification from assets designated as measured at fair value through profit or loss. In addition, investments in equity instruments accounted for using the option provided in paragraph 5.7.5 form a separate classification.
- B3.1.4 A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- B3.1.5 The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.
- B3.1.6 The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets measured at amortised cost; it is recognised in profit or loss for assets classified as financial assets measured at fair value through profit or loss; and it is recognised in other comprehensive income for financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A and for investments in equity instruments accounted for in accordance with paragraph 5.7.5.



## Derecognition of financial assets (Section 3.2)

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



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

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

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

- B3.2.4 Examples of when an entity has transferred substantially all the risks and rewards of ownership are:
- (a) an unconditional sale of a financial asset;
  - (b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
  - (c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).
- B3.2.5 Examples of when an entity has retained substantially all the risks and rewards of ownership are:
- (a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
  - (b) a securities lending agreement;
  - (c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
  - (d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
  - (e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.
- B3.2.6 If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

*Evaluation of the transfer of control*

- B3.2.7 An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset

if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

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

- (a) a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset, and
- (b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:
  - (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (ie it must be a unilateral ability), and
  - (ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (eg conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

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

### **Transfers that qualify for derecognition**

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

B3.2.11 When measuring the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 3.2.13, an entity applies the fair value measurement requirements in SB-FRS 113 *Fair Value Measurement* in addition to paragraph 3.2.14.

## Transfers that do not qualify for derecognition

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

## Continuing involvement in transferred assets

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

### *All assets*

- (a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss when (or as) the obligation is satisfied (in accordance with the principles of SB-FRS 115) and the carrying value of the asset is reduced by any loss allowance.

### *Assets measured at amortised cost*

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

### *Assets measured at fair value*

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

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

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

## All transfers

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

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

## Examples

B3.2.16 The following examples illustrate the application of the derecognition principles of this Standard.

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

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

- (c) *Repurchase agreements and securities lending—right of substitution.* If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognised because the transferor retains substantially all the risks and rewards of ownership.
- (d) *Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership.
- (e) *Wash sale transaction.* The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised.
- (f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.* If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) *A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money.* If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph B3.2.9). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.
- (j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value

of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.

- (k) *Cash-settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs B3.2.9 and (g), (h) and (i) above).
- (l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.
- (m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.
- (n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
- (o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
- (p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) *Amortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the

principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

- (r) *Write-off.* An entity has no reasonable expectations of recovering the contractual cash flows on a financial asset in its entirety or a portion thereof.

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

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

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

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

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

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 3.2.14 of SB-FRS 109 as follows:

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

*continued...*



...continued

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

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

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

	<i>Debit</i>	<i>Credit</i>
Original asset	—	9,000
Asset recognised for subordination or the residual interest	1,000	—
Asset for the consideration received in the form of excess spread	40	—
Profit or loss (gain on transfer)	—	90
Liability	—	1,065
Cash received	9,115	—
<b>Total</b>	<b>10,155</b>	<b>10,155</b>

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

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

### Derecognition of financial liabilities (Section 3.3)

B3.3.1 A financial liability (or part of it) is extinguished when the debtor either:

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

B3.3.2 If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.

- B3.3.3 Payment to a third party, including a trust (sometimes called ‘in-substance defeasance’), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.
- B3.3.4 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.
- B3.3.5 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 3.2.1–3.2.23 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.
- B3.3.6 For the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.
- B3.3.7 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:
- (a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and
  - (b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

## Classification (Chapter 4)

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### Classification of financial assets (Section 4.1)

#### The entity’s business model for managing financial assets

- B4.1.1 Paragraph 4.1.1(a) requires an entity to classify financial assets on the basis of the entity’s business model for managing the financial assets, unless paragraph 4.1.5 applies. An entity assesses whether its financial assets meet the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a) on the basis of the business model as determined by the entity’s key management personnel (as defined in SB-FRS 24 *Related Party Disclosures*).
- B4.1.2 An entity’s business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity’s business model does not depend on management’s intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes. Similarly, in some

circumstances, it may be appropriate to separate a portfolio of financial assets into subportfolios in order to reflect the level at which an entity manages those financial assets. For example, that may be the case if an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them.

- B4.1.2A An entity's business model refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called 'worst case' or 'stress case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity's assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur. If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements (see SB-FRS 8 *Accounting Policies, Changed in Accounting Estimates and Errors*) nor does it change the classification of the remaining financial assets held in that business model (ie those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information.
- B4.1.2B An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:
- (a) how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;
  - (b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
  - (c) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

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

- B4.1.2C Financial assets that are held within a business model whose objective is to hold assets in order to collect contractual cash flows are managed to realise cash flows by collecting contractual payments over the life of the instrument. That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows (instead of managing the overall return on the portfolio by both holding and selling assets). In determining whether cash flows are going to be realised by collecting the financial assets' contractual cash flows, it is necessary to consider the frequency, value and timing of sales in prior periods, the reasons for those sales and expectations about future sales activity. However sales in themselves do not determine the business model and therefore cannot be considered in isolation. Instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.

- B4.1.3 Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur or are expected to occur in the future.
- B4.1.3A The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets' credit risk. To determine whether there has been an increase in the assets' credit risk, the entity considers reasonable and supportable information, including forward looking information. Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. Credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a business model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk.
- B4.1.3B Sales that occur for other reasons, such as sales made to manage credit concentration risk (without an increase in the assets' credit risk), may also be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows. In particular, such sales may be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows if those sales are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to this assessment. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model. In addition, sales may be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows.
- B4.1.4 The following are examples of when the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive. Furthermore, the examples are not intended to discuss all factors that may be relevant to the assessment of the entity's business model nor specify the relative importance of the factors.

Example	Analysis
<p><b>Example 1</b></p> <p>An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs.</p> <p>The entity performs credit risk management activities with the objective of minimising credit losses. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.</p> <p>Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.</p>	<p>Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows. Sales would not contradict that objective if they were in response to an increase in the assets' credit risk, for example if the assets no longer meet the credit criteria specified in the entity's documented investment policy. Infrequent sales resulting from unanticipated funding needs (eg in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.</p>
<p><b>Example 2</b></p> <p>An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired.</p> <p>If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them.</p> <p>In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.</p>	<p>The objective of the entity's business model is to hold the financial assets in order to collect the contractual cash flows.</p> <p>The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets are credit impaired at initial recognition).</p> <p>Moreover, the fact that the entity enters into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model.</p>

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Example	Analysis
<p><b>Example 3</b></p> <p>An entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.</p> <p>The originating entity controls the securitisation vehicle and thus consolidates it.</p> <p>The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors.</p> <p>It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.</p>	<p>The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows.</p> <p>However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.</p>
<p><b>Example 4</b></p> <p>A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (eg, a run on the bank's deposits). The entity does not anticipate selling these assets except in such scenarios.</p> <p>The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised.</p> <p>However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.</p>	<p>The objective of the entity's business model is to hold the financial assets to collect contractual cash flows.</p> <p>The analysis would not change even if during a previous stress case scenario the entity had sales that were significant in value in order to meet its liquidity needs. Similarly, recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows.</p> <p>In contrast, if an entity holds financial assets to meet its everyday liquidity needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows.</p> <p>Similarly, if the entity is required by its regulator to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's business model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.</p>

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

- B4.1.4A An entity may hold financial assets in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. In this type of business model, the entity’s key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the business model. There are various objectives that may be consistent with this type of business model. For example, the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding. To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.
- B4.1.4B Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model's objective instead of being only incidental to it. However, there is no threshold for the frequency or value of sales that must occur in this business model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.
- B4.1.4C The following are examples of when the objective of the entity’s business model may be achieved by both collecting contractual cash flows and selling financial assets. This list of examples is not exhaustive. Furthermore, the examples are not intended to describe all the factors that may be relevant to the assessment of the entity’s business model nor specify the relative importance of the factors.

Example	Analysis
<p><b>Example 5</b></p> <p>An entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity’s anticipated investment period.</p> <p>The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return.</p> <p>The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.</p>	<p>The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.</p> <p>In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity uses the proceeds from the maturing financial assets to fund the capital expenditure. Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk). The objective of this contrasting business model is to hold financial assets to collect contractual cash flows.</p>

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Example	Analysis
<p><b>Example 6</b></p> <p>A financial institution holds financial assets to meet its everyday liquidity needs. The entity seeks to minimise the costs of managing those liquidity needs and therefore actively manages the return on the portfolio. That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets.</p> <p>As a result, the entity holds financial assets to collect contractual cash flows and sells financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future.</p>	<p>The objective of the business model is to maximise the return on the portfolio to meet everyday liquidity needs and the entity achieves that objective by both collecting contractual cash flows and selling financial assets. In other words, both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective.</p>
<p><b>Example 7</b></p> <p>An insurer holds financial assets in order to fund insurance contract liabilities. The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the insurer undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.</p>	<p>The objective of the business model is to fund the insurance contract liabilities. To achieve this objective, the entity collects contractual cash flows as they come due and sells financial assets to maintain the desired profile of the asset portfolio. Thus both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective.</p>

### *Other business models*

- B4.1.5 Financial assets are measured at fair value through profit or loss if they are not held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (but see also paragraph 5.7.5). One business model that results in measurement at fair value through profit or loss is one in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. In this case, the entity's objective will typically result in active buying and selling. Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a business model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the business model's objective; instead, it is incidental to it.



B4.1.6 A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 4.2.2(b)) is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. For such portfolios, the collection of contractual cash flows is only incidental to achieving the business model's objective. Consequently, such portfolios of financial assets must be measured at fair value through profit or loss.

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

B4.1.7 Paragraph 4.1.1(b) requires an entity to *classify* a financial on the basis of its contractual cash flow characteristics if the financial asset is held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, unless paragraph 4.1.5 applies. To do so, the condition in paragraphs 4.1.2(b) and 4.1.2A(b) requires an entity to determine whether the asset's contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

B4.1.7A Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs B4.1.9A–B4.1.9E) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

B4.1.7B In accordance with paragraph 4.1.3(a), principal is the fair value of the financial asset at initial recognition. However that principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

B4.1.8 An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

B4.1.9 Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts do not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) and cannot be subsequently measured at amortised cost or fair value through other comprehensive income.

### *Consideration for the time value of money*

B4.1.9A Time value of money is the element of interest that provides consideration for only the passage of time. That is, the time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the element provides consideration for only the passage of time, an entity applies judgement and considers

relevant factors such as the currency in which the financial asset is denominated and the period for which the interest rate is set.

- B4.1.9B However, in some cases, the time value of money element may be modified (ie imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment.
- B4.1.9C When assessing a modified time value of money element, the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit risk except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b). To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument. The reason for the interest rate being set in this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.
- B4.1.9D When assessing a modified time value of money element, an entity must consider factors that could affect future contractual cash flows. For example, if an entity is assessing a bond with a five-year term and the variable interest rate is reset every six months to a five-year rate, the entity cannot conclude that the contractual cash flows are solely payments of principal and interest on the principal amount outstanding simply because the interest rate curve at the time of the assessment is such that the difference between a five-year interest rate and a six-month interest rate is not significant. Instead, the entity must also consider whether the relationship between the five-year interest rate and the six-month interest rate could change over the life of the instrument such that the contractual (undiscounted) cash flows over the life of the instrument could be significantly different from the (undiscounted) benchmark cash flows. However, an entity must consider only reasonably possible scenarios instead of every possible scenario. If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) and therefore cannot be measured at amortised cost or fair value through other comprehensive income.
- B4.1.9E In some jurisdictions, the government or a regulatory authority sets interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, despite paragraphs B4.1.9A–B4.1.9D, a regulated interest rate shall be considered a proxy for the time value of money element for the purpose of applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.
- Contractual terms that change the timing or amount of contractual cash flows*

- B4.1.10 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (ie the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk. (See also paragraph B4.1.18.)
- B4.1.11 The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:
- (a) a variable interest rate that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin;
  - (b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract; and
  - (c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (ie an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.
- B4.1.12 Despite paragraph B4.1.10, a financial asset that would otherwise meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive income (subject to meeting the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a)) if:
- (a) the entity acquires or originates the financial asset at a premium or discount to the contractual par amount;
  - (b) the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable additional compensation for the early termination of the contract; and
  - (c) when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

B4.1.13 The following examples illustrate contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
<p><b>Instrument A</b></p> <p>Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.</p> <p>However, if the interest payments were indexed to another variable such as the debtor's performance (eg the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement (see paragraph B4.1.7A).</p>

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Instrument	Analysis
<p><b>Instrument B</b></p> <p>Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money, for the credit risk associated with the instrument and for other basic lending risks and costs, as well as a profit margin (see paragraph B4.1.7A). The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument.</p> <p>However, if the borrower is able to choose to pay a one-month interest rate that is reset every three months, the interest rate is reset with a frequency that does not match the tenor of the interest rate. Consequently, the time value of money element is modified. Similarly, if an instrument has a contractual interest rate that is based on a term that can exceed the instrument's remaining life (for example, if an instrument with a five-year maturity pays a variable rate that is reset periodically but always reflects a five-year maturity), the time value of money element is modified. That is because the interest payable in each period is disconnected from the interest period.</p> <p>In such cases, the entity must qualitatively or quantitatively assess the contractual cash flows against those on an instrument that is identical in all respects except the tenor of the interest rate matches the interest period to determine if the cash flows are solely payments of principal and interest on the principal amount outstanding. (But see paragraph B4.1.9E for guidance on regulated interest rates.)</p> <p>For example, in assessing a bond with a five-year term that pays a variable rate that is reset every six months but always reflects a five-year maturity, an entity considers the contractual cash flows on an instrument that resets every six months to a six-month interest rate but is otherwise identical.</p> <p>The same analysis would apply if the borrower is able to choose between the lender's various published interest rates (eg the borrower can choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate).</p>

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Instrument	Analysis
<p><b>Instrument C</b></p> <p>Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.</p>	<p>The contractual cash flows of both:</p> <ul style="list-style-type: none"> <li>(a) an instrument that has a fixed interest rate and</li> <li>(b) an instrument that has a variable interest rate</li> </ul> <p>are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money, for the credit risk associated with the instrument during the term of the instrument and for other basic lending risks and costs, as well as a profit margin. (See paragraph B4.1.7A)</p> <p>Consequently, an instrument that is a combination of (a) and (b) (eg a bond with an interest rate cap) can have cash flows that are solely payments of principal and interest on the principal amount outstanding. Such a contractual term may reduce cash flow variability by setting a limit on a variable interest rate (eg an interest rate cap or floor) or increase the cash flow variability because a fixed rate becomes variable.</p>
<p><b>Instrument D</b></p> <p>Instrument D is a full recourse loan and is secured by collateral.</p>	<p>The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.</p>
<p><b>Instrument E</b></p> <p>Instrument E is issued by a regulated bank and has a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are non-discretionary.</p> <p>However, the issuer is subject to legislation that permits or requires a national resolving authority to impose losses on holders of particular instruments, including Instrument E, in particular circumstances. For example, the national resolving authority has the power to write down the par amount of Instrument E or to convert it into a fixed number of the issuer's ordinary shares if the national resolving authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is 'failing'.</p>	<p>The holder would analyse the <b>contractual terms</b> of the financial instrument to determine whether they give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and thus are consistent with a basic lending arrangement.</p> <p>That analysis would not consider the payments that arise only as a result of the national resolving authority's power to impose losses on the holders of Instrument E. That is because that power, and the resulting payments, are not <b>contractual terms</b> of the financial instrument.</p> <p>In contrast, the contractual cash flows would not be solely payments of principal and interest on the principal amount outstanding if the <b>contractual terms</b> of the financial instrument permit or require the issuer or another entity to impose losses on the holder (eg by writing down the par amount or by converting the instrument into a fixed number of the issuer's ordinary shares) as long as those contractual terms are genuine, even if the probability is remote that such a loss will be imposed.</p>

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

<b>Instrument</b>	<b>Analysis</b>
<p><b>Instrument F</b></p> <p>Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer.</p>	<p>The holder would analyse the convertible bond in its entirety.</p> <p>The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement (see paragraph B4.1.7A); ie the return is linked to the value of the equity of the issuer.</p>
<p><b>Instrument G</b></p> <p>Instrument G is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates).</p>	<p>The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding.</p> <p>The interest amounts are not consideration for the time value of money on the principal amount outstanding.</p>

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Instrument	Analysis
<p><b>Instrument H</b></p> <p>Instrument H is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.</p> <p>Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards.</p> <p>Deferred interest does not accrue additional interest.</p>	<p>The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.</p> <p>If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.</p> <p>The fact that Instrument H is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.</p> <p>Also, the fact that Instrument H is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal amount outstanding. Even if the callable amount includes an amount that reasonably compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding. (See also paragraph B4.1.12.)</p>

- B4.1.15 In some cases a financial asset may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding as described in paragraphs 4.1.2(b), 4.1.2A(b) and 4.1.3 of this Standard.
- B4.1.16 This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the condition in paragraphs 4.1.2(b) and 4.1.2A(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).
- B4.1.17 However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraphs 4.1.2(b) and 4.1.2A(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the

terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

- B4.1.18 A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.
- B4.1.19 In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

#### *Contractually linked instruments*

- B4.1.20 In some types of transactions, an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches.
- B4.1.21 In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:
- (a) the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (eg the interest rate on the tranche is not linked to a commodity index);
  - (b) the underlying pool of financial instruments has the cash flow characteristics set out in paragraphs B4.1.23 and B4.1.24; and
  - (c) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, the credit rating of the tranche being assessed for classification is equal to or higher than the credit rating that would apply to a single tranche that funded the underlying pool of financial instruments).
- B4.1.22 An entity must look through until it can identify the underlying pool of instruments that are creating (instead of passing through) the cash flows. This is the underlying pool of financial instruments.
- B4.1.23 The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

B4.1.24 The underlying pool of instruments may also include instruments that:

- (a) reduce the cash flow variability of the instruments in paragraph B4.1.23 and, when combined with the instruments in paragraph B4.1.23, result in cash flows that are solely payments of principal and interest on the principal amount outstanding (eg an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in paragraph B4.1.23); or
- (b) align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph B4.1.23 to address differences in and only in:
  - (i) whether the interest rate is fixed or floating;
  - (ii) the currency in which the cash flows are denominated, including inflation in that currency; or
  - (iii) the timing of the cash flows.

B4.1.25 If any instrument in the pool does not meet the conditions in either paragraph B4.1.23 or paragraph B4.1.24, the condition in paragraph B4.1.21(b) is not met. In performing this assessment, a detailed instrument-by-instrument analysis of the pool may not be necessary. However, an entity must use judgement and perform sufficient analysis to determine whether the instruments in the pool meet the conditions in paragraphs B4.1.23–B4.1.24. (See also paragraph B4.1.18 for guidance on contractual cash flow characteristics that have only a de minimis effect.)

B4.1.26 If the holder cannot assess the conditions in paragraph B4.1.21 at initial recognition, the tranche must be measured at fair value through profit or loss. If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the conditions in paragraphs B4.1.23–B4.1.24, the tranche does not meet the conditions in paragraph B4.1.21 and must be measured at fair value through profit or loss. However, if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions in paragraphs B4.1.23–B4.1.24, the ability to take possession of such assets shall be disregarded for the purposes of applying this paragraph unless the entity acquired the tranche with the intention of controlling the collateral.

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

B4.1.27 Subject to the conditions in paragraphs 4.1.5 and 4.2.2, this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.

B4.1.28 The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of SB-FRS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of designation of a financial liability as at fair value through profit or loss, paragraph 4.2.2 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 4.2.2, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

### **Designation eliminates or significantly reduces an accounting mismatch**

- B4.1.29 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as subsequently measured at fair value through profit or loss and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss.
- B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a):
- (a) an entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by paragraph 24 of SB-FRS 104) and financial assets that it considers to be related and that would otherwise be measured at either fair value through other comprehensive income or amortised cost.
  - (b) an entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, and that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (for example, those that are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met because, for example, the requirements for hedge effectiveness in paragraph 6.4.1 are not met.
  - (c) an entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and none of the financial assets or financial liabilities qualifies for designation as a hedging instrument because they are not measured at fair value through profit or loss. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of the recognition of the gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.
- B4.1.31 In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.
- B4.1.32 It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100 and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities

with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

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

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

### **Embedded derivatives (Section 4.3)**

- B4.3.1 When an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this Standard, paragraph 4.3.3 requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss.
- B4.3.2 If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.
- B4.3.3 An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

B4.3.4 Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see SB-FRS 32 *Financial Instruments: Presentation*) are accounted for separately from those classified as assets or liabilities. In addition, if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

B4.3.5 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 4.3.3(a)) in the following examples. In these examples, assuming the conditions in paragraph 4.3.3(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

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

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with SB-FRS 32.

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

- B4.3.6 An example of a hybrid contract is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (ie the indexed principal payment) under paragraph 4.3.3 because the host contract is a debt instrument under paragraph B4.3.2 and the indexed principal payment is not closely related to a host debt instrument under paragraph B4.3.5(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.
- B4.3.7 In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.
- B4.3.8 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.
- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.
  - (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.
  - (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (for example, a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because SB-FRS 21 *The Effects of Changes in Foreign Exchange Rates* requires foreign currency gains and losses on monetary items to be recognised in profit or loss.
  - (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
    - (i) the functional currency of any substantial party to that contract;
    - (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

- (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).
- (e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.
- (f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.
- (g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.
- (h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

### **Instruments containing embedded derivatives**

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

### **Reassessment of embedded derivatives**

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



- (a) a business combination (as defined in SB-FRS 103 *Business Combinations*);
- (b) a combination of entities or businesses under common control as described in paragraphs B1–B4 of SB-FRS 103; or
- (c) the formation of a joint venture as defined in SB-FRS 111 *Joint Arrangements*

or their possible reassessment at the date of acquisition.<sup>3</sup>

## Reclassification of financial assets (Section 4.4)

### Reclassification of financial assets

B4.4.1 Paragraph 4.4.1 requires an entity to reclassify financial assets if the entity changes its business model for managing those financial assets. Such changes are expected to be very infrequent. Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line. Examples of a change in business model include the following:

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

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

B4.4.3 The following are not changes in business model:

- (a) a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).
- (b) the temporary disappearance of a particular market for financial assets.
- (c) a transfer of financial assets between parts of the entity with different business models.

## Measurement (Chapter 5)

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### Initial measurement (Section 5.1)

B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.1.2A and SB-FRS 113). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing

<sup>3</sup> SB-FRS 103 addresses the acquisition of contracts with embedded derivatives in a business combination.

market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

B5.1.2 If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives.

B5.1.2A The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also SB-FRS 113). If an entity determines that the fair value at initial recognition differs from the transaction price as mentioned in paragraph 5.1.1A, the entity shall account for that instrument at that date as follows:

- (a) at the measurement required by paragraph 5.1.1 if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) or based on a valuation technique that uses only data from observable markets. An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.
- (b) in all other cases, at the measurement required by paragraph 5.1.1, adjusted to defer the difference between the fair value at initial recognition and the transaction price. After initial recognition, the entity shall recognise that deferred difference as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

### **Subsequent measurement (Sections 5.2 and 5.3)**

B5.2.1 If a financial instrument that was previously recognised as a financial asset is measured at fair value through profit or loss and its fair value decreases below zero, it is a financial liability measured in accordance with paragraph 4.2.1. However, hybrid contracts with hosts that are assets within the scope of this Standard are always measured in accordance with paragraph 4.3.2.

B5.2.2 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income in accordance with either paragraph 5.7.5 or 4.1.2A. An entity acquires a financial asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income. If the financial asset is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A, the transaction costs are amortised to profit or loss using the effective interest method.

B5.2.2A The subsequent measurement of a financial asset or financial liability and the subsequent recognition of gains and losses described in paragraph B5.1.2A shall be consistent with the requirements of this Standard.

#### **Investments in equity instruments and contracts on those investments**

B5.2.3 All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

B5.2.4 Indicators that cost might not be representative of fair value include:

- (a) a significant change in the performance of the investee compared with budgets, plans or milestones.
- (b) changes in expectation that the investee's technical product milestones will be achieved.
- (c) a significant change in the market for the investee's equity or its products or potential products.
- (d) a significant change in the global economy or the economic environment in which the investee operates.
- (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.
- (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.
- (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

B5.2.5 The list in paragraph B5.2.4 is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.

B5.2.6 Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

## **Amortised cost measurement (Section 5.4)**

### **Effective interest method**

B5.4.1 In applying the effective interest method, an entity identifies fees that are an integral part of the effective interest rate of a financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

B5.4.2 Fees that are an integral part of the effective interest rate of a financial instrument include:

- (a) origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.
- (b) commitment fees received by the entity to originate a loan when the loan commitment is not measured in accordance with paragraph 4.2.1(a) and it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.
- (c) origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity

distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

- B5.4.3 Fees that are not an integral part of the effective interest rate of a financial instrument and are accounted for in accordance with SB-FRS 115 include:
- (a) fees charged for servicing a loan;
  - (b) commitment fees to originate a loan when the loan commitment is not measured in accordance with paragraph 4.2.1(a) and it is unlikely that a specific lending arrangement will be entered into; and
  - (c) loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).
- B5.4.4 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts that are included in the calculation of the effective interest rate over the expected life of the financial instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the financial instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating-rate financial instrument reflects the interest that has accrued on that financial instrument since the interest was last paid, or changes in the market rates since the floating interest rate was reset to the 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 (ie interest rates) is reset to the market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the financial instrument, or other variables that are not reset to the market rates, it is amortised over the expected life of the financial instrument.
- B5.4.5 For floating-rate financial assets and floating-rate financial liabilities, periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate. If a floating-rate financial asset or a 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 the liability.
- B5.4.6 If an entity revises its estimates of payments or receipts (excluding modifications in accordance with paragraph 5.4.3 and changes in estimates of expected credit losses), it shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. The adjustment is recognised in profit or loss as income or expense.
- B5.4.7 In some cases a financial asset is considered credit-impaired at initial recognition because the credit risk is very high, and in the case of a purchase it is acquired at a deep discount. An entity is required to include the initial expected credit losses in the estimated cash flows when calculating the credit-adjusted effective interest rate for financial assets that are considered to be purchased or originated credit-impaired at initial recognition. However, this does not mean that a credit-adjusted effective interest rate should be applied solely because the financial asset has high credit risk at initial recognition.

## Transaction costs

- B5.4.8 Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

## Write-off

- B5.4.9 Write-offs can relate to a financial asset in its entirety or to a portion of it. For example, an entity plans to enforce the collateral on a financial asset and expects to recover no more than 30 per cent of the financial asset from the collateral. If the entity has no reasonable prospects of recovering any further cash flows from the financial asset, it should write off the remaining 70 per cent of the financial asset.

## Impairment (Section 5.5)

### Collective and individual assessment basis

- B5.5.1 In order to meet the objective of recognising lifetime expected credit losses for significant increases in credit risk since initial recognition, it may be necessary to perform the assessment of significant increases in credit risk on a collective basis by considering information that is indicative of significant increases in credit risk on, for example, a group or sub-group of financial instruments. This is to ensure that an entity meets the objective of recognising lifetime expected credit losses when there are significant increases in credit risk, even if evidence of such significant increases in credit risk at the individual instrument level is not yet available.
- B5.5.2 Lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.
- B5.5.3 However, depending on the nature of the financial instruments and the credit risk information available for particular groups of financial instruments, an entity may not be able to identify significant changes in credit risk for individual financial instruments before the financial instrument becomes past due. This may be the case for financial instruments such as retail loans for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument until a customer breaches the contractual terms. If changes in the credit risk for individual financial instruments are not captured before they become past due, a loss allowance based only on credit information at an individual financial instrument level would not faithfully represent the changes in credit risk since initial recognition.
- B5.5.4 In some circumstances an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime expected credit losses on an individual instrument basis. In that case, lifetime expected credit losses shall be recognised on a collective basis that considers comprehensive credit risk information. This comprehensive credit risk information must incorporate not only past due information but also all relevant credit information, including forward-looking macroeconomic information, in order to approximate the result of recognising lifetime expected credit losses when there has been a significant increase in credit risk since initial recognition on an individual instrument level.
- B5.5.5 For the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk characteristics. Examples of shared credit risk characteristics may include, but are not limited to, the:

- (a) instrument type;
- (b) credit risk ratings;
- (c) collateral type;
- (d) date of initial recognition;
- (e) remaining term to maturity;
- (f) industry;
- (g) geographical location of the borrower; and
- (h) the value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios).

B5.5.6 Paragraph 5.5.4 requires that lifetime expected credit losses are recognised on all financial instruments for which there has been significant increases in credit risk since initial recognition. In order to meet this objective, if an entity is not able to group financial instruments for which the credit risk is considered to have increased significantly since initial recognition based on shared credit risk characteristics, the entity should recognise lifetime expected credit losses on a portion of the financial assets for which credit risk is deemed to have increased significantly. The aggregation of financial instruments to assess whether there are changes in credit risk on a collective basis may change over time as new information becomes available on groups of, or individual, financial instruments.

### **Timing of recognising lifetime expected credit losses**

- B5.5.7 The assessment of whether lifetime expected credit losses should be recognised is based on significant increases in the likelihood or risk of a default occurring since initial recognition (irrespective of whether a financial instrument has been repriced to reflect an increase in credit risk) instead of on evidence of a financial asset being credit-impaired at the reporting date or an actual default occurring. Generally, there will be a significant increase in credit risk before a financial asset becomes credit-impaired or an actual default occurs.
- B5.5.8 For loan commitments, an entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default on the contract.
- B5.5.9 The significance of a change in the credit risk since initial recognition depends on the risk of a default occurring as at initial recognition. Thus, a given change, in absolute terms, in the risk of a default occurring will be more significant for a financial instrument with a lower initial risk of a default occurring compared to a financial instrument with a higher initial risk of a default occurring.
- B5.5.10 The risk of a default occurring on financial instruments that have comparable credit risk is higher the longer the expected life of the instrument; for example, the risk of a default occurring on an AAA-rated bond with an expected life of 10 years is higher than that on an AAA-rated bond with an expected life of five years.
- B5.5.11 Because of the relationship between the expected life and the risk of a default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of a default occurring over time. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is identical to the risk of a default occurring on that financial instrument when its expected life in a subsequent period is only five years, that may indicate an increase in credit risk. This is because the risk of a default occurring over the expected life usually decreases as time passes if the credit risk is

unchanged and the financial instrument is closer to maturity. However, for financial instruments that only have significant payment obligations close to the maturity of the financial instrument the risk of a default occurring may not necessarily decrease as time passes. In such a case, an entity should also consider other qualitative factors that would demonstrate whether credit risk has increased significantly since initial recognition.

B5.5.12 An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition or when measuring expected credit losses. An entity may apply different approaches for different financial instruments. An approach that does not include an explicit probability of default as an input per se, such as a credit loss rate approach, can be consistent with the requirements in this Standard, provided that an entity is able to separate the changes in the risk of a default occurring from changes in other drivers of expected credit losses, such as collateral, and considers the following when making the assessment:

- (a) the change in the risk of a default occurring since initial recognition;
- (b) the expected life of the financial instrument; and
- (c) reasonable and supportable information that is available without undue cost or effort that may affect credit risk.

B5.5.13 The methods used to determine whether credit risk has increased significantly on a financial instrument since initial recognition should consider the characteristics of the financial instrument (or group of financial instruments) and the default patterns in the past for comparable financial instruments. Despite the requirement in paragraph 5.5.9, for financial instruments for which default patterns are not concentrated at a specific point during the expected life of the financial instrument, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of the changes in the lifetime risk of a default occurring. In such cases, an entity may use changes in the risk of a default occurring over the next 12 months to determine whether credit risk has increased significantly since initial recognition, unless circumstances indicate that a lifetime assessment is necessary.

B5.5.14 However, for some financial instruments, or in some circumstances, it may not be appropriate to use changes in the risk of a default occurring over the next 12 months to determine whether lifetime expected credit losses should be recognised. For example, the change in the risk of a default occurring in the next 12 months may not be a suitable basis for determining whether credit risk has increased on a financial instrument with a maturity of more than 12 months when:

- (a) the financial instrument only has significant payment obligations beyond the next 12 months;
- (b) changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months; or
- (c) changes in credit-related factors only have an impact on the credit risk of the financial instrument (or have a more pronounced effect) beyond 12 months.

### **Determining whether credit risk has increased significantly since initial recognition**

B5.5.15 When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect the credit risk on a financial instrument in accordance with paragraph 5.5.17(c). An entity need not undertake an exhaustive search for information when determining whether credit risk has increased significantly since initial recognition.

B5.5.16 Credit risk analysis is a multifactor and holistic analysis; whether a specific factor is relevant, and its weight compared to other factors, will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region. An entity shall

consider reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed. However, some factors or indicators may not be identifiable on an individual financial instrument level. In such a case, the factors or indicators should be assessed for appropriate portfolios, groups of portfolios or portions of a portfolio of financial instruments to determine whether the requirement in paragraph 5.5.3 for the recognition of lifetime expected credit losses has been met.

B5.5.17 The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

- (a) significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.
- (b) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.
- (c) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:
  - (i) the credit spread;
  - (ii) the credit default swap prices for the borrower;
  - (iii) the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and
  - (iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.
- (d) an actual or expected significant change in the financial instrument's external credit rating.
- (e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies.
- (f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.
- (g) an actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in the borrower's ability to meet its debt obligations.
- (h) significant increases in credit risk on other financial instruments of the same borrower.



- (i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology.
- (j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.
- (k) a significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion.
- (l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security).
- (m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument.
- (n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or significant increases in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount).
- (o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.
- (p) past due information, including the rebuttable presumption as set out in paragraph 5.5.11.

B5.5.18 In some cases, the qualitative and non-statistical quantitative information available may be sufficient to determine that a financial instrument has met the criterion for the recognition of a loss allowance at an amount equal to lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, ie qualitative factors that are not captured through the internal ratings process and a specific internal rating category at the reporting date, taking into consideration the credit risk characteristics at initial recognition, if both types of information are relevant.

*More than 30 days past due rebuttable presumption*

- B5.5.19 The rebuttable presumption in paragraph 5.5.11 is not an absolute indicator that lifetime expected credit losses should be recognised, but is presumed to be the latest point at which lifetime expected credit losses should be recognised even when using forward-looking information (including macroeconomic factors on a portfolio level).
- B5.5.20 An entity can rebut this presumption. However, it can do so only when it has reasonable and supportable information available that demonstrates that even if contractual payments become more than 30 days past due, this does not represent a significant increase in the credit risk of a financial instrument. For example when non-payment was an administrative oversight, instead of resulting from financial difficulty of the borrower, or the entity has access to historical evidence that demonstrates that there is no correlation between significant increases in the risk of a default occurring and financial assets on which payments are more than 30 days past due, but that evidence does identify such a correlation when payments are more than 60 days past due.
- B5.5.21 An entity cannot align the timing of significant increases in credit risk and the recognition of lifetime expected credit losses to when a financial asset is regarded as credit-impaired or an entity's internal definition of default.

*Financial instruments that have low credit risk at the reporting date*

- B5.5.22 The credit risk on a financial instrument is considered low for the purposes of paragraph 5.5.10, if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which an entity operates.
- B5.5.23 To determine whether a financial instrument has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed. An external rating of 'investment grade' is an example of a financial instrument that may be considered as having low credit risk. However, financial instruments are not required to be externally rated to be considered to have low credit risk. They should, however, be considered to have low credit risk from a market participant perspective taking into account all of the terms and conditions of the financial instrument.
- B5.5.24 Lifetime expected credit losses are not recognised on a financial instrument simply because it was considered to have low credit risk in the previous reporting period and is not considered to have low credit risk at the reporting date. In such a case, an entity shall determine whether there has been a significant increase in credit risk since initial recognition and thus whether lifetime expected credit losses are required to be recognised in accordance with paragraph 5.5.3.

**Modifications**

- B5.5.25 In some circumstances, the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset in accordance with this Standard. When the modification of a financial asset results in the derecognition of the existing financial asset and the subsequent recognition of the modified financial asset, the modified asset is considered a 'new' financial asset for the purposes of this Standard.
- B5.5.26 Accordingly the date of the modification shall be treated as the date of initial recognition of that financial asset when applying the impairment requirements to the modified financial asset. This typically means measuring the loss allowance at an amount equal to 12-month expected credit losses until the requirements for the recognition of lifetime expected credit losses in paragraph

5.5.3 are met. However, in some unusual circumstances following a modification that results in derecognition of the original financial asset, there may be evidence that the modified financial asset is credit-impaired at initial recognition, and thus, the financial asset should be recognised as an originated credit-impaired financial asset. This might occur, for example, in a situation in which there was a substantial modification of a distressed asset that resulted in the derecognition of the original financial asset. In such a case, it may be possible for the modification to result in a new financial asset which is credit-impaired at initial recognition.

B5.5.27 If the contractual cash flows on a financial asset have been renegotiated or otherwise modified, but the financial asset is not derecognised, that financial asset is not automatically considered to have lower credit risk. An entity shall assess whether there has been a significant increase in credit risk since initial recognition on the basis of all reasonable and supportable information that is available without undue cost or effort. This includes historical and forward-looking information and an assessment of the credit risk over the expected life of the financial asset, which includes information about the circumstances that led to the modification. Evidence that the criteria for the recognition of lifetime expected credit losses are no longer met may include a history of up-to-date and timely payment performance against the modified contractual terms. Typically a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms.

## Measurement of expected credit losses

### Expected credit losses

B5.5.28 Expected credit losses are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

B5.5.29 For financial assets, a credit loss is the present value of the difference between:

- (a) the contractual cash flows that are due to an entity under the contract; and
- (b) the cash flows that the entity expects to receive.

B5.5.30 For undrawn loan commitments, a credit loss is the present value of the difference between:

- (a) the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan; and
- (b) the cash flows that the entity expects to receive if the loan is drawn down.

B5.5.31 An entity's estimate of expected credit losses on loan commitments shall be consistent with its expectations of drawdowns on that loan commitment, ie it shall consider the expected portion of the loan commitment that will be drawn down within 12 months of the reporting date when estimating 12-month expected credit losses, and the expected portion of the loan commitment that will be drawn down over the expected life of the loan commitment when estimating lifetime expected credit losses.

B5.5.32 For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

- B5.5.33 For a financial asset that is credit-impaired at the reporting date, but that is not a purchased or originated credit-impaired financial asset, an entity shall measure the expected credit losses as the difference between the asset's gross carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. Any adjustment is recognised in profit or loss as an impairment gain or loss.
- B5.5.34 When measuring a loss allowance for a lease receivable, the cash flows used for determining the expected credit losses should be consistent with the cash flows used in measuring the lease receivable in accordance with SB-FRS 17 *Leases*.
- B5.5.35 An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17. An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience (adjusted as appropriate in accordance with paragraphs B5.5.51–B5.5.52) for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90–180 days past due etc). Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

### **Definition of default**

- B5.5.36 Paragraph 5.5.9 requires that when determining whether the credit risk on a financial instrument has increased significantly, an entity shall consider the change in the risk of a default occurring since initial recognition.
- B5.5.37 When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes shall be applied consistently to all financial instruments unless information becomes available that demonstrates that another default definition is more appropriate for a particular financial instrument.

### **Period over which to estimate expected credit losses**

- B5.5.38 In accordance with paragraph 5.5.19, the maximum period over which expected credit losses shall be measured is the maximum contractual period over which the entity is exposed to credit risk. For loan commitments and financial guarantee contracts, this is the maximum contractual period over which an entity has a present contractual obligation to extend credit.
- B5.5.39 However, in accordance with paragraph 5.5.20, some financial instruments include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For example, revolving credit facilities, such as credit cards and overdraft facilities, can be contractually withdrawn by the lender with as little as one day's notice. However, in practice lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases, which could be too late to prevent some or all of the expected credit losses. These financial instruments generally have the following characteristics as a result of the nature of the financial instrument,

the way in which the financial instruments are managed, and the nature of the available information about significant increases in credit risk:

- (a) the financial instruments do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day);
- (b) the contractual ability to cancel the contract is not enforced in the normal day-to-day management of the financial instrument and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level; and
- (c) the financial instruments are managed on a collective basis.

B5.5.40 When determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions, an entity should consider factors such as historical information and experience about:

- (a) the period over which the entity was exposed to credit risk on similar financial instruments;
- (b) the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and
- (c) the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

### **Probability-weighted outcome**

B5.5.41 The purpose of estimating expected credit losses is neither to estimate a worst-case scenario nor to estimate the best-case scenario. Instead, an estimate of expected credit losses shall always reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs even if the most likely outcome is no credit loss.

B5.5.42 Paragraph 5.5.17(a) requires the estimate of expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. In practice, this may not need to be a complex analysis. In some cases, relatively simple modelling may be sufficient, without the need for a large number of detailed simulations of scenarios. For example, the average credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. In those situations, the expected credit losses shall reflect at least two outcomes in accordance with paragraph 5.5.18.

B5.5.43 For lifetime expected credit losses, an entity shall estimate the risk of a default occurring on the financial instrument during its expected life. 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring. Thus, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months nor the cash shortfalls that are predicted over the next 12 months.

### **Time value of money**

B5.5.44 Expected credit losses shall be discounted to the reporting date, not to the expected default or some other date, using the effective interest rate determined at initial recognition or an approximation thereof. If a financial instrument has a variable interest rate, expected credit losses shall be discounted using the current effective interest rate determined in accordance with paragraph B5.4.5.

- B5.5.45 For purchased or originated credit-impaired financial assets, expected credit losses shall be discounted using the credit-adjusted effective interest rate determined at initial recognition.
- B5.5.46 Expected credit losses on lease receivables shall be discounted using the same discount rate used in the measurement of the lease receivable in accordance with SB-FRS 17.
- B5.5.47 The expected credit losses on a loan commitment shall be discounted using the effective interest rate, or an approximation thereof, that will be applied when recognising the financial asset resulting from the loan commitment. This is because for the purpose of applying the impairment requirements, a financial asset that is recognised following a draw down on a loan commitment shall be treated as a continuation of that commitment instead of as a new financial instrument. The expected credit losses on the financial asset shall therefore be measured considering the initial credit risk of the loan commitment from the date that the entity became a party to the irrevocable commitment.
- B5.5.48 Expected credit losses on financial guarantee contracts or on loan commitments for which the effective interest rate cannot be determined shall be discounted by applying a discount rate that reflects the current market assessment of the time value of money and the risks that are specific to the cash flows but only if, and to the extent that, the risks are taken into account by adjusting the discount rate instead of adjusting the cash shortfalls being discounted.

### **Reasonable and supportable information**

- B5.5.49 For the purpose of this Standard, reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions. Information that is available for financial reporting purposes is considered to be available without undue cost or effort.
- B5.5.50 An entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument. The degree of judgement that is required to estimate expected credit losses depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement required to estimate expected credit losses increases. The estimate of expected credit losses does not require a detailed estimate for periods that are far in the future—for such periods, an entity may extrapolate projections from available, detailed information.
- B5.5.51 An entity need not undertake an exhaustive search for information but shall consider all reasonable and supportable information that is available without undue cost or effort and that is relevant to the estimate of expected credit losses, including the effect of expected prepayments. The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, that may be both internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).
- B5.5.52 Historical information is an important anchor or base from which to measure expected credit losses. However, an entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows. In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered. Estimates of changes in expected credit losses should reflect, and be directionally consistent with, changes in related observable

data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience.

- B5.5.53 When using historical credit loss experience in estimating expected credit losses, it is important that information about historical credit loss rates is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit loss rates were observed. Consequently, the method used shall enable each group of financial assets to be associated with information about past credit loss experience in groups of financial assets with similar risk characteristics and with relevant observable data that reflects current conditions.
- B5.5.54 Expected credit losses reflect an entity's own expectations of credit losses. However, when considering all reasonable and supportable information that is available without undue cost or effort in estimating expected credit losses, an entity should also consider observable market information about the credit risk of the particular financial instrument or similar financial instruments.

### **Collateral**

- B5.5.55 For the purposes of measuring expected credit losses, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity. The estimate of expected cash shortfalls on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable (ie the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset in this or other Standards.

### **Reclassification of financial assets (Section 5.6)**

- B5.6.1 If an entity reclassifies financial assets in accordance with paragraph 4.4.1, paragraph 5.6.1 requires that the reclassification is applied prospectively from the reclassification date. Both the amortised cost measurement category and the fair value through other comprehensive income measurement category require that the effective interest rate is determined at initial recognition. Both of those measurement categories also require that the impairment requirements are applied in the same way. Consequently, when an entity reclassifies a financial asset between the amortised cost measurement category and the fair value through other comprehensive income measurement category:
- (a) the recognition of interest revenue will not change and therefore the entity continues to use the same effective interest rate.
  - (b) the measurement of expected credit losses will not change because both measurement categories apply the same impairment approach. However if a financial asset is reclassified out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category, a loss allowance would be recognised as an adjustment to the gross carrying amount of the financial asset from the reclassification date. If a financial asset is reclassified out of the amortised cost measurement category and into the fair value through other comprehensive income measurement category, the loss allowance would be derecognised (and thus would no longer be recognised as an adjustment to the gross carrying amount) but instead would be recognised as an accumulated impairment amount (of an equal amount) in other comprehensive income and would be disclosed from the reclassification date.

B5.6.2 However, an entity is not required to separately recognise interest revenue or impairment gains or losses for a financial asset measured at fair value through profit or loss. Consequently, when an entity reclassifies a financial asset out of the fair value through profit or loss measurement category, the effective interest rate is determined on the basis of the fair value of the asset at the reclassification date. In addition, for the purposes of applying Section 5.5 to the financial asset from the reclassification date, the date of the reclassification is treated as the date of initial recognition.

## **Gains and losses (Section 5.7)**

B5.7.1 Paragraph 5.7.5 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. This election is made on an instrument-by-instrument (ie share-by-share) basis. Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity. Dividends on such investments are recognised in profit or loss in accordance with paragraph 5.7.6 unless the dividend clearly represents a recovery of part of the cost of the investment.

B5.7.1A Unless paragraph 4.1.5 applies, paragraph 4.1.2A requires that a financial asset is measured at fair value through other comprehensive income if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and the asset is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. This measurement category recognises information in profit or loss as if the financial asset is measured at amortised cost, while the financial asset is measured in the statement of financial position at fair value. Gains or losses, other than those that are recognised in profit or loss in accordance with paragraphs 5.7.10–5.7.11, are recognised in other comprehensive income. When these financial assets are derecognised, cumulative gains or losses previously recognised in other comprehensive income are reclassified to profit or loss. This reflects the gain or loss that would have been recognised in profit or loss upon derecognition if the financial asset had been measured at amortised cost.

B5.7.2 An entity applies SB-FRS 21 to financial assets and financial liabilities that are monetary items in accordance with SB-FRS 21 and denominated in a foreign currency. SB-FRS 21 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in a cash flow hedge (see paragraph 6.5.11), a hedge of a net investment (see paragraph 6.5.13) or a fair value hedge of an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5 (see paragraph 6.5.8).

B5.7.2A For the purpose of recognising foreign exchange gains and losses under SB-FRS 21, a financial asset measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A is treated as a monetary item. Accordingly, such a financial asset is treated as an asset measured at amortised cost in the foreign currency. Exchange differences on the amortised cost are recognised in profit or loss and other changes in the carrying amount are recognised in accordance with paragraph 5.7.10.

B5.7.3 Paragraph 5.7.5 permits an entity to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of particular investments in equity instruments. Such an investment is not a monetary item. Accordingly, the gain or loss that is presented in other comprehensive income in accordance with paragraph 5.7.5 includes any related foreign exchange component.

B5.7.4 If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in profit or loss.



**Liabilities designated as at fair value through profit or loss**

- B5.7.5 When an entity designates a financial liability as at fair value through profit or loss, it must determine whether presenting in other comprehensive income the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss. An accounting mismatch would be created or enlarged if presenting the effects of changes in the liability's credit risk in other comprehensive income would result in a greater mismatch in profit or loss than if those amounts were presented in profit or loss.
- B5.7.6 To make that determination, an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument measured at fair value through profit or loss. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument.
- B5.7.7 That determination is made at initial recognition and is not reassessed. For practical purposes the entity need not enter into all of the assets and liabilities giving rise to an accounting mismatch at exactly the same time. A reasonable delay is permitted provided that any remaining transactions are expected to occur. An entity must apply consistently its methodology for determining whether presenting in other comprehensive income the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss. However, an entity may use different methodologies when there are different economic relationships between the characteristics of the liabilities designated as at fair value through profit or loss and the characteristics of the other financial instruments. SB-FRS 107 requires an entity to provide qualitative disclosures in the notes to the financial statements about its methodology for making that determination.
- B5.7.8 If such a mismatch would be created or enlarged, the entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in profit or loss. If such a mismatch would not be created or enlarged, the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income.
- B5.7.9 Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity.
- B5.7.10 The following example describes a situation in which an accounting mismatch would be created in profit or loss if the effects of changes in the credit risk of the liability were presented in other comprehensive income. A mortgage bank provides loans to customers and funds those loans by selling bonds with matching characteristics (eg amount outstanding, repayment profile, term and currency) in the market. The contractual terms of the loan permit the mortgage customer to prepay its loan (ie satisfy its obligation to the bank) by buying the corresponding bond at fair value in the market and delivering that bond to the mortgage bank. As a result of that contractual prepayment right, if the credit quality of the bond worsens (and, thus, the fair value of the mortgage bank's liability decreases), the fair value of the mortgage bank's loan asset also decreases. The change in the fair value of the asset reflects the mortgage customer's contractual right to prepay the mortgage loan by buying the underlying bond at fair value (which, in this example, has decreased) and delivering the bond to the mortgage bank. Consequently, the effects of changes in the credit risk of the liability (the bond) will be offset in profit or loss by a corresponding change in the fair value of a financial asset (the loan). If the effects of changes in the liability's credit risk were presented in other comprehensive income there would be an accounting mismatch in profit or loss. Consequently, the mortgage bank is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in profit or loss.
- B5.7.11 In the example in paragraph B5.7.10, there is a contractual linkage between the effects of changes in the credit risk of the liability and changes in the fair value of the financial asset (ie as a result of the mortgage customer's contractual right to prepay the loan by buying the bond at fair value and delivering the bond to the mortgage bank). However, an accounting mismatch may also occur in the absence of a contractual linkage.

B5.7.12 For the purposes of applying the requirements in paragraphs 5.7.7 and 5.7.8, an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk. An accounting mismatch in profit or loss would arise only when the effects of changes in the liability's credit risk (as defined in SB-FRS 107) are expected to be offset by changes in the fair value of another financial instrument. A mismatch that arises solely as a result of the measurement method (ie because an entity does not isolate changes in a liability's credit risk from some other changes in its fair value) does not affect the determination required by paragraphs 5.7.7 and 5.7.8. For example, an entity may not isolate changes in a liability's credit risk from changes in liquidity risk. If the entity presents the combined effect of both factors in other comprehensive income, a mismatch may occur because changes in liquidity risk may be included in the fair value measurement of the entity's financial assets and the entire fair value change of those assets is presented in profit or loss. However, such a mismatch is caused by measurement imprecision, not the offsetting relationship described in paragraph B5.7.6 and, therefore, does not affect the determination required by paragraphs 5.7.7 and 5.7.8.

*The meaning of 'credit risk' (paragraphs 5.7.7 and 5.7.8)*

B5.7.13 SB-FRS 107 defines credit risk as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. The requirement in paragraph 5.7.7(a) relates to the risk that the issuer will fail to perform on that particular liability. It does not necessarily relate to the creditworthiness of the issuer. For example, if an entity issues a collateralised liability and a non-collateralised liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero.

B5.7.14 For the purposes of applying the requirement in paragraph 5.7.7(a), credit risk is different from asset-specific performance risk. Asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but instead it is related to the risk that a single asset or a group of assets will perform poorly (or not at all).

B5.7.15 The following are examples of asset-specific performance risk:

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

*Determining the effects of changes in credit risk*

B5.7.16 For the purposes of applying the requirement in paragraph 5.7.7(a), an entity shall determine the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability either:

- (a) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see paragraphs B5.7.17 and B5.7.18); or
- (b) using an alternative method the entity believes more faithfully represents the amount of change in the liability's fair value that is attributable to changes in its credit risk.

- B5.7.17 Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates.
- B5.7.18 If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount in paragraph B5.7.16(a) can be estimated as follows:
- (a) First, the entity computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.
  - (b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).
  - (c) The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).
- B5.7.19 The example in paragraph B5.7.18 assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in observed (benchmark) interest rates are not significant. This method would not be appropriate if changes in fair value arising from other factors are significant. In those cases, an entity is required to use an alternative method that more faithfully measures the effects of changes in the liability's credit risk (see paragraph B5.7.16(b)). For example, if the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).
- B5.7.20 As with all fair value measurements, an entity's measurement method for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk must make maximum use of relevant observable inputs and minimum use of unobservable inputs.

## Hedge accounting (Chapter 6)

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### Hedging instruments (Section 6.2)

#### Qualifying instruments

- B6.2.1 Derivatives that are embedded in hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments.
- B6.2.2 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.
- B6.2.3 For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument is determined in accordance with SB-FRS 21.

#### *Written options*

- B6.2.4 This Standard does not restrict the circumstances in which a derivative that is measured at fair value through profit or loss may be designated as a hedging instrument, except for some

written options. A written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability).

### **Designation of hedging instruments**

- B6.2.5 For hedges other than hedges of foreign currency risk, when an entity designates a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss as a hedging instrument, it may only designate the non-derivative financial instrument in its entirety or a proportion of it.
- B6.2.6 A single hedging instrument may be designated as a hedging instrument of more than one type of risk, provided that there is a specific designation of the hedging instrument and of the different risk positions as hedged items. Those hedged items can be in different hedging relationships.

### **Hedged items (Section 6.3)**

#### **Qualifying items**

- B6.3.1 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.
- B6.3.2 An equity method investment cannot be a hedged item in a fair value hedge. This is because the equity method recognises in profit or loss the investor's share of the investee's profit or loss, instead of changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge. This is because consolidation recognises in profit or loss the subsidiary's profit or loss, instead of changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.
- B6.3.3 Paragraph 6.3.4 permits an entity to designate as hedged items aggregated exposures that are a combination of an exposure and a derivative. When designating such a hedged item, an entity assesses whether the aggregated exposure combines an exposure with a derivative so that it creates a different aggregated exposure that is managed as one exposure for a particular risk (or risks). In that case, the entity may designate the hedged item on the basis of the aggregated exposure. For example:
- (a) an entity may hedge a given quantity of highly probable coffee purchases in 15 months' time against price risk (based on US dollars) using a 15-month futures contract for coffee. The highly probable coffee purchases and the futures contract for coffee in combination can be viewed as a 15-month fixed-amount US dollar foreign currency risk exposure for risk management purposes (ie like any fixed-amount US dollar cash outflow in 15 months' time).
  - (b) an entity may hedge the foreign currency risk for the entire term of a 10-year fixed-rate debt denominated in a foreign currency. However, the entity requires fixed-rate exposure in its functional currency only for a short to medium term (say two years) and floating rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years' interest rate exposure (if the interest level is such that the entity wants to fix interest rates). In such a situation an entity may enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed-rate foreign currency debt into a variable-rate functional currency exposure. This is overlaid with a two-year interest rate swap that—on the basis of the functional currency—swaps variable-rate debt into fixed-rate debt. In effect, the fixed-rate foreign currency debt and the 10-year

fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable-rate debt functional currency exposure for risk management purposes.

B6.3.4 When designating the hedged item on the basis of the aggregated exposure, an entity considers the combined effect of the items that constitute the aggregated exposure for the purpose of assessing hedge effectiveness and measuring hedge ineffectiveness. However, the items that constitute the aggregated exposure remain accounted for separately. This means that, for example:

- (a) derivatives that are part of an aggregated exposure are recognised as separate assets or liabilities measured at fair value; and
- (b) if a hedging relationship is designated between the items that constitute the aggregated exposure, the way in which a derivative is included as part of an aggregated exposure must be consistent with the designation of that derivative as the hedging instrument at the level of the aggregated exposure. For example, if an entity excludes the forward element of a derivative from its designation as the hedging instrument for the hedging relationship between the items that constitute the aggregated exposure, it must also exclude the forward element when including that derivative as a hedged item as part of the aggregated exposure. Otherwise, the aggregated exposure shall include a derivative, either in its entirety or a proportion of it.

B6.3.5 Paragraph 6.3.6 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and that the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint arrangement or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group, unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

B6.3.6 If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss is recognised in, and taken out of, other comprehensive income in accordance with paragraph 6.5.11. The relevant period or periods during which the foreign currency risk of the hedged transaction affects profit or loss is when it affects consolidated profit or loss.

### **Designation of hedged items**

B6.3.7 A component is a hedged item that is less than the entire item. Consequently, a component reflects only some of the risks of the item of which it is a part or reflects the risks only to some extent (for example, when designating a proportion of an item).

### *Risk components*

B6.3.8 To be eligible for designation as a hedged item, a risk component must be a separately identifiable component of the financial or the non-financial item, and the changes in the cash flows or the fair value of the item attributable to changes in that risk component must be reliably measurable.

B6.3.9 When identifying what risk components qualify for designation as a hedged item, an entity assesses such risk components within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market.

B6.3.10 When designating risk components as hedged items, an entity considers whether the risk components are explicitly specified in a contract (contractually specified risk components) or whether they are implicit in the fair value or the cash flows of an item of which they are a part (non-contractually specified risk components). Non-contractually specified risk components can relate to items that are not a contract (for example, forecast transactions) or contracts that do not explicitly specify the component (for example, a firm commitment that includes only one single price instead of a pricing formula that references different underlyings). For example:

- (a) Entity A has a long-term supply contract for natural gas that is priced using a contractually specified formula that references commodities and other factors (for example, gas oil, fuel oil and other components such as transport charges). Entity A hedges the gas oil component in that supply contract using a gas oil forward contract. Because the gas oil component is specified by the terms and conditions of the supply contract it is a contractually specified risk component. Hence, because of the pricing formula, Entity A concludes that the gas oil price exposure is separately identifiable. At the same time, there is a market for gas oil forward contracts. Hence, Entity A concludes that the gas oil price exposure is reliably measurable. Consequently, the gas oil price exposure in the supply contract is a risk component that is eligible for designation as a hedged item.
- (b) Entity B hedges its future coffee purchases based on its production forecast. Hedging starts up to 15 months before delivery for part of the forecast purchase volume. Entity B increases the hedged volume over time (as the delivery date approaches). Entity B uses two different types of contracts to manage its coffee price risk:
  - (i) exchange-traded coffee futures contracts; and
  - (ii) coffee supply contracts for Arabica coffee from Colombia delivered to a specific manufacturing site. These contracts price a tonne of coffee based on the exchange-traded coffee futures contract price plus a fixed price differential plus a variable logistics services charge using a pricing formula. The coffee supply contract is an executory contract in accordance with which Entity B takes actual delivery of coffee.

For deliveries that relate to the current harvest, entering into the coffee supply contracts allows Entity B to fix the price differential between the actual coffee quality purchased (Arabica coffee from Colombia) and the benchmark quality that is the underlying of the exchange-traded futures contract. However, for deliveries that relate to the next harvest, the coffee supply contracts are not yet available, so the price differential cannot be fixed. Entity B uses exchange-traded coffee futures contracts to hedge the benchmark quality component of its coffee price risk for deliveries that relate to the current harvest as well as the next harvest. Entity B determines that it is exposed to three different risks: coffee price risk reflecting the benchmark quality, coffee price risk reflecting the difference (spread) between the price for the benchmark quality coffee and the particular Arabica coffee from Colombia that it actually receives, and the variable logistics costs. For deliveries related to the current harvest, after Entity B enters into a coffee supply contract, the coffee price risk reflecting the benchmark quality is a contractually specified risk component because the pricing formula includes an indexation to the exchange-traded coffee futures contract price. Entity B concludes that this risk component is separately identifiable and reliably measurable. For deliveries related to the next harvest, Entity B has not yet entered into any coffee supply contracts (ie those deliveries are forecast transactions). Hence, the coffee price risk reflecting the benchmark quality is a non-contractually specified risk component. Entity B's analysis of the market structure takes into account how eventual deliveries of the particular coffee that it receives are priced. Hence, on the basis of this analysis of the market

structure, Entity B concludes that the forecast transactions also involve the coffee price risk that reflects the benchmark quality as a risk component that is separately identifiable and reliably measurable even though it is not contractually specified. Consequently, Entity B may designate hedging relationships on a risk components basis (for the coffee price risk that reflects the benchmark quality) for coffee supply contracts as well as forecast transactions.

- (c) Entity C hedges part of its future jet fuel purchases on the basis of its consumption forecast up to 24 months before delivery and increases the volume that it hedges over time. Entity C hedges this exposure using different types of contracts depending on the time horizon of the hedge, which affects the market liquidity of the derivatives. For the longer time horizons (12–24 months) Entity C uses crude oil contracts because only these have sufficient market liquidity. For time horizons of 6–12 months Entity C uses gas oil derivatives because they are sufficiently liquid. For time horizons up to six months Entity C uses jet fuel contracts. Entity C's analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances is as follows:
- (i) Entity C operates in a geographical area in which Brent is the crude oil benchmark. Crude oil is a raw material benchmark that affects the price of various refined oil products as their most basic input. Gas oil is a benchmark for refined oil products, which is used as a pricing reference for oil distillates more generally. This is also reflected in the types of derivative financial instruments for the crude oil and refined oil products markets of the environment in which Entity C operates, such as:
- the benchmark crude oil futures contract, which is for Brent crude oil;
  - the benchmark gas oil futures contract, which is used as the pricing reference for distillates—for example, jet fuel spread derivatives cover the price differential between jet fuel and that benchmark gas oil; and
  - the benchmark gas oil crack spread derivative (ie the derivative for the price differential between crude oil and gas oil—a refining margin), which is indexed to Brent crude oil.
- (ii) the pricing of refined oil products does not depend on which particular crude oil is processed by a particular refinery because those refined oil products (such as gas oil or jet fuel) are standardised products.

Hence, Entity C concludes that the price risk of its jet fuel purchases includes a crude oil price risk component based on Brent crude oil and a gas oil price risk component, even though crude oil and gas oil are not specified in any contractual arrangement. Entity C concludes that these two risk components are separately identifiable and reliably measurable even though they are not contractually specified. Consequently, Entity C may designate hedging relationships for forecast jet fuel purchases on a risk components basis (for crude oil or gas oil). This analysis also means that if, for example, Entity C used crude oil derivatives based on West Texas Intermediate (WTI) crude oil, changes in the price differential between Brent crude oil and WTI crude oil would cause hedge ineffectiveness.

- (d) Entity D holds a fixed-rate debt instrument. This instrument is issued in an environment with a market in which a large variety of similar debt instruments are compared by their spreads to a benchmark rate (for example, LIBOR) and variable-rate instruments in that environment are typically indexed to that benchmark rate. Interest rate swaps are frequently used to manage interest rate risk on the basis of that benchmark rate, irrespective of the spread of debt instruments to that benchmark rate. The price of fixed-rate debt instruments varies directly in response to changes in the benchmark rate as they happen. Entity D concludes that the benchmark rate is a component that can be separately identified and reliably measured. Consequently, Entity D may designate

hedging relationships for the fixed-rate debt instrument on a risk component basis for the benchmark interest rate risk.

- B6.3.11 When designating a risk component as a hedged item, the hedge accounting requirements apply to that risk component in the same way as they apply to other hedged items that are not risk components. For example, the qualifying criteria apply, including that the hedging relationship must meet the hedge effectiveness requirements, and any hedge ineffectiveness must be measured and recognised.
- B6.3.12 An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a 'one-sided risk'). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, the entity designates only cash flow losses that result from an increase in the price above the specified level. The hedged risk does not include the time value of a purchased option, because the time value is not a component of the forecast transaction that affects profit or loss.
- B6.3.13 There is a rebuttable presumption that unless inflation risk is contractually specified, it is not separately identifiable and reliably measurable and hence cannot be designated as a risk component of a financial instrument. However, in limited cases, it is possible to identify a risk component for inflation risk that is separately identifiable and reliably measurable because of the particular circumstances of the inflation environment and the relevant debt market.
- B6.3.14 For example, an entity issues debt in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. This means that for the respective currency, inflation is a relevant factor that is separately considered by the debt markets. In those circumstances the inflation risk component could be determined by discounting the cash flows of the hedged debt instrument using the term structure of zero-coupon real interest rates (ie in a manner similar to how a risk-free (nominal) interest rate component can be determined). Conversely, in many cases an inflation risk component is not separately identifiable and reliably measurable. For example, an entity issues only nominal interest rate debt in an environment with a market for inflation-linked bonds that is not sufficiently liquid to allow a term structure of zero-coupon real interest rates to be constructed. In this case the analysis of the market structure and of the facts and circumstances does not support the entity concluding that inflation is a relevant factor that is separately considered by the debt markets. Hence, the entity cannot overcome the rebuttable presumption that inflation risk that is not contractually specified is not separately identifiable and reliably measurable. Consequently, an inflation risk component would not be eligible for designation as the hedged item. This applies irrespective of any inflation hedging instrument that the entity has actually entered into. In particular, the entity cannot simply impute the terms and conditions of the actual inflation hedging instrument by projecting its terms and conditions onto the nominal interest rate debt.
- B6.3.15 A contractually specified inflation risk component of the cash flows of a recognised inflation-linked bond (assuming that there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable, as long as other cash flows of the instrument are not affected by the inflation risk component.

#### *Components of a nominal amount*

- B6.3.16 There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component. The type of component changes the accounting outcome. An entity shall designate the component for accounting purposes consistently with its risk management objective.
- B6.3.17 An example of a component that is a proportion is 50 per cent of the contractual cash flows of a loan.



B6.3.18 A layer component may be specified from a defined, but open, population, or from a defined nominal amount. Examples include:

- (a) part of a monetary transaction volume, for example, the next FC10 cash flows from sales denominated in a foreign currency after the first FC20 in March 201X;<sup>4</sup>
- (b) a part of a physical volume, for example, the bottom layer, measuring 5 million cubic metres, of the natural gas stored in location XYZ;
- (c) a part of a physical or other transaction volume, for example, the first 100 barrels of the oil purchases in June 201X or the first 100 MWh of electricity sales in June 201X; or
- (d) a layer from the nominal amount of the hedged item, for example, the last CU80 million of a CU100 million firm commitment, the bottom layer of CU20 million of a CU100 million fixed-rate bond or the top layer of CU30 million from a total amount of CU100 million of fixed-rate debt that can be prepaid at fair value (the defined nominal amount is CU100 million).

B6.3.19 If a layer component is designated in a fair value hedge, an entity shall specify it from a defined nominal amount. To comply with the requirements for qualifying fair value hedges, an entity shall remeasure the hedged item for fair value changes (ie remeasure the item for fair value changes attributable to the hedged risk). The fair value hedge adjustment must be recognised in profit or loss no later than when the item is derecognised. Consequently, it is necessary to track the item to which the fair value hedge adjustment relates. For a layer component in a fair value hedge, this requires an entity to track the nominal amount from which it is defined. For example, in paragraph B6.3.18(d), the total defined nominal amount of CU100 million must be tracked in order to track the bottom layer of CU20 million or the top layer of CU30 million.

B6.3.20 A layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the prepayment option's fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.

#### *Relationship between components and the total cash flows of an item*

B6.3.21 If a component of the cash flows of a financial or a non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item. However, all of the cash flows of the entire item may be designated as the hedged item and hedged for only one particular risk (for example, only for those changes that are attributable to changes in LIBOR or a benchmark commodity price).

B6.3.22 For example, in the case of a financial liability whose effective interest rate is below LIBOR, an entity cannot designate:

- (a) a component of the liability equal to interest at LIBOR (plus the principal amount in case of a fair value hedge); and
- (b) a negative residual component.

B6.3.23 However, in the case of a fixed-rate financial liability whose effective interest rate is (for example) 100 basis points below LIBOR, an entity can designate as the hedged item the change in the value of that entire liability (ie principal plus interest at LIBOR minus 100 basis points) that is attributable to changes in LIBOR. If a fixed-rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a risk component equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day when it first designates the hedged item. For example, assume that an

<sup>4</sup> In this Standard monetary amounts are denominated in 'currency units' (CU) and 'foreign currency units' (FC).

entity originates a fixed-rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates the related LIBOR interest rate risk as the hedged item, the effective yield of the asset based on its then fair value of CU90 would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR component of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (ie CU90) and the amount repayable on maturity (ie CU100).

- B6.3.24 If a variable-rate financial liability bears interest of (for example) three-month LIBOR minus 20 basis points (with a floor at zero basis points), an entity can designate as the hedged item the change in the cash flows of that entire liability (ie three-month LIBOR minus 20 basis points—including the floor) that is attributable to changes in LIBOR. Hence, as long as the three-month LIBOR forward curve for the remaining life of that liability does not fall below 20 basis points, the hedged item has the same cash flow variability as a liability that bears interest at three-month LIBOR with a zero or positive spread. However, if the three-month LIBOR forward curve for the remaining life of that liability (or a part of it) falls below 20 basis points, the hedged item has a lower cash flow variability than a liability that bears interest at three-month LIBOR with a zero or positive spread.
- B6.3.25 A similar example of a non-financial item is a specific type of crude oil from a particular oil field that is priced off the relevant benchmark crude oil. If an entity sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at the benchmark crude oil price minus CU10 with a floor of CU15, the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in the benchmark crude oil price. Hence, as long as the forward price (for each delivery) does not fall below CU25, the hedged item has the same cash flow variability as a crude oil sale at the benchmark crude oil price (or with a positive spread). However, if the forward price for any delivery falls below CU25, the hedged item has a lower cash flow variability than a crude oil sale at the benchmark crude oil price (or with a positive spread).

## **Qualifying criteria for hedge accounting (Section 6.4)**

### **Hedge effectiveness**

- B6.4.1 Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item.
- B6.4.2 When designating a hedging relationship and on an ongoing basis, an entity shall analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis (including any updates in accordance with paragraph B6.5.21 arising from rebalancing a hedging relationship) is the basis for the entity's assessment of meeting the hedge effectiveness requirements.
- B6.4.3 For the avoidance of doubt, the effects of replacing the original counterparty with a clearing counterparty and making the associated changes as described in paragraph 6.5.6 shall be reflected in the measurement of the hedging instrument and therefore in the assessment of hedge effectiveness and the measurement of hedge effectiveness.

### **Economic relationship between the hedged item and the hedging instrument**

- B6.4.4 The requirement that an economic relationship exists means that the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk. Hence, there must be an expectation that the value of the hedging instrument and the value of the hedged item will systematically change in response to movements in either the same underlying or underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged (for example, Brent and WTI crude oil).
- B6.4.5 If the underlyings are not the same but are economically related, there can be situations in which the values of the hedging instrument and the hedged item move in the same direction, for example, because the price differential between the two related underlyings changes while the underlyings themselves do not move significantly. That is still consistent with an economic relationship between the hedging instrument and the hedged item if the values of the hedging instrument and the hedged item are still expected to typically move in the opposite direction when the underlyings move.
- B6.4.6 The assessment of whether an economic relationship exists includes an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it can be expected to meet the risk management objective. The mere existence of a statistical correlation between two variables does not, by itself, support a valid conclusion that an economic relationship exists.

### **The effect of credit risk**

- B6.4.7 Because the hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item, hedge effectiveness is determined not only by the economic relationship between those items (ie the changes in their underlyings) but also by the effect of credit risk on the value of both the hedging instrument and the hedged item. The effect of credit risk means that even if there is an economic relationship between the hedging instrument and the hedged item, the level of offset might become erratic. This can result from a change in the credit risk of either the hedging instrument or the hedged item that is of such a magnitude that the credit risk dominates the value changes that result from the economic relationship (ie the effect of the changes in the underlyings). A level of magnitude that gives rise to dominance is one that would result in the loss (or gain) from credit risk frustrating the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant. Conversely, if during a particular period there is little change in the underlyings, the fact that even small credit risk-related changes in the value of the hedging instrument or the hedged item might affect the value more than the underlyings does not create dominance.
- B6.4.8 An example of credit risk dominating a hedging relationship is when an entity hedges an exposure to commodity price risk using an uncollateralised derivative. If the counterparty to that derivative experiences a severe deterioration in its credit standing, the effect of the changes in the counterparty's credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument, whereas changes in the value of the hedged item depend largely on the commodity price changes.

### **Hedge ratio**

- B6.4.9 In accordance with the hedge effectiveness requirements, the hedge ratio of the hedging relationship must be the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. Hence, if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from 85 per cent of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 85 per cent. Similarly, if, for example, an entity hedges an exposure using a nominal amount of 40 units of a financial instrument, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from that quantity of 40 units (ie the entity must not use a hedge ratio based on

a higher quantity of units that it might hold in total or a lower quantity of units) and the quantity of the hedged item that it actually hedges with those 40 units.

B6.4.10 However, the designation of the hedging relationship using the same hedge ratio as that resulting from the quantities of the hedged item and the hedging instrument that the entity actually uses shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would in turn create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. Hence, for the purpose of designating a hedging relationship, an entity must adjust the hedge ratio that results from the quantities of the hedged item and the hedging instrument that the entity actually uses if that is needed to avoid such an imbalance.

B6.4.11 Examples of relevant considerations in assessing whether an accounting outcome is inconsistent with the purpose of hedge accounting are:

- (a) whether the intended hedge ratio is established to avoid recognising hedge ineffectiveness for cash flow hedges, or to achieve fair value hedge adjustments for more hedged items with the aim of increasing the use of fair value accounting, but without offsetting fair value changes of the hedging instrument; and
- (b) whether there is a commercial reason for the particular weightings of the hedged item and the hedging instrument, even though that creates hedge ineffectiveness. For example, an entity enters into and designates a quantity of the hedging instrument that is not the quantity that it determined as the best hedge of the hedged item because the standard volume of the hedging instruments does not allow it to enter into that exact quantity of hedging instrument (a 'lot size issue'). An example is an entity that hedges 100 tonnes of coffee purchases with standard coffee futures contracts that have a contract size of 37,500 lbs (pounds). The entity could only use either five or six contracts (equivalent to 85.0 and 102.1 tonnes respectively) to hedge the purchase volume of 100 tonnes. In that case, the entity designates the hedging relationship using the hedge ratio that results from the number of coffee futures contracts that it actually uses, because the hedge ineffectiveness resulting from the mismatch in the weightings of the hedged item and the hedging instrument would not result in an accounting outcome that is inconsistent with the purpose of hedge accounting.

### **Frequency of assessing whether the hedge effectiveness requirements are met**

B6.4.12 An entity shall assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a minimum, an entity shall perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

### **Methods for assessing whether the hedge effectiveness requirements are met**

B6.4.13 This Standard does not specify a method for assessing whether a hedging relationship meets the hedge effectiveness requirements. However, an entity shall use a method that captures the relevant characteristics of the hedging relationship including the sources of hedge ineffectiveness. Depending on those factors, the method can be a qualitative or a quantitative assessment.

B6.4.14 For example, when the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging instrument and the hedged item have values that will generally move in the

opposite direction because of the same risk and hence that an economic relationship exists between the hedged item and the hedging instrument (see paragraphs B6.4.4–B6.4.6).

- B6.4.15 The fact that a derivative is in or out of the money when it is designated as a hedging instrument does not in itself mean that a qualitative assessment is inappropriate. It depends on the circumstances whether hedge ineffectiveness arising from that fact could have a magnitude that a qualitative assessment would not adequately capture.
- B6.4.16 Conversely, if the critical terms of the hedging instrument and the hedged item are not closely aligned, there is an increased level of uncertainty about the extent of offset. Consequently, the hedge effectiveness during the term of the hedging relationship is more difficult to predict. In such a situation it might only be possible for an entity to conclude on the basis of a quantitative assessment that an economic relationship exists between the hedged item and the hedging instrument (see paragraphs B6.4.4–B6.4.6). In some situations a quantitative assessment might also be needed to assess whether the hedge ratio used for designating the hedging relationship meets the hedge effectiveness requirements (see paragraphs B6.4.9–B6.4.11). An entity can use the same or different methods for those two different purposes.
- B6.4.17 If there are changes in circumstances that affect hedge effectiveness, an entity may have to change the method for assessing whether a hedging relationship meets the hedge effectiveness requirements in order to ensure that the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness, are still captured.
- B6.4.18 An entity's risk management is the main source of information to perform the assessment of whether a hedging relationship meets the hedge effectiveness requirements. This means that the management information (or analysis) used for decision-making purposes can be used as a basis for assessing whether a hedging relationship meets the hedge effectiveness requirements.
- B6.4.19 An entity's documentation of the hedging relationship includes how it will assess the hedge effectiveness requirements, including the method or methods used. The documentation of the hedging relationship shall be updated for any changes to the methods (see paragraph B6.4.17).

## **Accounting for qualifying hedging relationships (Section 6.5)**

- B6.5.1 An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed-rate debt instrument arising from changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.
- B6.5.2 The purpose of a cash flow hedge is to defer the gain or loss on the hedging instrument to a period or periods in which the hedged expected future cash flows affect profit or loss. An example of a cash flow hedge is the use of a swap to change floating rate debt (whether measured at amortised cost or fair value) to fixed-rate debt (ie a hedge of a future transaction in which the future cash flows being hedged are the future interest payments). Conversely, a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value through profit or loss, is an example of an item that cannot be the hedged item in a cash flow hedge, because any gain or loss on the hedging instrument that would be deferred could not be appropriately reclassified to profit or loss during a period in which it would achieve offset. For the same reason, a forecast purchase of an equity instrument that, once acquired, will be accounted for at fair value with changes in fair value presented in other comprehensive income also cannot be the hedged item in a cash flow hedge.
- B6.5.3 A hedge of a firm commitment (for example, a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, in accordance with paragraph 6.5.4, a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

## Measurement of hedge ineffectiveness

- B6.5.4 When measuring hedge ineffectiveness, an entity shall consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.
- B6.5.5 To calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, an entity may use a derivative that would have terms that match the critical terms of the hedged item (this is commonly referred to as a 'hypothetical derivative'), and, for example for a hedge of a forecast transaction, would be calibrated using the hedged price (or rate) level. For example, if the hedge was for a two-sided risk at the current market level, the hypothetical derivative would represent a hypothetical forward contract that is calibrated to a value of nil at the time of designation of the hedging relationship. If the hedge was for example for a one-sided risk, the hypothetical derivative would represent the intrinsic value of a hypothetical option that at the time of designation of the hedging relationship is at the money if the hedged price level is the current market level, or out of the money if the hedged price level is above (or, for a hedge of a long position, below) the current market level. Using a hypothetical derivative is one possible way of calculating the change in the value of the hedged item. The hypothetical derivative replicates the hedged item and hence results in the same outcome as if that change in value was determined by a different approach. Hence, using a 'hypothetical derivative' is not a method in its own right but a mathematical expedient that can only be used to calculate the value of the hedged item. Consequently, a 'hypothetical derivative' cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item). An example is debt denominated in a foreign currency (irrespective of whether it is fixed-rate or variable-rate debt). When using a hypothetical derivative to calculate the change in the value of such debt or the present value of the cumulative change in its cash flows, the hypothetical derivative cannot simply impute a charge for exchanging different currencies even though actual derivatives under which different currencies are exchanged might include such a charge (for example, cross-currency interest rate swaps).
- B6.5.6 The change in the value of the hedged item determined using a hypothetical derivative may also be used for the purpose of assessing whether a hedging relationship meets the hedge effectiveness requirements.

## Rebalancing the hedging relationship and changes to the hedge ratio

- B6.5.7 Rebalancing refers to the adjustments made to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedged item or of a hedging instrument for a different purpose do not constitute rebalancing for the purpose of this Standard.
- B6.5.8 Rebalancing is accounted for as a continuation of the hedging relationship in accordance with paragraphs B6.5.9–B6.5.21. On rebalancing, the hedge ineffectiveness of the hedging relationship is determined and recognised immediately before adjusting the hedging relationship.
- B6.5.9 Adjusting the hedge ratio allows an entity to respond to changes in the relationship between the hedging instrument and the hedged item that arise from their underlyings or risk variables. For example, a hedging relationship in which the hedging instrument and the hedged item have different but related underlyings changes in response to a change in the relationship between those two underlyings (for example, different but related reference indices, rates or prices). Hence, rebalancing allows the continuation of a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that can be compensated for by adjusting the hedge ratio.

- B6.5.10 For example, an entity hedges an exposure to Foreign Currency A using a currency derivative that references Foreign Currency B and Foreign Currencies A and B are pegged (ie their exchange rate is maintained within a band or at an exchange rate set by a central bank or other authority). If the exchange rate between Foreign Currency A and Foreign Currency B were changed (ie a new band or rate was set), rebalancing the hedging relationship to reflect the new exchange rate would ensure that the hedging relationship would continue to meet the hedge effectiveness requirement for the hedge ratio in the new circumstances. In contrast, if there was a default on the currency derivative, changing the hedge ratio could not ensure that the hedging relationship would continue to meet that hedge effectiveness requirement. Hence, rebalancing does not facilitate the continuation of a hedging relationship in situations in which the relationship between the hedging instrument and the hedged item changes in a way that cannot be compensated for by adjusting the hedge ratio.
- B6.5.11 Not every change in the extent of offset between the changes in the fair value of the hedging instrument and the hedged item's fair value or cash flows constitutes a change in the relationship between the hedging instrument and the hedged item. An entity analyses the sources of hedge ineffectiveness that it expected to affect the hedging relationship during its term and evaluates whether changes in the extent of offset are:
- (a) fluctuations around the hedge ratio, which remains valid (ie continues to appropriately reflect the relationship between the hedging instrument and the hedged item); or
  - (b) an indication that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item.

An entity performs this evaluation against the hedge effectiveness requirement for the hedge ratio, ie to ensure that the hedging relationship does not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. Hence, this evaluation requires judgement.

- B6.5.12 Fluctuation around a constant hedge ratio (and hence the related hedge ineffectiveness) cannot be reduced by adjusting the hedge ratio in response to each particular outcome. Hence, in such circumstances, the change in the extent of offset is a matter of measuring and recognising hedge ineffectiveness but does not require rebalancing.
- B6.5.13 Conversely, if changes in the extent of offset indicate that the fluctuation is around a hedge ratio that is different from the hedge ratio that is currently used for that hedging relationship, or that there is a trend leading away from that hedge ratio, hedge ineffectiveness can be reduced by adjusting the hedge ratio, whereas retaining the hedge ratio would increasingly produce hedge ineffectiveness. Hence, in such circumstances, an entity must evaluate whether the hedging relationship reflects an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting. If the hedge ratio is adjusted, it also affects the measurement and recognition of hedge ineffectiveness because, on rebalancing, the hedge ineffectiveness of the hedging relationship must be determined and recognised immediately before adjusting the hedging relationship in accordance with paragraph B6.5.8.
- B6.5.14 Rebalancing means that, for hedge accounting purposes, after the start of a hedging relationship an entity adjusts the quantities of the hedging instrument or the hedged item in response to changes in circumstances that affect the hedge ratio of that hedging relationship. Typically, that adjustment should reflect adjustments in the quantities of the hedging instrument and the hedged item that it actually uses. However, an entity must adjust the hedge ratio that results from the quantities of the hedged item or the hedging instrument that it actually uses if:
- (a) the hedge ratio that results from changes to the quantities of the hedging instrument or the hedged item that the entity actually uses would reflect an imbalance that would

create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting; or

- (b) an entity would retain quantities of the hedging instrument and the hedged item that it actually uses, resulting in a hedge ratio that, in new circumstances, would reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (ie an entity must not create an imbalance by omitting to adjust the hedge ratio).

**B6.5.15** Rebalancing does not apply if the risk management objective for a hedging relationship has changed. Instead, hedge accounting for that hedging relationship shall be discontinued (despite that an entity might designate a new hedging relationship that involves the hedging instrument or hedged item of the previous hedging relationship as described in paragraph B6.5.28).

**B6.5.16** If a hedging relationship is rebalanced, the adjustment to the hedge ratio can be effected in different ways:

- (a) the weighting of the hedged item can be increased (which at the same time reduces the weighting of the hedging instrument) by:
  - (i) increasing the volume of the hedged item; or
  - (ii) decreasing the volume of the hedging instrument.
- (b) the weighting of the hedging instrument can be increased (which at the same time reduces the weighting of the hedged item) by:
  - (i) increasing the volume of the hedging instrument; or
  - (ii) decreasing the volume of the hedged item.

Changes in volume refer to the quantities that are part of the hedging relationship. Hence, decreases in volumes do not necessarily mean that the items or transactions no longer exist, or are no longer expected to occur, but that they are not part of the hedging relationship. For example, decreasing the volume of the hedging instrument can result in the entity retaining a derivative, but only part of it might remain a hedging instrument of the hedging relationship. This could occur if the rebalancing could be effected only by reducing the volume of the hedging instrument in the hedging relationship, but with the entity retaining the volume that is no longer needed. In that case, the undesignated part of the derivative would be accounted for at fair value through profit or loss (unless it was designated as a hedging instrument in a different hedging relationship).

**B6.5.17** Adjusting the hedge ratio by increasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item related to the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the value of the hedged item also include the change in the value of the additional volume of the hedged item. These changes are measured starting from, and by reference to, the date of rebalancing instead of the date on which the hedging relationship was designated. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price of CU80 (the forward price at inception of the hedging relationship) and added a volume of 10 tonnes on rebalancing when the forward price was CU90, the hedged item after rebalancing would comprise two layers: 100 tonnes hedged at CU80 and 10 tonnes hedged at CU90.



- B6.5.18 Adjusting the hedge ratio by decreasing the volume of the hedging instrument does not affect how the changes in the value of the hedged item are measured. The measurement of the changes in the fair value of the hedging instrument related to the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and reduces that volume by 10 tonnes on rebalancing, a nominal amount of 90 tonnes of the hedging instrument volume would remain (see paragraph B6.5.16 for the consequences for the derivative volume (ie the 10 tonnes) that is no longer a part of the hedging relationship).
- B6.5.19 Adjusting the hedge ratio by increasing the volume of the hedging instrument does not affect how the changes in the value of the hedged item are measured. The measurement of the changes in the fair value of the hedging instrument related to the previously designated volume also remains unaffected. However, from the date of rebalancing, the changes in the fair value of the hedging instrument also include the changes in the value of the additional volume of the hedging instrument. The changes are measured starting from, and by reference to, the date of rebalancing instead of the date on which the hedging relationship was designated. For example, if an entity originally hedged the price risk of a commodity using a derivative volume of 100 tonnes as the hedging instrument and added a volume of 10 tonnes on rebalancing, the hedging instrument after rebalancing would comprise a total derivative volume of 110 tonnes. The change in the fair value of the hedging instrument is the total change in the fair value of the derivatives that make up the total volume of 110 tonnes. These derivatives could (and probably would) have different critical terms, such as their forward rates, because they were entered into at different points in time (including the possibility of designating derivatives into hedging relationships after their initial recognition).
- B6.5.20 Adjusting the hedge ratio by decreasing the volume of the hedged item does not affect how the changes in the fair value of the hedging instrument are measured. The measurement of the changes in the value of the hedged item related to the volume that continues to be designated also remains unaffected. However, from the date of rebalancing, the volume by which the hedged item was decreased is no longer part of the hedging relationship. For example, if an entity originally hedged a volume of 100 tonnes of a commodity at a forward price of CU80 and reduces that volume by 10 tonnes on rebalancing, the hedged item after rebalancing would be 90 tonnes hedged at CU80. The 10 tonnes of the hedged item that are no longer part of the hedging relationship would be accounted for in accordance with the requirements for the discontinuation of hedge accounting (see paragraphs 6.5.6–6.5.7 and B6.5.22–B6.5.28).
- B6.5.21 When rebalancing a hedging relationship, an entity shall update its analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its (remaining) term (see paragraph B6.4.2). The documentation of the hedging relationship shall be updated accordingly.

### **Discontinuation of hedge accounting**

- B6.5.22 Discontinuation of hedge accounting applies prospectively from the date on which the qualifying criteria are no longer met.
- B6.5.23 An entity shall not de-designate and thereby discontinue a hedging relationship that:
- (a) still meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity still pursues that risk management objective); and
  - (b) continues to meet all other qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable).
- B6.5.24 For the purposes of this Standard, an entity's risk management strategy is distinguished from its risk management objectives. The risk management strategy is established at the highest level at which an entity determines how it manages its risk. Risk management strategies

typically identify the risks to which the entity is exposed and set out how the entity responds to them. A risk management strategy is typically in place for a longer period and may include some flexibility to react to changes in circumstances that occur while that strategy is in place (for example, different interest rate or commodity price levels that result in a different extent of hedging). This is normally set out in a general document that is cascaded down through an entity through policies containing more specific guidelines. In contrast, the risk management objective for a hedging relationship applies at the level of a particular hedging relationship. It relates to how the particular hedging instrument that has been designated is used to hedge the particular exposure that has been designated as the hedged item. Hence, a risk management strategy can involve many different hedging relationships whose risk management objectives relate to executing that overall risk management strategy. For example:

- (a) an entity has a strategy of managing its interest rate exposure on debt funding that sets ranges for the overall entity for the mix between variable-rate and fixed-rate funding. The strategy is to maintain between 20 per cent and 40 per cent of the debt at fixed rates. The entity decides from time to time how to execute this strategy (ie where it positions itself within the 20 per cent to 40 per cent range for fixed-rate interest exposure) depending on the level of interest rates. If interest rates are low the entity fixes the interest for more debt than when interest rates are high. The entity's debt is CU100 of variable-rate debt of which CU30 is swapped into a fixed-rate exposure. The entity takes advantage of low interest rates to issue an additional CU50 of debt to finance a major investment, which the entity does by issuing a fixed-rate bond. In the light of the low interest rates, the entity decides to set its fixed interest-rate exposure to 40 per cent of the total debt by reducing by CU20 the extent to which it previously hedged its variable-rate exposure, resulting in CU60 of fixed-rate exposure. In this situation the risk management strategy itself remains unchanged. However, in contrast the entity's execution of that strategy has changed and this means that, for CU20 of variable-rate exposure that was previously hedged, the risk management objective has changed (ie at the hedging relationship level). Consequently, in this situation hedge accounting must be discontinued for CU20 of the previously hedged variable-rate exposure. This could involve reducing the swap position by a CU20 nominal amount but, depending on the circumstances, an entity might retain that swap volume and, for example, use it for hedging a different exposure or it might become part of a trading book. Conversely, if an entity instead swapped a part of its new fixed-rate debt into a variable-rate exposure, hedge accounting would have to be continued for its previously hedged variable-rate exposure.
- (b) some exposures result from positions that frequently change, for example, the interest rate risk of an open portfolio of debt instruments. The addition of new debt instruments and the derecognition of debt instruments continuously change that exposure (ie it is different from simply running off a position that matures). This is a dynamic process in which both the exposure and the hedging instruments used to manage it do not remain the same for long. Consequently, an entity with such an exposure frequently adjusts the hedging instruments used to manage the interest rate risk as the exposure changes. For example, debt instruments with 24 months' remaining maturity are designated as the hedged item for interest rate risk for 24 months. The same procedure is applied to other time buckets or maturity periods. After a short period of time, the entity discontinues all, some or a part of the previously designated hedging relationships for maturity periods and designates new hedging relationships for maturity periods on the basis of their size and the hedging instruments that exist at that time. The discontinuation of hedge accounting in this situation reflects that those hedging relationships are established in such a way that the entity looks at a new hedging instrument and a new hedged item instead of the hedging instrument and the hedged item that were designated previously. The risk management strategy remains the same, but there is no risk management objective that continues for those previously designated hedging relationships, which as such no longer exist. In such a situation, the discontinuation of hedge accounting applies to the extent to which the risk management objective has changed. This depends on the situation of an entity and

could, for example, affect all or only some hedging relationships of a maturity period, or only part of a hedging relationship.

- (c) an entity has a risk management strategy whereby it manages the foreign currency risk of forecast sales and the resulting receivables. Within that strategy the entity manages the foreign currency risk as a particular hedging relationship only up to the point of the recognition of the receivable. Thereafter, the entity no longer manages the foreign currency risk on the basis of that particular hedging relationship. Instead, it manages together the foreign currency risk from receivables, payables and derivatives (that do not relate to forecast transactions that are still pending) denominated in the same foreign currency. For accounting purposes, this works as a 'natural' hedge because the gains and losses from the foreign currency risk on all of those items are immediately recognised in profit or loss. Consequently, for accounting purposes, if the hedging relationship is designated for the period up to the payment date, it must be discontinued when the receivable is recognised, because the risk management objective of the original hedging relationship no longer applies. The foreign currency risk is now managed within the same strategy but on a different basis. Conversely, if an entity had a different risk management objective and managed the foreign currency risk as one continuous hedging relationship specifically for that forecast sales amount and the resulting receivable until the settlement date, hedge accounting would continue until that date.

B6.5.25 The discontinuation of hedge accounting can affect:

- (a) a hedging relationship in its entirety; or
- (b) a part of a hedging relationship (which means that hedge accounting continues for the remainder of the hedging relationship).

B6.5.26 A hedging relationship is discontinued in its entirety when, as a whole, it ceases to meet the qualifying criteria. For example:

- (a) the hedging relationship no longer meets the risk management objective on the basis of which it qualified for hedge accounting (ie the entity no longer pursues that risk management objective);
- (b) the hedging instrument or instruments have been sold or terminated (in relation to the entire volume that was part of the hedging relationship); or
- (c) there is no longer an economic relationship between the hedged item and the hedging instrument or the effect of credit risk starts to dominate the value changes that result from that economic relationship.

B6.5.27 A part of a hedging relationship is discontinued (and hedge accounting continues for its remainder) when only a part of the hedging relationship ceases to meet the qualifying criteria. For example:

- (a) on rebalancing of the hedging relationship, the hedge ratio might be adjusted in such a way that some of the volume of the hedged item is no longer part of the hedging relationship (see paragraph B6.5.20); hence, hedge accounting is discontinued only for the volume of the hedged item that is no longer part of the hedging relationship; or
- (b) when the occurrence of some of the volume of the hedged item that is (or is a component of) a forecast transaction is no longer highly probable, hedge accounting is discontinued only for the volume of the hedged item whose occurrence is no longer highly probable. However, if an entity has a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur, the entity's ability to predict forecast transactions accurately is called into question when predicting similar forecast transactions. This affects the assessment of whether similar forecast transactions are

highly probable (see paragraph 6.3.3) and hence whether they are eligible as hedged items.

**B6.5.28** An entity can designate a new hedging relationship that involves the hedging instrument or hedged item of a previous hedging relationship for which hedge accounting was (in part or in its entirety) discontinued. This does not constitute a continuation of a hedging relationship but is a restart. For example:

- (a) a hedging instrument experiences such a severe credit deterioration that the entity replaces it with a new hedging instrument. This means that the original hedging relationship failed to achieve the risk management objective and is hence discontinued in its entirety. The new hedging instrument is designated as the hedge of the same exposure that was hedged previously and forms a new hedging relationship. Hence, the changes in the fair value or the cash flows of the hedged item are measured starting from, and by reference to, the date of designation of the new hedging relationship instead of the date on which the original hedging relationship was designated.
- (b) a hedging relationship is discontinued before the end of its term. The hedging instrument in that hedging relationship can be designated as the hedging instrument in another hedging relationship (for example, when adjusting the hedge ratio on rebalancing by increasing the volume of the hedging instrument or when designating a whole new hedging relationship).

### **Accounting for the time value of options**

**B6.5.29** An option can be considered as being related to a time period because its time value represents a charge for providing protection for the option holder over a period of time. However, the relevant aspect for the purpose of assessing whether an option hedges a transaction or time-period related hedged item are the characteristics of that hedged item, including how and when it affects profit or loss. Hence, an entity shall assess the type of hedged item (see paragraph 6.5.15(a)) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

- (a) the time value of an option relates to a transaction related hedged item if the nature of the hedged item is a transaction for which the time value has the character of costs of that transaction. An example is when the time value of an option relates to a hedged item that results in the recognition of an item whose initial measurement includes transaction costs (for example, an entity hedges a commodity purchase, whether it is a forecast transaction or a firm commitment, against the commodity price risk and includes the transaction costs in the initial measurement of the inventory). As a consequence of including the time value of the option in the initial measurement of the particular hedged item, the time value affects profit or loss at the same time as that hedged item. Similarly, an entity that hedges a sale of a commodity, whether it is a forecast transaction or a firm commitment, would include the time value of the option as part of the cost related to that sale (hence, the time value would be recognised in profit or loss in the same period as the revenue from the hedged sale).
- (b) the time value of an option relates to a time-period related hedged item if the nature of the hedged item is such that the time value has the character of a cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of a transaction cost in accordance with (a)). For example, if commodity inventory is hedged against a fair value decrease for six months using a commodity option with a corresponding life, the time value of the option would be allocated to profit or loss (ie amortised on a systematic and rational basis) over that six-month period. Another example is a hedge of a net investment in a foreign operation that is hedged for 18 months using a foreign-exchange option, which would result in allocating the time value of the option over that 18-month period.

**B6.5.30** The characteristics of the hedged item, including how and when the hedged item affects profit or loss, also affect the period over which the time value of an option that hedges a time-period

related hedged item is amortised, which is consistent with the period over which the option's intrinsic value can affect profit or loss in accordance with hedge accounting. For example, if an interest rate option (a cap) is used to provide protection against increases in the interest expense on a floating rate bond, the time value of that cap is amortised to profit or loss over the same period over which any intrinsic value of the cap would affect profit or loss:

- (a) if the cap hedges increases in interest rates for the first three years out of a total life of the floating rate bond of five years, the time value of that cap is amortised over the first three years; or
- (b) if the cap is a forward start option that hedges increases in interest rates for years two and three out of a total life of the floating rate bond of five years, the time value of that cap is amortised during years two and three.

**B6.5.31** The accounting for the time value of options in accordance with paragraph 6.5.15 also applies to a combination of a purchased and a written option (one being a put option and one being a call option) that at the date of designation as a hedging instrument has a net nil time value (commonly referred to as a 'zero-cost collar'). In that case, an entity shall recognise any changes in time value in other comprehensive income, even though the cumulative change in time value over the total period of the hedging relationship is nil. Hence, if the time value of the option relates to:

- (a) a transaction related hedged item, the amount of time value at the end of the hedging relationship that adjusts the hedged item or that is reclassified to profit or loss (see paragraph 6.5.15(b)) would be nil.
- (b) a time-period related hedged item, the amortisation expense related to the time value is nil.

**B6.5.32** The accounting for the time value of options in accordance with paragraph 6.5.15 applies only to the extent that the time value relates to the hedged item (aligned time value). The time value of an option relates to the hedged item if the critical terms of the option (such as the nominal amount, life and underlying) are aligned with the hedged item. Hence, if the critical terms of the option and the hedged item are not fully aligned, an entity shall determine the aligned time value, ie how much of the time value included in the premium (actual time value) relates to the hedged item (and therefore should be treated in accordance with paragraph 6.5.15). An entity determines the aligned time value using the valuation of the option that would have critical terms that perfectly match the hedged item.

**B6.5.33** If the actual time value and the aligned time value differ, an entity shall determine the amount that is accumulated in a separate component of equity in accordance with paragraph 6.5.15 as follows:

- (a) if, at inception of the hedging relationship, the actual time value is higher than the aligned time value, the entity shall:
  - (i) determine the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and
  - (ii) account for the differences in the fair value changes between the two time values in profit or loss.
- (b) if, at inception of the hedging relationship, the actual time value is lower than the aligned time value, the entity shall determine the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:
  - (i) the actual time value; and
  - (ii) the aligned time value.

Any remainder of the change in fair value of the actual time value shall be recognised in profit or loss.

### **Accounting for the forward element of forward contracts and foreign currency basis spreads of financial instruments**

B6.5.34 A forward contract can be considered as being related to a time period because its forward element represents charges for a period of time (which is the tenor for which it is determined). However, the relevant aspect for the purpose of assessing whether a hedging instrument hedges a transaction or time-period related hedged item are the characteristics of that hedged item, including how and when it affects profit or loss. Hence, an entity shall assess the type of hedged item (see paragraphs 6.5.16 and 6.5.15(a)) on the basis of the nature of the hedged item (regardless of whether the hedging relationship is a cash flow hedge or a fair value hedge):

- (a) the forward element of a forward contract relates to a transaction related hedged item if the nature of the hedged item is a transaction for which the forward element has the character of costs of that transaction. An example is when the forward element relates to a hedged item that results in the recognition of an item whose initial measurement includes transaction costs (for example, an entity hedges an inventory purchase denominated in a foreign currency, whether it is a forecast transaction or a firm commitment, against foreign currency risk and includes the transaction costs in the initial measurement of the inventory). As a consequence of including the forward element in the initial measurement of the particular hedged item, the forward element affects profit or loss at the same time as that hedged item. Similarly, an entity that hedges a sale of a commodity denominated in a foreign currency against foreign currency risk, whether it is a forecast transaction or a firm commitment, would include the forward element as part of the cost that is related to that sale (hence, the forward element would be recognised in profit or loss in the same period as the revenue from the hedged sale).
- (b) the forward element of a forward contract relates to a time-period related hedged item if the nature of the hedged item is such that the forward element has the character of a cost for obtaining protection against a risk over a particular period of time (but the hedged item does not result in a transaction that involves the notion of a transaction cost in accordance with (a)). For example, if commodity inventory is hedged against changes in fair value for six months using a commodity forward contract with a corresponding life, the forward element of the forward contract would be allocated to profit or loss (ie amortised on a systematic and rational basis) over that six-month period. Another example is a hedge of a net investment in a foreign operation that is hedged for 18 months using a foreign-exchange forward contract, which would result in allocating the forward element of the forward contract over that 18-month period.

B6.5.35 The characteristics of the hedged item, including how and when the hedged item affects profit or loss, also affect the period over which the forward element of a forward contract that hedges a time-period related hedged item is amortised, which is over the period to which the forward element relates. For example, if a forward contract hedges the exposure to variability in three-month interest rates for a three-month period that starts in six months' time, the forward element is amortised during the period that spans months seven to nine.

B6.5.36 The accounting for the forward element of a forward contract in accordance with paragraph 6.5.16 also applies if, at the date on which the forward contract is designated as a hedging instrument, the forward element is nil. In that case, an entity shall recognise any fair value changes attributable to the forward element in other comprehensive income, even though the cumulative fair value change attributable to the forward element over the total period of the hedging relationship is nil. Hence, if the forward element of a forward contract relates to:

- (a) a transaction related hedged item, the amount in respect of the forward element at the end of the hedging relationship that adjusts the hedged item or that is reclassified to profit or loss (see paragraphs 6.5.15(b) and 6.5.16) would be nil.

- (b) a time-period related hedged item, the amortisation amount related to the forward element is nil.

B6.5.37 The accounting for the forward element of forward contracts in accordance with paragraph 6.5.16 applies only to the extent that the forward element relates to the hedged item (aligned forward element). The forward element of a forward contract relates to the hedged item if the critical terms of the forward contract (such as the nominal amount, life and underlying) are aligned with the hedged item. Hence, if the critical terms of the forward contract and the hedged item are not fully aligned, an entity shall determine the aligned forward element, ie how much of the forward element included in the forward contract (actual forward element) relates to the hedged item (and therefore should be treated in accordance with paragraph 6.5.16). An entity determines the aligned forward element using the valuation of the forward contract that would have critical terms that perfectly match the hedged item.

B6.5.38 If the actual forward element and the aligned forward element differ, an entity shall determine the amount that is accumulated in a separate component of equity in accordance with paragraph 6.5.16 as follows:

- (a) if, at inception of the hedging relationship, the absolute amount of the actual forward element is higher than that of the aligned forward element the entity shall:
  - (i) determine the amount that is accumulated in a separate component of equity on the basis of the aligned forward element; and
  - (ii) account for the differences in the fair value changes between the two forward elements in profit or loss.
- (b) if, at inception of the hedging relationship, the absolute amount of the actual forward element is lower than that of the aligned forward element, the entity shall determine the amount that is accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:
  - (i) the absolute amount of the actual forward element; and
  - (ii) the absolute amount of the aligned forward element.

Any remainder of the change in fair value of the actual forward element shall be recognised in profit or loss.

B6.5.39 When an entity separates the foreign currency basis spread from a financial instrument and excludes it from the designation of that financial instrument as the hedging instrument (see paragraph 6.2.4(b)), the application guidance in paragraphs B6.5.34–B6.5.38 applies to the foreign currency basis spread in the same manner as it is applied to the forward element of a forward contract.

## **Hedge of a group of items (Section 6.6)**

### **Hedge of a net position**

#### *Eligibility for hedge accounting and designation of a net position*

B6.6.1 A net position is eligible for hedge accounting only if an entity hedges on a net basis for risk management purposes. Whether an entity hedges in this way is a matter of fact (not merely of assertion or documentation). Hence, an entity cannot apply hedge accounting on a net basis solely to achieve a particular accounting outcome if that would not reflect its risk management approach. Net position hedging must form part of an established risk management strategy. Normally this would be approved by key management personnel as defined in SB-FRS 24.

- B6.6.2 For example, Entity A, whose functional currency is its local currency, has a firm commitment to pay FC150,000 for advertising expenses in nine months' time and a firm commitment to sell finished goods for FC150,000 in 15 months' time. Entity A enters into a foreign currency derivative that settles in nine months' time under which it receives FC100 and pays CU70. Entity A has no other exposures to FC. Entity A does not manage foreign currency risk on a net basis. Hence, Entity A cannot apply hedge accounting for a hedging relationship between the foreign currency derivative and a net position of FC100 (consisting of FC150,000 of the firm purchase commitment—ie advertising services—and FC149,900 (of the FC150,000) of the firm sale commitment) for a nine-month period.
- B6.6.3 If Entity A did manage foreign currency risk on a net basis and did not enter into the foreign currency derivative (because it increases its foreign currency risk exposure instead of reducing it), then the entity would be in a natural hedged position for nine months. Normally, this hedged position would not be reflected in the financial statements because the transactions are recognised in different reporting periods in the future. The nil net position would be eligible for hedge accounting only if the conditions in paragraph 6.6.6 are met.
- B6.6.4 When a group of items that constitute a net position is designated as a hedged item, an entity shall designate the overall group of items that includes the items that can make up the net position. An entity is not permitted to designate a non-specific abstract amount of a net position. For example, an entity has a group of firm sale commitments in nine months' time for FC100 and a group of firm purchase commitments in 18 months' time for FC120. The entity cannot designate an abstract amount of a net position up to FC20. Instead, it must designate a gross amount of purchases and a gross amount of sales that together give rise to the hedged net position. An entity shall designate gross positions that give rise to the net position so that the entity is able to comply with the requirements for the accounting for qualifying hedging relationships.

*Application of the hedge effectiveness requirements to a hedge of a net position*

- B6.6.5 When an entity determines whether the hedge effectiveness requirements of paragraph 6.4.1(c) are met when it hedges a net position, it shall consider the changes in the value of the items in the net position that have a similar effect as the hedging instrument in conjunction with the fair value change on the hedging instrument. For example, an entity has a group of firm sale commitments in nine months' time for FC100 and a group of firm purchase commitments in 18 months' time for FC120. It hedges the foreign currency risk of the net position of FC20 using a forward exchange contract for FC20. When determining whether the hedge effectiveness requirements of paragraph 6.4.1(c) are met, the entity shall consider the relationship between:
- (a) the fair value change on the forward exchange contract together with the foreign currency risk related changes in the value of the firm sale commitments; and
  - (b) the foreign currency risk related changes in the value of the firm purchase commitments.
- B6.6.6 Similarly, if in the example in paragraph B6.6.5 the entity had a nil net position it would consider the relationship between the foreign currency risk related changes in the value of the firm sale commitments and the foreign currency risk related changes in the value of the firm purchase commitments when determining whether the hedge effectiveness requirements of paragraph 6.4.1(c) are met.



*Cash flow hedges that constitute a net position*

- B6.6.7 When an entity hedges a group of items with offsetting risk positions (ie a net position), the eligibility for hedge accounting depends on the type of hedge. If the hedge is a fair value hedge, then the net position may be eligible as a hedged item. If, however, the hedge is a cash flow hedge, then the net position can only be eligible as a hedged item if it is a hedge of foreign currency risk and the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss and also specifies their nature and volume.
- B6.6.8 For example, an entity has a net position that consists of a bottom layer of FC100 of sales and a bottom layer of FC150 of purchases. Both sales and purchases are denominated in the same foreign currency. In order to sufficiently specify the designation of the hedged net position, the entity specifies in the original documentation of the hedging relationship that sales can be of Product A or Product B and purchases can be of Machinery Type A, Machinery Type B and Raw Material A. The entity also specifies the volumes of the transactions by each nature. The entity documents that the bottom layer of sales (FC100) is made up of a forecast sales volume of the first FC70 of Product A and the first FC30 of Product B. If those sales volumes are expected to affect profit or loss in different reporting periods, the entity would include that in the documentation, for example, the first FC70 from sales of Product A that are expected to affect profit or loss in the first reporting period and the first FC30 from sales of Product B that are expected to affect profit or loss in the second reporting period. The entity also documents that the bottom layer of the purchases (FC150) is made up of purchases of the first FC60 of Machinery Type A, the first FC40 of Machinery Type B and the first FC50 of Raw Material A. If those purchase volumes are expected to affect profit or loss in different reporting periods, the entity would include in the documentation a disaggregation of the purchase volumes by the reporting periods in which they are expected to affect profit or loss (similarly to how it documents the sales volumes). For example, the forecast transaction would be specified as:
- (a) the first FC60 of purchases of Machinery Type A that are expected to affect profit or loss from the third reporting period over the next ten reporting periods;
  - (b) the first FC40 of purchases of Machinery Type B that are expected to affect profit or loss from the fourth reporting period over the next 20 reporting periods; and
  - (c) the first FC50 of purchases of Raw Material A that are expected to be received in the third reporting period and sold, ie affect profit or loss, in that and the next reporting period.

Specifying the nature of the forecast transaction volumes would include aspects such as the depreciation pattern for items of property, plant and equipment of the same kind, if the nature of those items is such that the depreciation pattern could vary depending on how the entity uses those items. For example, if the entity uses items of Machinery Type A in two different production processes that result in straight-line depreciation over ten reporting periods and the units of production method respectively, its documentation of the forecast purchase volume for Machinery Type A would disaggregate that volume by which of those depreciation patterns will apply.

- B6.6.9 For a cash flow hedge of a net position, the amounts determined in accordance with paragraph 6.5.11 shall include the changes in the value of the items in the net position that have a similar effect as the hedging instrument in conjunction with the fair value change on the hedging instrument. However, the changes in the value of the items in the net position that have a similar effect as the hedging instrument are recognised only once the transactions that they relate to are recognised, such as when a forecast sale is recognised as revenue. For example, an entity has a group of highly probable forecast sales in nine months' time for FC100 and a group of highly probable forecast purchases in 18 months' time for FC120. It hedges the foreign currency risk of the net position of FC20 using a forward exchange contract for FC20. When determining the amounts that are recognised in the cash flow hedge reserve in accordance with paragraph 6.5.11(a)–6.5.11(b), the entity compares:

- (a) the fair value change on the forward exchange contract together with the foreign currency risk related changes in the value of the highly probable forecast sales; with
- (b) the foreign currency risk related changes in the value of the highly probable forecast purchases.

However, the entity recognises only amounts related to the forward exchange contract until the highly probable forecast sales transactions are recognised in the financial statements, at which time the gains or losses on those forecast transactions are recognised (ie the change in the value attributable to the change in the foreign exchange rate between the designation of the hedging relationship and the recognition of revenue).

- B6.6.10 Similarly, if in the example the entity had a nil net position it would compare the foreign currency risk related changes in the value of the highly probable forecast sales with the foreign currency risk related changes in the value of the highly probable forecast purchases. However, those amounts are recognised only once the related forecast transactions are recognised in the financial statements.

### **Layers of groups of items designated as the hedged item**

- B6.6.11 For the same reasons noted in paragraph B6.3.19, designating layer components of groups of existing items requires the specific identification of the nominal amount of the group of items from which the hedged layer component is defined.

- B6.6.12 A hedging relationship can include layers from several different groups of items. For example, in a hedge of a net position of a group of assets and a group of liabilities, the hedging relationship can comprise, in combination, a layer component of the group of assets and a layer component of the group of liabilities.

### **Presentation of hedging instrument gains or losses**

- B6.6.13 If items are hedged together as a group in a cash flow hedge, they might affect different line items in the statement of profit or loss and other comprehensive income. The presentation of hedging gains or losses in that statement depends on the group of items.

- B6.6.14 If the group of items does not have any offsetting risk positions (for example, a group of foreign currency expenses that affect different line items in the statement of profit or loss and other comprehensive income that are hedged for foreign currency risk) then the reclassified hedging instrument gains or losses shall be apportioned to the line items affected by the hedged items. This apportionment shall be done on a systematic and rational basis and shall not result in the grossing up of the net gains or losses arising from a single hedging instrument.

- B6.6.15 If the group of items does have offsetting risk positions (for example, a group of sales and expenses denominated in a foreign currency hedged together for foreign currency risk) then an entity shall present the hedging gains or losses in a separate line item in the statement of profit or loss and other comprehensive income. Consider, for example, a hedge of the foreign currency risk of a net position of foreign currency sales of FC100 and foreign currency expenses of FC80 using a forward exchange contract for FC20. The gain or loss on the forward exchange contract that is reclassified from the cash flow hedge reserve to profit or loss (when the net position affects profit or loss) shall be presented in a separate line item from the hedged sales and expenses. Moreover, if the sales occur in an earlier period than the expenses, the sales revenue is still measured at the spot exchange rate in accordance with SB-FRS 21. The related hedging gain or loss is presented in a separate line item, so that profit or loss reflects the effect of hedging the net position, with a corresponding adjustment to the cash flow hedge reserve. When the hedged expenses affect profit or loss in a later period, the hedging gain or loss previously recognised in the cash flow hedge reserve on the sales is reclassified to profit or loss and presented as a separate line item from those that include the hedged expenses, which are measured at the spot exchange rate in accordance with SB-FRS 21.

- B6.6.16 For some types of fair value hedges, the objective of the hedge is not primarily to offset the fair value change of the hedged item but instead to transform the cash flows of the hedged item. For example, an entity hedges the fair value interest rate risk of a fixed-rate debt instrument using an interest rate swap. The entity's hedge objective is to transform the fixed-interest cash flows into floating interest cash flows. This objective is reflected in the accounting for the hedging relationship by accruing the net interest accrual on the interest rate swap in profit or loss. In the case of a hedge of a net position (for example, a net position of a fixed-rate asset and a fixed-rate liability), this net interest accrual must be presented in a separate line item in the statement of profit or loss and other comprehensive income. This is to avoid the grossing up of a single instrument's net gains or losses into offsetting gross amounts and recognising them in different line items (for example, this avoids grossing up a net interest receipt on a single interest rate swap into gross interest revenue and gross interest expense).

## **Effective date and transition (Chapter 7)**

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### **Transition (Section 7.2)**

#### **Financial assets held for trading**

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

#### **Impairment**

- B7.2.2 On transition, an entity should seek to approximate the credit risk on initial recognition by considering all reasonable and supportable information that is available without undue cost or effort. An entity is not required to undertake an exhaustive search for information when determining, at the date of transition, whether there have been significant increases in credit risk since initial recognition. If an entity is unable to make this determination without undue cost or effort paragraph 7.2.20 applies.
- B7.2.3 In order to determine the loss allowance on financial instruments initially recognised (or loan commitments or financial guarantee contracts to which the entity became a party to the contract) prior to the date of initial application, both on transition and until the derecognition of those items an entity shall consider information that is relevant in determining or approximating the credit risk at initial recognition. In order to determine or approximate the initial credit risk, an entity may consider internal and external information, including portfolio information, in accordance with paragraphs B5.5.1–B5.5.6.
- B7.2.4 An entity with little historical information may use information from internal reports and statistics (that may have been generated when deciding whether to launch a new product), information about similar products or peer group experience for comparable financial instruments, if relevant.

## Definitions (Appendix A)

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### Derivatives

- BA.1 Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000 if six-month LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.
- BA.2 The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (eg a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (eg a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. However, this Standard applies to such contracts for an entity's expected purchase, sale or usage requirements if the entity makes a designation in accordance with paragraph 2.5 (see paragraphs 2.4–2.7).
- BA.3 One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.
- BA.4 A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Instead, this Standard provides for special accounting for such regular way contracts (see paragraphs 3.1.2 and B3.1.3–B3.1.6).
- BA.5 The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

### Financial assets and liabilities held for trading

- BA.6 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

BA.7 Financial liabilities held for trading include:

- (a) derivative liabilities that are not accounted for as hedging instruments;
- (b) obligations to deliver financial assets borrowed by a short seller (ie an entity that sells financial assets it has borrowed and does not yet own);
- (c) financial liabilities that are incurred with an intention to repurchase them in the near term (eg a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
- (d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

BA.8 The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

## **Appendix C**

### **Amendments to other Standards**

*This appendix sets out amendments to other SB-FRSs that are a consequence of the issuance of this SB-FRS. An entity shall apply the amendments for annual periods beginning on or after 1 January 2018. If an entity applies SB-FRS 109 for an earlier period, it shall apply the amendments for that earlier period. Amended paragraphs are shown with new text underlined and deleted text struck through.*

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*The amendments contained in this appendix when this SB-FRS was issued in 2014 have been incorporated into the relevant SB-FRSs published in this volume.*