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ACCOUNTING STANDARDS**

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IPSAS 28—FINANCIAL INSTRUMENTS: PRESENTATION

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 32, *Financial Instruments: Presentation* and International Financial Reporting Interpretations Committee Interpretation 2 (IFRIC 2), *Members' Shares in Co-operative Entities and Similar Instruments* published by the International Accounting Standards Board (IASB). Extracts from IAS 32 and IFRIC 2 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 28—FINANCIAL INSTRUMENTS: PRESENTATION

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 28, *Financial Instruments: Presentation* was issued in January 2010.

Since then, IPSAS 28 has been amended by the following IPSASs:

- IPSAS 39, *Employee Benefits* (issued July 2016)
- *The Applicability of IPSASs* (issued April 2016)
- IPSAS 37, *Joint Arrangements* (issued January 2015)
- IPSAS 35, *Consolidated Financial Statements* (issued January 2015)
- IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* (issued January 2015)
- *Improvements to IPSASs 2014* (issued January 2015)
- *Improvements to IPSASs 2011* (issued October 2011)

Table of Amended Paragraphs in IPSAS 28

Paragraph Affected	How Affected	Affected By
Introduction section	Deleted	Improvements to IPSASs October 2011
3	Amended	IPSAS 35 January 2015 IPSAS 37 January 2015 IPSAS 39 July 2016
7	Deleted	The Applicability of IPSASs April 2016
8	Deleted	The Applicability of IPSASs April 2016
40	Amended	Improvements to IPSASs January 2015
40A	New	Improvements to IPSASs January 2015

Paragraph Affected	How Affected	Affected By
42	Amended	Improvements to IPSASs January 2015
44	Amended	Improvements to IPSASs January 2015
56	Deleted	IPSAS 33 January 2015
57	Deleted	IPSAS 33 January 2015
58	Deleted	IPSAS 33 January 2015
60A	New	Improvements to IPSASs January 2015
60B	New	IPSAS 33 January 2015
60C	New	IPSAS 37 January 2015 IPSAS 35 January 2015
60D	New	The Applicability of IPSASs April 2016
60E	New	IPSAS 39 July 2016
61	Amended	IPSAS 33 January 2015
AG53	Amended	IPSAS 35 January 2015

IPSAS 28—FINANCIAL INSTRUMENTS: PRESENTATION

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International Public Sector Accounting Standard 28, *Financial Instruments: Presentation*, is set out in paragraphs 1–62. All the paragraphs have equal authority. IPSAS 28 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to establish principles for presenting financial instruments as liabilities or net assets/equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends or similar distributions, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.
2. The principles in this Standard complement the principles for recognizing and measuring financial assets and financial liabilities in IPSAS 29, *Financial Instruments: Recognition and Measurement*, and for disclosing information about them in IPSAS 30, *Financial Instruments: Disclosures*.

Scope (see also paragraphs AG3–AG9)

3. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard to all types of financial instruments except:**
 - (a) **Those interests in controlled entities, associates or joint ventures that are accounted for in accordance with IPSAS 35, *Consolidated Financial Statements*, IPSAS 34, *Separate Financial Statements*, IPSAS 36, *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 34, IPSAS 35, or IPSAS 36 require or permits an entity to account for an interest in a controlled entity, associate, or joint venture using IPSAS 29; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in controlled entities, associates, or joint ventures.**
 - (b) **Employers' rights and obligations under employee benefit plans, to which IPSAS 39, *Employee Benefits* applies.**
 - (c) **Obligations arising from insurance contracts. However, this Standard applies to:**
 - (i) **Derivatives that are embedded in insurance contracts if IPSAS 29 requires the entity to account for them separately; and**
 - (ii) **Financial guarantee contracts, if the issuer applies IPSAS 29 in recognizing and measuring the contracts, but shall apply the relevant international or national accounting standard dealing with insurance contracts if the issuer elects to apply that standard in recognizing and measuring them.**

In addition to (i) and (ii) above, an entity may apply this Standard to insurance contracts which involve the transfer of financial risk.

(d) Financial instruments that are within the scope of the international or national accounting standard dealing with insurance contracts because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 13–37 and AG49–AG60 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see IPSAS 29).

(e) Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share-based payments applies, except for:

(i) Contracts within the scope of paragraphs 4–6 of this Standard, to which this Standard applies; or

(ii) Paragraphs 38 and 39 of this Standard, which shall be applied to treasury shares purchased, sold, issued, or cancelled in connection with employee share option plans, employee share purchase plans, and all other share-based payment arrangements.

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

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

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

(b) When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial

instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

- (c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
- (d) When the non-financial item that is the subject of the contract is readily convertible to cash.

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

- 6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.
- 7. [Deleted]
- 8. [Deleted]

Definitions (see also paragraphs AG10–AG48)

- 9. The following terms are used in this Standard with the meanings specified:

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

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

A financial asset is any asset that is:

- (a) **Cash;**
- (b) **An equity instrument of another entity;**
- (c) **A contractual right:**

- (i) To receive cash or another financial asset from another entity; or
- (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or
- (d) A contract that will or may be settled in the entity's own equity instruments and is:
 - (i) A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

A financial liability is any liability that is:

- (a) A contractual obligation:
 - (i) To deliver cash or another financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
- (b) A contract that will or may be settled in the entity's own equity instruments and is:
 - (i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as

equity instruments in accordance with paragraphs 15 and 16, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraph 15 and 16 or paragraphs 17 and 18.

A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

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

10. The following terms are defined in paragraph 10 of IPSAS 29 and are used in this Standard with the meaning specified in that Standard.

- Amortized cost of a financial asset or financial liability;
- Available-for-sale financial assets;
- Derecognizing;
- Derivative;
- Effective interest method;
- Financial asset or financial liability at fair value through surplus or deficit;
- Financial guarantee contract;
- Firm commitment;
- Forecast transaction;
- Hedge effectiveness;
- Hedged item;
- Hedging instrument;
- Held-to-maturity investments;
- Loans and receivables;

- Regular way purchase or sale; and
 - Transaction costs.
11. In this Standard, “contract” and “contractual” refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.
 12. In this Standard, “entity” includes public sector entities, individuals, partnerships, incorporated bodies and trusts.

Presentation

Liabilities and Net Assets/Equity (see also paragraphs AG49–AG54)

13. **The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.**
14. When an issuer applies the definitions in paragraph 9 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.
 - (a) The instrument includes no contractual obligation:
 - (i) To deliver cash or another financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the issuer.
 - (b) If the instrument will or may be settled in the issuer’s own equity instruments, it is:
 - (i) A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
 - (ii) A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer’s own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 15 and 16 or paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the issuer’s own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument. As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraph 15 and 16 or paragraphs 17 and 18.

Puttable Instruments

15. A puttable financial instrument includes a contractual obligation for the issuer to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all of the following features:
 - (a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
 - (i) Dividing the entity's net assets on liquidation into units of equal amount; and
 - (ii) Multiplying that amount by the number of the units held by the financial instrument holder.
 - (b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:
 - (i) Has no priority over other claims to the assets of the entity on liquidation; and
 - (ii) Does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.
 - (c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features. For example, they must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.
 - (d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity, and it is not a contract that will

or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability.

- (e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the surplus or deficit, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity over the life of the instrument (excluding any effects of the instrument).

16. For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

- (a) Total cash flows based substantially on the surplus or deficit, the change in the recognized net assets, or the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of such instrument or contract); and
- (b) The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 15 that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the puttable instrument as an equity instrument.

Instruments, or Components of Instruments, that Impose on the Entity an Obligation to Deliver to Another Party a pro rata Share of the Net Assets of the Entity only on Liquidation

17. Some financial instruments include a contractual obligation for the issuing entity to deliver to another entity a pro rata share of its net assets only on liquidation. The obligation arises because liquidation either is certain to occur and outside the control of the entity (e.g., a limited life entity) or is uncertain to occur but is at the option of the instrument holder. As an exception to the definition of a financial liability, an instrument that includes such an obligation is classified as an equity instrument if it has all of the following features:

- (a) It entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets. A pro rata share is determined by:
 - (i) Dividing the net assets of the entity on liquidation into units of equal amount; and

- (ii) Multiplying that amount by the number of the units held by the financial instrument holder.
 - (b) The instrument is in the class of instruments that is subordinate to all other classes of instruments. To be in such a class the instrument:
 - (i) Has no priority over other claims to the assets of the entity on liquidation; and
 - (ii) Does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments.
 - (c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.
18. For an instrument to be classified as an equity instrument, in addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:
- (a) Total cash flows based substantially on the surplus or deficit, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of such instrument or contract); and
 - (b) The effect of substantially restricting or fixing the residual return to the instrument holders.

For the purposes of applying this condition, the entity shall not consider non-financial contracts with a holder of an instrument described in paragraph 17 that have contractual terms and conditions that are similar to the contractual terms and conditions of an equivalent contract that might occur between a non-instrument holder and the issuing entity. If the entity cannot determine that this condition is met, it shall not classify the instrument as an equity instrument.

Reclassification of Puttable Instruments and Instruments that Impose on the Entity an Obligation to Deliver to Another Party a pro rata Share of the Net Assets of the Entity only on Liquidation

19. An entity shall classify a financial instrument as an equity instrument in accordance with paragraphs 15 and 16 or paragraphs 17 and 18 from the date when the instrument has all the features and meets the conditions set out in those paragraphs. An entity shall reclassify a financial instrument from the date when the instrument ceases to have all the features or meet all the conditions set out in those paragraphs. For example, if an entity redeems all its issued non-puttable instruments and any puttable instruments that remain outstanding have all of the features and meet all the conditions in paragraphs

15 and 16, the entity shall reclassify the puttable instruments as equity instruments from the date when it redeems the non-puttable instruments.

20. An entity shall account as follows for the reclassification of an instrument in accordance with paragraph 19:

- (a) It shall reclassify an equity instrument as a financial liability from the date when the instrument ceases to have all of the features or meet the conditions in paragraphs 15 and 16 or paragraphs 17 and 18. The financial liability shall be measured at the instrument's fair value at the date of reclassification. The entity shall recognize in net assets/equity any difference between the carrying value of the equity instrument and the fair value of the financial liability at the date of reclassification.
- (b) It shall reclassify a financial liability as an equity instrument from the date when the instrument has all of the features and meets the conditions set out in paragraphs 15 and 16 or paragraphs 17 and 18. An equity instrument shall be measured at the carrying value of the financial liability at the date of reclassification.

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraph 14(a))

- 21. With the exception of the circumstances described in paragraphs 15 and 16 or paragraphs 17 and 18, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavorable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or similar distributions declared, or distributions of the net assets/equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party.
- 22. The substance of a financial instrument, rather than its legal form, governs its classification on the entity's statement of financial position. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity instruments but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:
 - (a) A preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

- (b) A financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a “puttable instrument”) is a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. For example, open-ended mutual funds, unit trusts, partnerships and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash, which results in the unitholders’ or members’ interests being classified as financial liabilities, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. However, classification as a financial liability does not preclude the use of descriptors such as “net asset value attributable to unitholders” and “change in net asset value attributable to unitholders” on the face of the financial statements of an entity that has no contributed net assets/equity (such as some mutual funds and unit trusts, see Illustrative Example 7) or the use of additional disclosure to show that total members’ interests comprise items such as reserves that meet the definition of net assets/equity and puttable instruments that do not (see Illustrative Example 8).

23. If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. For example:

- (a) A restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity’s contractual obligation or the holder’s contractual right under the instrument.
- (b) A contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

24. A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:
- (a) A financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.
 - (b) A financial instrument is a financial liability if it provides that on settlement the entity will deliver either:
 - (i) Cash or another financial asset; or
 - (ii) Its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 25).

Settlement in the Entity's Own Equity Instruments (paragraph 14(b))

25. A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (e.g., an interest rate, a commodity price, or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to CU100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 barrels of oil. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.
26. Except as stated in paragraph 27, a contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a

right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to net assets/equity. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from net assets/equity. Changes in the fair value of an equity instrument are not recognized in the financial statements.

27. If the entity's own equity instruments to be received, or delivered, by the entity upon settlement of a contract are puttable financial instruments with all of the features and meeting the conditions described in paragraphs 15 and 16, or instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation with all of the features and meeting the conditions described in paragraphs 17 and 18, the contract is a financial asset or a financial liability. This includes a contract that will be settled by the entity receiving or delivering a fixed number of such instruments in exchange for a fixed amount of cash or another financial asset.
28. With the exception of the circumstances described in paragraphs 15 and 16 or paragraphs 17 and 18, a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (e.g., for the present value of the forward repurchase price, option exercise price, or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognized initially under IPSAS 29, its fair value (the present value of the redemption amount) is reclassified from net assets/equity. Subsequently, the financial liability is measured in accordance with IPSAS 29. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to net assets/equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (e.g., a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).
29. A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity

instruments in return for an amount of cash calculated to equal the value of 100 barrels of oil.

Contingent Settlement Provisions

30. A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate, or taxation requirements, or the issuer's future revenues, surplus or deficit, or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:
 - (a) The part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;
 - (b) The issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or
 - (c) The instrument has all of the features and meets the conditions in paragraphs 15 and 16.

Settlement Options

31. **When a derivative financial instrument gives one party a choice over how it is settled (e.g., the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.**
32. An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contracts to buy or sell a non-financial item in exchange for the entity's own equity instruments are within the scope of this Standard because they can be settled either by delivery of the non-financial item or net in cash or another financial instrument (see paragraphs 4–6). Such contracts are financial assets or financial liabilities and not equity instruments.

Compound Financial Instruments (see also paragraphs AG55–AG60 and Illustrative Examples 9–12)

33. **The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability component and a net assets/equity component. Such components shall be classified separately as financial liabilities, financial assets, or equity instruments in accordance with paragraph 13.**
34. An entity recognizes separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and net assets/equity components separately in its statement of financial position.
35. Classification of a convertible instrument into its components is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument, or some other transaction.
36. IPSAS 29 deals with the measurement of financial assets and financial liabilities. Equity instruments evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated into its components, the net assets/equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument is included in the liability component unless it forms part of the component of net assets/equity (such as an equity conversion option). The sum of the carrying amounts assigned to the liability and the net assets/equity components on initial recognition is always equal to the fair value that

would be ascribed to the instrument as a whole. No gain or loss arises from initially recognizing the components of the instrument separately.

37. Under the approach described in paragraph 36, the issuer of a bond convertible into ordinary shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated net assets/equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares is then determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

Treasury Shares (see also paragraph AG61)

38. **If an entity reacquires its own equity instruments, those instruments (“treasury shares”) shall be deducted from net assets/equity. No gain or loss shall be recognized in surplus or deficit on the purchase, sale, issue, or cancellation of an entity’s own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the economic entity. Consideration paid or received shall be recognized directly in net assets/equity.**
39. The amount of treasury shares held is disclosed separately either in the statement of financial position or in the notes, in accordance with IPSAS 1. An entity provides disclosure in accordance with IPSAS 20, *Related Party Disclosures* if the entity reacquires its own equity instruments from related parties.

Interest, Dividends or Similar Distributions, Losses, and Gains (see also paragraph AG62)

40. **Interest, dividends or similar distributions, losses, and gains relating to a financial instrument or a component that is a financial liability shall be recognized as revenue or expense in surplus or deficit. Distributions to holders of an equity instrument shall be recognized by the entity directly in net assets/equity. Transaction costs incurred on transactions in net assets/equity shall be accounted for as a deduction from net assets/equity.**
- 40A. Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with the relevant international or national accounting standard dealing with income taxes.
41. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends or similar distributions, losses, and gains relating to that instrument are recognized as revenue or expense in surplus or deficit. Thus, dividends or similar distributions on shares wholly recognized as liabilities are recognized as expenses in the

same way as interest on a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognized in surplus or deficit, whereas redemptions or refinancings of equity instruments are recognized as changes in net assets/equity. Changes in the fair value of an equity instrument are not recognized in the financial statements.

42. An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs, and stamp duties. Any related transaction costs are accounted for as a deduction from net assets/equity to the extent they are incremental costs directly attributable to the transaction that otherwise would have been avoided. The costs of such a transaction that is abandoned are recognized as an expense.
43. Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and the net assets/equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.
44. The amount of transaction costs accounted for as a deduction from net assets/equity in the period is disclosed separately in accordance with IPSAS 1.
45. Dividends or similar distributions classified as an expense are presented in the statement of financial performance either with interest on other liabilities or as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends or similar distributions is subject to the requirements of IPSAS 1 and IPSAS 30. In some circumstances, because of the differences between interest and dividends or similar distributions with respect to matters such as tax deductibility, it is desirable to disclose them separately in the statement financial performance.
46. Gains and losses related to changes in the carrying amount of a financial liability are recognized as revenue or expense in surplus or deficit even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 22(b)). Under IPSAS 1 the entity presents any gain or loss arising from remeasurement of such an instrument separately in the statement of financial performance when it is relevant in explaining the entity's performance.

Offsetting a Financial Asset and a Financial Liability (see also paragraphs AG63 and AG64)

47. **A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:**
- (a) **Currently has a legally enforceable right to set off the recognized amounts; and**
 - (b) **Intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.**

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see IPSAS 29, paragraph 38).

48. This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity.
49. Offsetting a recognized financial asset and a recognized financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognized item from the statement of financial position but also may result in recognition of a gain or loss.
50. A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered.
51. The existence of an enforceable right to set-off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash

flows are not affected. When an entity intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

52. An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal operating practices, the requirements of the financial markets, and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off, but does not intend to settle net or to realize the asset and settle the liability simultaneously, the effect of the right on the entity's credit risk exposure is disclosed in accordance with paragraph 42 of IPSAS 30.
53. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organized financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realization of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.
54. The conditions set out in paragraph 47 are generally not satisfied and offsetting is usually inappropriate when:
 - (a) Several different financial instruments are used to emulate the features of a single financial instrument (a "synthetic instrument");
 - (b) Financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (e.g., assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;
 - (c) Financial or other assets are pledged as collateral for non-recourse financial liabilities;
 - (d) Financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (e.g., a sinking fund arrangement); or

- (e) Obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

55. An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a “master netting arrangement” with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements may be commonly used to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realization or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of operations. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 47 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity’s exposure to credit risk is disclosed in accordance with paragraph 42 of IPSAS 30.

Transition

- 56. [Deleted]
- 57. [Deleted]
- 58. [Deleted]

Effective Date

- 59. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2013. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2013, it shall disclose that fact.**
- 60. **An entity shall not apply this Standard before January 1, 2013, unless it also applies IPSAS 29 and IPSAS 30.**
- 60A. **Paragraphs 40, 42 and 44 were amended and paragraph 40A added by *Improvements to IPSASs 2014* issued in January 2015. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2015. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2015, it shall disclose that fact.**
- 60B. **Paragraphs 56, 57, 58 and 61 were amended by IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* issued in January 2015. An entity shall apply those**

amendments for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is permitted. If an entity applies IPSAS 33 for a period beginning before January 1, 2017, the amendments shall also be applied for that earlier period.

- 60C. **IPSAS 35, *Consolidated Financial Statements* and IPSAS 37, *Joint Arrangements* issued in January 2015, amended paragraphs 3(a) and AG53. An entity shall apply those amendments when it applies IPSAS 35, and IPSAS 37.**
- 60D. **Paragraphs 7 and 8 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.**
- 60E. **Paragraph 3 was amended by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.**
- 61. When an entity adopts the accrual basis IPSASs of accounting as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.

Withdrawal and Replacement of IPSAS 15 (2001)

- 62. This Standard and IPSAS 30 supersede IPSAS 15, issued in 2001. IPSAS 15 remains applicable until IPSAS 28 and IPSAS 30 are applied or become effective, whichever is earlier.

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 28.

- AG1. This Application Guidance explains the application of particular aspects of the Standard.
- AG2. The Standard does not deal with the recognition or measurement of financial instruments. Requirements about the recognition and measurement of financial assets and financial liabilities are set out in IPSAS 29.

Scope (paragraphs 3–6)

Financial Guarantee Contracts

- AG3. Financial guarantee contracts are those contracts that require 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 terms of a debt instrument. Governments may issue financial guarantees for a variety of reasons. They are often issued to further a government's policy objectives, for example, to support infrastructure projects and stabilize the financial market in times of distress. Governments and public sector entities may be granted the power to issue financial guarantees by legislation or other authority. In assessing whether a guarantee is contractual or non-contractual, an entity distinguishes the right to issue the guarantee and the actual issue of the guarantee. The right to issue the guarantee in terms of legislation or other authority is non-contractual, while the actual issue of the guarantee should be assessed using the principles in paragraph AG20 to determine whether the guarantee is contractual.
- AG4. The issuing of financial guarantees in favor of a third party, whether explicitly or implicitly, may result in a contractual arrangement. Financial guarantees may be issued to a specific party or they may be issued to the holder of an instrument. Consider the following two examples:
- In a service concession arrangement, a government may issue a financial guarantee directly to the financiers of the transaction stating that, in the event of default, it would assume payment for any outstanding principal and interest payments of a loan. In this instance, the financial guarantee is explicitly issued in favor of an identified counterparty.
 - Road authority A is responsible for constructing and maintaining a country's road infrastructure. It finances the construction of new roads by issuing long term bonds. National government A exercises its powers in legislation and guarantees the bond issue of road authority A. At the time the guarantee is issued, there are no specific counterparties

that have been identified, rather the guarantee is implicitly issued in favor of the holders of a specific instrument.

In both these scenarios, assuming that all the other features of a contract are met, the financial guarantee is contractual in nature.

Insurance Contracts

- AG5. Some economic entities in the public sector may include entities that issue insurance contracts. Those entities are within the scope of this Standard, but the insurance contracts themselves are outside the scope of this Standard.
- AG6. For the purposes of this Standard, an insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (i.e., in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others, and interruption of operations. Additional guidance on insurance contracts is available in the relevant international or national standard dealing with insurance contracts.
- AG7. Some financial instruments take the form of insurance contracts but principally involve the transfer of financial risks, such as market, credit, or liquidity risk. Examples of such instruments include financial guarantee contracts, reinsurance, and guaranteed investment contracts issued by public sector insurers and other entities. An entity is required to apply this Standard to certain financial guarantee contracts, and is permitted to apply this Standard to other insurance contracts that involve the transfer of financial risk.
- AG8. Financial guarantee contracts are treated as financial instruments unless an entity elects to treat them as insurance contracts in accordance with this paragraph and also complies with the requirements of paragraph AG9. An entity may make this election in the following instances:
- (a) If an entity previously applied accounting applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, it may continue to treat such contracts either as insurance contracts or as financial instruments in accordance with this Standard.
 - (b) If an entity previously did not apply accounting applicable to insurance contracts, it may elect to treat financial guarantee contracts either as insurance contracts or as financial instruments when an entity adopts this Standard.

In both (a) and (b) above, the election is made on a contract by contract basis, and the choice is irrevocable.

- AG9. In accordance with paragraph 3(c), an entity treats financial guarantee contracts as financial instruments unless it elects to treat such contracts as insurance contracts in accordance with the relevant international or national

standard dealing with insurance contracts. An entity is permitted to treat a financial guarantee contract as an insurance contract using a national accounting standard only if that standard requires the measurement of insurance liabilities at an amount that is not less than the carrying amount that would be determined if the relevant insurance liabilities were within the scope of IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*. In determining the carrying amount of insurance liabilities, an entity considers the current estimates of all cash flows arising from its insurance contracts and of related cash flows.

Definitions (paragraphs 9–12)

Financial Assets and Financial Liabilities

- AG10. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognized in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a check or similar instrument against the balance in favor of a creditor in payment of a financial liability. Unissued currency does not meet the definition of a financial instrument. An entity applies paragraph 13 of IPSAS 12, *Inventories* in accounting for any unissued currency. Currency issued as legal tender from the perspective of the issuer, is not addressed in this Standard.
- AG11. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:
- (a) Accounts receivable and payable;
 - (b) Notes receivable and payable;
 - (c) Loans receivable and payable; and
 - (d) Bonds receivable and payable.

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

- AG12. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.

- AG13. “Perpetual” debt instruments (such as “perpetual” bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 percent applied to a stated par or principal amount of CU1,000. Assuming 8 percent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.
- AG14. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument.
- AG15. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender’s ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognized in the financial statements. Some of these contingent rights and obligations may be insurance contracts.
- AG16. Under IPSAS 13, *Leases*, a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. An operating lease, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, a finance lease is regarded as a financial instrument and an operating lease is

not regarded as a financial instrument (except as regards individual payments currently due and payable).

- AG17. Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.
- AG18. Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.
- AG19. Assets and liabilities in the public sector arise out of both contractual and non-contractual arrangements. Assets and liabilities arising out of non-contractual arrangements do not meet the definition of a financial asset or a financial liability.
- AG20. An entity considers the substance rather than the legal form of an arrangement in determining whether it is a “contract” for purposes of this Standard. Contracts, for the purposes of this Standard, are generally evidenced by the following (although this may differ from jurisdiction to jurisdiction):
- Contracts involve willing parties entering into an arrangement;
 - The terms of the contract create rights and obligations for the parties to the contract, and those rights and obligations need not result in equal performance by each party. For example, a donor funding arrangement creates an obligation for the donor to transfer resources to the recipient in terms of the agreement concluded, and establishes the right of the recipient to receive those resources. These types of arrangements may be contractual even though the recipient did not provide equal consideration in return i.e., the arrangement does not result in equal performance by the parties; and
 - The remedy for non-performance is enforceable by law.
- AG21. In the public sector, it is possible that contractual and non-contractual arrangements are non-exchange in nature. Assets and liabilities arising from non-exchange revenue transactions are accounted for in accordance with IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. If non-exchange revenue transactions are contractual, an entity assesses if the assets or liabilities arising from such transactions are financial assets or financial liabilities by using paragraphs 10 and AG10–AG18 of this Standard. An entity uses the guidance in this Standard and IPSAS 23 in assessing

whether a non-exchange transaction gives rise to a liability or an equity instrument (contribution from owners).

- AG22. An entity would particularly consider the classification requirements of this Standard in determining whether an inflow of resources as part of a contractual non-exchange revenue transaction is in substance a liability or an equity instrument.
- AG23. Statutory obligations can be accounted for in a number of ways:
- Obligations to pay income taxes are accounted for in accordance with the relevant international or national accounting standard dealing with income taxes.
 - Obligations to provide social benefits are accounted for in accordance with IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors* and IPSAS 19.
 - Other statutory obligations are accounted for in accordance with IPSAS 19.
- AG24. Constructive obligations, as defined in IPSAS 19, also do not arise from contracts and are therefore not financial liabilities.

Equity Instruments

- AG25. It is not common for entities in the public sector to have contributed capital comprising equity instruments, for example, shares and other forms of unitized capital. Where entities do issue equity instruments, the ownership and use of those instruments may be restricted by legislation. For example, legislation may stipulate that shares in a public sector entity may only be owned by another public sector entity and may therefore not be used as consideration for the settlement of transactions.
- AG26. Contributed capital in the public sector may also be evidenced by transfers of resources between parties. The issuance of equity instruments in respect of a transfer of resources is not essential for the transfer to meet the definition of a contribution from owners. Transfers of resources that result in an interest in the net assets/equity of an entity are distinguished from other transfers of resources because they may be evidenced by the following:
- A formal designation of a transfer of resources (or a class of such transfers) by the parties to the transaction as forming part of an entity's net assets/equity, either before the contribution occurs or at the time of the contribution. For example, on establishing a new entity, the budget office of the department of finance may deem that the initial transfers of resources to an entity establish an interest in the net assets/equity of an entity rather than provide funding to meet operational requirements.

- A formal agreement, in relation to the transfer, establishing or increasing an existing financial interest in the net assets/equity of an entity that can be sold, transferred or redeemed.

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

AG27. For the purposes of this Standard, the term “equity instrument” may be used to denote the following:

- A form of unitized capital such as ordinary or preference shares;
- Transfers of resources (either designated or agreed as such between the parties to the transaction) that evidence a residual interest in the net assets of another entity; and/or
- Financial liabilities in the legal form of debt that, in substance, represent an interest in an entity’s net assets.

Puttable Instruments

- AG28. Where an entity’s contributed capital is comprised of shares or other forms of unitized capital, these instruments may take a number of forms, for example non-puttable ordinary shares, some puttable instruments (see paragraphs 15 and 16), some instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation (see paragraphs 17 and 18), some types of preference shares (see paragraphs AG49 and AG50), and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. An entity’s obligation to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity (except as stated in paragraph 27). However, if such a contract contains an obligation for the entity to pay cash or another financial asset (other than a contract classified as an equity instrument in accordance with paragraphs 15 and 16 or paragraphs 17 and 18), it also gives rise to a liability for the present value of the redemption amount (see paragraph AG51(a)). An issuer of non-puttable ordinary shares assumes a liability when it formally acts to make a distribution and becomes legally obliged to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.
- AG29. A purchased call option or other similar contract acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset is

not a financial asset of the entity (except as stated in paragraph 27). Instead, any consideration paid for such a contract is deducted from net assets/equity.

The Class of Instruments that is Subordinate to all Other Classes (paragraphs 15(b) and 17(b))

- AG30. One of the features of paragraphs 15 and 17 is that the financial instrument is in the class of instruments that is subordinate to all other classes.
- AG31. When determining whether an instrument is in the subordinate class, an entity evaluates the instrument's claim on liquidation as if it were to liquidate on the date when it classifies the instrument. An entity shall reassess the classification if there is a change in relevant circumstances. For example, if the entity issues or redeems another financial instrument, this may affect whether the instrument in question is in the class of instruments that is subordinate to all other classes.
- AG32. An instrument that has a preferential right on liquidation of the entity is not an instrument with an entitlement to a pro rata share of the net assets of the entity. For example, an instrument has a preferential right on liquidation if it entitles the holder to a fixed dividend on liquidation, in addition to a share of the entity's net assets, when other instruments in the subordinate class with a right to a pro rata share of the net assets of the entity do not have the same right on liquidation.
- AG33. If an entity has only one class of financial instruments, that class shall be treated as if it were subordinate to all other classes.

Total Expected Cash Flows Attributable to the Instrument over the Life of the Instrument (paragraph 15(e))

- AG34. The total expected cash flows of the instrument over the life of the instrument must be substantially based on the surplus or deficit, change in the recognized net assets, or fair value of the recognized and unrecognized net assets of the entity over the life of the instrument. Surplus or deficit and the change in the recognized net assets shall be measured in accordance with relevant IPSASs.

Transactions Entered into by an Instrument Holder Other Than as Owner of the Entity (paragraphs 15 and 17)

- AG35. The holder of a puttable financial instrument or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation may enter into transactions with the entity in a role other than that of an owner. For example, an instrument holder also may be an employee of the entity. Only the cash flows and the contractual terms and conditions of the instrument that relate to the instrument holder as an owner of the entity shall be considered when assessing whether the instrument should be classified as an equity instrument under paragraph 15 or paragraph 17.

- AG36. An example is a limited partnership that has limited and general partners. Some general partners may provide a guarantee to the entity and may be remunerated for providing that guarantee. In such situations, the guarantee and the associated cash flows relate to the instrument holders in their role as guarantors and not in their roles as owners of the entity. Therefore, such a guarantee and the associated cash flows would not result in the general partners being considered subordinate to the limited partners, and would be disregarded when assessing whether the contractual terms of the limited partnership instruments and the general partnership instruments are identical.
- AG37. Another example is a surplus or deficit sharing arrangement that allocates surpluses and deficits to the instrument holders on the basis of services rendered or business generated during the current and previous years. Such arrangements are transactions with instrument holders in their role as non-owners and should not be considered when assessing the features listed in paragraph 15 or paragraph 17. However, such arrangements that allocate surpluses and deficits to instrument holders based on the nominal amount of their instruments relative to others in the class represent transactions with the instrument holders in their roles as owners and should be considered when assessing the features listed in paragraph 15 or paragraph 17.
- AG38. The cash flows and contractual terms and conditions of a transaction between the instrument holder (in the role as a non-owner) and the issuing entity must be similar to an equivalent transaction that might occur between a non-instrument holder and the issuing entity.

No Other Financial Instrument or Contract with Total Cash Flows that Substantially Fixes or Restricts the Residual Return to the Instrument Holder (paragraphs 16 and 18)

- AG39. A condition for classifying an equity instrument as a financial instrument that otherwise meets the criteria in paragraph 15 or paragraph 17 is that the entity has no other financial instrument or contract that has (a) total cash flows based substantially on the surplus or deficit, the change in the recognized net assets, or the change in the fair value of the recognized and unrecognized net assets of the entity and (b) the effect of substantially restricting or fixing the residual return. The following instruments, when entered into on normal commercial terms with unrelated parties, are unlikely to prevent instruments that otherwise meet the criteria in paragraph 15 or paragraph 17 from being classified as equity instruments:
- (a) Instruments with total cash flows substantially based on specific assets of the entity.
 - (b) Instruments with total cash flows based on a percentage of revenue.
 - (c) Contracts designed to reward individual employees for services rendered to the entity.

- (d) Contracts requiring the payment of an insignificant percentage of profit for services rendered or goods provided.

Derivative Financial Instruments

- AG40. Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and, accordingly, are within the scope of this Standard.
- AG41. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favorable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavorable. However, they generally¹ do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favorable or unfavorable.
- AG42. A put or call option to exchange financial assets or financial liabilities (i.e., financial instruments other than an entity's own equity instruments) gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forgo potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability, respectively. The financial instrument underlying an option contract may be any financial asset, including shares in other entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the financial asset under potentially favorable conditions and the writer's obligation to exchange the financial asset under potentially unfavorable conditions are distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and

¹ This is true of most, but not all derivatives, e.g., in some cross-currency interest rate swaps principal is exchanged on inception (and re-exchanged on maturity).

of the writer's obligation are not affected by the likelihood that the option will be exercised.

- AG43. Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver CU1,000,000 cash in exchange for CU1,000,000 face amount of fixed rate government bonds, and the other party (the seller) promises to deliver CU1,000,000 face amount of fixed rate government bonds in exchange for CU1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above CU1,000,000, the conditions will be favorable to the purchaser and unfavorable to the seller; if the market price falls below CU1,000,000, the effect will be the opposite. The purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.
- AG44. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments, note issuance facilities, and letters of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardized and traded on an exchange.

Contracts to Buy or Sell Non-Financial Items (paragraphs 4–6)

- AG45. Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g., an option, futures or forward contract on oil) are not financial instruments. Many commodity contracts are of this type. Some are standardized in form and traded on organized markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be

bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments (see paragraph 4).

- AG46. A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on credit.
- AG47. Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.
- AG48. The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

Presentation

Liabilities and Net Assets/Equity (paragraphs 13–32)

No Contractual Obligation to Deliver Cash or another Financial Asset (paragraphs 21–24)

- AG49. Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction, or insufficient surpluses or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.
- AG50. When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
- (a) A history of making distributions;
 - (b) An intention to make distributions in the future;
 - (c) A possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
 - (d) The amount of the issuer's reserves;
 - (e) An issuer's expectation of a surplus or deficit for a period; or
 - (f) An ability or inability of the issuer to influence the amount of its surplus or deficit for the period.

Settlement in the Entity's Own Equity Instruments (paragraphs 25–29)

AG51. As noted in paragraph AG25, it is not common for entities in the public sector to issue equity instruments comprising shares or other forms of unitized capital; and where such instruments do exist, their use and ownership is usually restricted in legislation. As a result of the capital structure of public sector entities generally being different from private sector entities, and the legislative environment in which public sector entities operate, transactions that are settled in an entity's own equity instruments are not likely to occur as frequently in the public sector as in the private sector. However, where such transactions do occur, the following examples may assist in illustrating how to classify different types of contracts on an entity's own equity instruments:

- (a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument (except as stated in paragraph 27). Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from net assets/equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognizes a financial liability for the present value of the redemption amount (with the exception of instruments that have all the features and meet the conditions in paragraph 15 and 16 or paragraphs 17 and 18). One example is an entity's obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.
- (b) An entity's obligation to purchase its own shares for cash gives rise to a financial liability for the present value of the redemption amount even if the number of shares that the entity is obliged to repurchase is not fixed or if the obligation is conditional on the counterparty exercising a right to redeem (except as stated in paragraphs 15 and 16 or paragraphs 17 and 18). One example of a conditional obligation is an issued option that requires the entity to repurchase its own shares for cash if the counterparty exercises the option.
- (c) A contract that will be settled in cash or another financial asset is a financial asset or financial liability even if the amount of cash or another financial asset that will be received or delivered is based on changes in the market price of the entity's own equity instruments (except as stated in paragraphs 15 and 16 or paragraphs 17 and 18). One example is a net cash-settled share option.

A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (e.g., a commodity price) is a financial asset or a financial liability. An example is a written option to buy oil that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than oil. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.

Contingent Settlement Provisions (paragraph 30)

- AG52. Paragraph 30 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Treatment in Consolidated Financial Statements

- AG53. In consolidated financial statements, an entity presents non-controlling interests i.e., the interests of other parties in the net assets/equity and revenue of its controlled entities in accordance with IPSAS 1 and IPSAS 35. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the economic entity and the holders of the instrument in determining whether the economic entity as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a controlled entity issues a financial instrument and a controlling entity or other entity within the economic entity agrees additional terms directly with the holders of the instrument (e.g., a guarantee), the economic entity may not have discretion over distributions or redemption. Although the controlled entity may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the economic entity and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect

the contracts and transactions entered into by the economic entity as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

- AG54. Some types of instruments that impose a contractual obligation on the entity are classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. Classification in accordance with those paragraphs is an exception to the principles otherwise applied in this Standard to the classification of an instrument and cannot be applied by analogy to other instruments. This exception is not extended to the classification of non-controlling interests in the consolidated financial statements. Therefore, instruments classified as equity instruments in accordance with either paragraphs 15 and 16 or paragraphs 17 and 18 in the separate or individual financial statements that are non-controlling interests are classified as liabilities in the consolidated financial statements of the economic entity.

Compound Financial Instruments (paragraphs 33–37)

- AG55. Paragraph 33 applies only to issuers of non-derivative compound financial instruments. Paragraph 33 does not deal with compound financial instruments from the perspective of holders. IPSAS 29 deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain the features of both debt and equity instruments.
- AG56. Compound financial instruments are not common in the public sector because of the capital structure of public sector entities. The following discussion does, however, illustrate how a compound financial instrument would be analyzed into its component parts. A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a bond convertible into ordinary shares of the issuer, and without any other embedded derivative features. Paragraph 33 requires the issuer of such a financial instrument to present the liability component and net assets/equity component separately in the statement of financial position, as follows:
- (a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. On initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.
 - (b) The equity instrument is an embedded option to convert the liability into net assets/equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. This option has value on initial recognition even when it is out of the money.

- AG57. On conversion of a convertible instrument at maturity, the entity derecognizes the liability component and recognizes it as net assets/equity. The original net assets/equity component remains as net assets/equity (although it may be transferred from one line item within net assets/equity to another.) There is no gain or loss on conversion at maturity.
- AG58. When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued, in accordance with paragraphs 33–37.
- AG59. Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:
- (a) The amount of gain or loss relating to the liability component is recognized in surplus or deficit; and
 - (b) The amount of consideration relating to the net assets/equity component is recognized in net assets/equity.
- AG60. An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favorable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognized as a loss in surplus or deficit.

Treasury Shares (paragraphs 38 and 39)

- AG61. An entity's own equity instruments are not recognized as a financial asset regardless of the reason for which they are reacquired. Paragraph 38 requires an entity that reacquires its own equity instruments to deduct those equity instruments from net assets/equity. However, when an entity holds its own equity instruments on behalf of others, for example, a financial institution holding its own equity instruments on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's statement of financial position.

Interest, Dividends or Similar Distributions, Losses, and Gains (paragraphs 40–46)

AG62. The following example illustrates the application of paragraph 40 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognized in surplus or deficit and classified as interest expense. Any dividends paid relate to the net assets/equity component and, accordingly, are recognized as a distribution of surplus or deficit. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of ordinary shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (for example, a commodity). However, if any unpaid dividends or similar distributions are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends or similar distributions are classified as interest expense.

Offsetting a Financial Asset and a Financial Liability (paragraphs 47–55)

AG63. To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognized amounts. An entity may have a conditional right to set off recognized amounts, such as in a master netting agreement or in some forms of non-recourse debt, but such rights are enforceable only on the occurrence of some future event, usually a default of the counterparty. Thus, such an arrangement does not meet the conditions for offset.

AG64. The Standard does not provide special treatment for so-called “synthetic instruments,” which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesizes a fixed rate long-term debt. Each of the individual financial instruments that together constitute a “synthetic instrument” represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a “synthetic instrument” is an asset and another is a liability, they are not offset and presented in an entity’s statement of financial position on a net basis unless they meet the criteria for offsetting in paragraph 47.

Appendix B

Members' Shares in Co-operative Entities and Similar Instruments

This Appendix is an integral part of IPSAS 28.

Introduction

- B1. Co-operatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a co-operative as a society endeavoring to promote its members' economic advancement by way of a joint business operation (the principle of self-help). Members' interests in a co-operative are often characterised as members' shares, units or the like, and are referred to below as "members' shares." This Appendix applies to financial instruments issued to members of co-operative entities that evidence the members' ownership interest in the entity and does not apply to financial instruments that will or may be settled in the entity's own equity instruments.
- B2. IPSAS 28 establishes principles for the classification of financial instruments as financial liabilities or net assets/equity. In particular, those principles apply to the classification of puttable instruments that allow the holder to put those instruments to the issuer for cash or another financial instrument. The application of those principles to members' shares in co-operative entities and similar instruments is difficult. This guidance is provided to illustrate the application of the principles in IPSAS 28 to members' shares and similar instruments that have certain features, and the circumstances in which those features affect the classification as liabilities or net assets/equity.
- B3. Many financial instruments, including members' shares, have characteristics of equity instruments, including voting rights and rights to participate in dividend or similar distributions. Some financial instruments give the holder the right to request redemption for cash or another financial asset, but may include or be subject to limits on whether the financial instruments will be redeemed. The following paragraphs outline how those redemption terms should be evaluated in determining whether the financial instruments should be classified as liabilities or net assets/equity.

Application of IPSASs to Members' Shares in Co-operative Entities and Similar Instruments

- B4. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or an equity instrument. Those terms and conditions include relevant local

laws, regulations and the entity's governing charter in effect at the date of classification, but not expected future amendments to those laws, regulations or charter.

- B5. Members' shares that would be classified as equity instruments if the members did not have a right to request redemption are equity instruments if either of the conditions described in paragraphs B6 and B7 is present or the members' shares have all the features and meet the conditions in paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS 28. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.
- B6. Members' shares are equity instruments if the entity has an unconditional right to refuse redemption of the members' shares.
- B7. Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, e.g., unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity instruments. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity instruments.
- B8. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph B6 or the members' shares have all the features and meet the conditions in paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS 28. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and net assets/equity.
- B9. At initial recognition, the entity shall measure its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the entity measures the fair value of the financial liability for redemption at no less than the maximum amount payable under the redemption provisions of its governing charter or applicable law discounted from the first date that the amount could be required to be paid (see example 3).
- B10. As required by paragraph 40 of IPSAS 28, distributions to holders of equity instruments are recognized directly in net assets/equity, net of any income tax benefits. Interest, dividends or similar distributions and other

returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterized as dividends or similar distributions, interest or otherwise.

- B11. When a change in the redemption prohibition leads to a transfer between financial liabilities and net assets/equity, the entity shall disclose separately the amount, timing and reason for the transfer.
- B12. The following examples illustrate the application of the preceding paragraphs.

Illustrative Examples

The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability and that the financial instrument does not have all the features or does not meet the conditions in paragraph 15 and 16 or paragraphs 17 and 18 of IPSAS 28.

Unconditional Right to Refuse Redemption (paragraph B6)

Example 1

Facts

- B13. The entity's charter states that redemptions are made at the sole discretion of the entity. The charter does not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board has the right to do so.

Classification

- B14. The entity has the unconditional right to refuse redemption and the members' shares are equity instruments. IPSAS 28 establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph AG50 of IPSAS 28 states:

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

- (a) A history of making distributions;
- (b) An intention to make distributions in the future;
- (c) A possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
- (d) The amount of the issuer's reserves;

- (e) An issuer's expectation of a surplus or deficit for a period; or
- (f) An ability or inability of the issuer to influence the amount of its surplus or deficit for the period.

Example 2

Facts

- B15. The entity's charter states that redemptions are made at the sole discretion of the entity. However, the charter further states that approval of a redemption request is automatic unless the entity is unable to make payments without violating local regulations regarding liquidity or reserves.

Classification

- B16. The entity does not have the unconditional right to refuse redemption and the members' shares are classified as a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in IPSAS 28, result in the classification of the financial instrument as equity instruments. Paragraph AG49 of IPSAS 28 states:

Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient surpluses or reserves, does not negate the obligation.* [Emphasis added]

Prohibitions against Redemption (paragraphs B7 and B8)

Example 3

Facts

- B17. A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:
- (a) January 1, 20X1 100,000 shares at CU10 each (CU1,000,000);
 - (b) January 1, 20X2 100,000 shares at CU20 each (a further CU2,000,000, so that the total for shares issued is CU3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

- B18. The entity's charter states that cumulative redemptions cannot exceed 20 percent of the highest number of its members' shares ever outstanding. At

December 31, 20X2 the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On January 1, 20X3 the entity amends its governing charter and increases the permitted level of cumulative redemptions to 25 percent of the highest number of its members' shares ever outstanding.

Classification

Before the Governing Charter is Amended

- B19. Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 52 of IPSAS 29, which states: "The fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand ..." Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.
- B20. On January 1, 20X1 the maximum amount payable under the redemption provisions is 20,000 shares at CU10 each and accordingly the entity classifies CU200,000 as financial liability and CU800,000 as equity instruments. However, on January 1, 20X2 because of the new issue of shares at CU20, the maximum amount payable under the redemption provisions increases to 40,000 shares at CU20 each. The issue of additional shares at CU20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 percent of the total shares in issue (200,000), measured at CU20, or CU800,000. This requires recognition of an additional liability of CU600,000. In this example no gain or loss is recognized. Accordingly the entity now classifies CU800,000 as financial liabilities and CU2,200,000 as equity instruments. This example assumes these amounts are not changed between January 1, 20X1 and December 31, 20X2.

After the Governing Charter is Amended

- B21. Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 percent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on January 1, 20X3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 52 of IPSAS 28. It therefore transfers on January 1, 20X3 from net assets/equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity instruments. In this example the entity does not recognize a gain or loss on the transfer.

Example 4*Facts*

- B22. Local law governing the operations of co-operatives, or the terms of the entity's governing charter, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 percent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is CU1,000,000. At the end of the reporting period the balance of paid-in capital is CU900,000.

Classification

- B23. In this case, CU750,000 would be classified as equity instruments and CU150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 22(b) of IPSAS 28 states in part:

... a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a "puttable instrument") is a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18. The financial instrument is a financial liability even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability, except for those instruments classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18.

- B24. The redemption prohibition described in this example is different from the restrictions described in paragraphs 23 and AG49 of IPSAS 28. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, i.e., they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (e.g., given its cash resources, surpluses or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-in capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5*Facts*

- B25. The facts of this example are as stated in example 4. In addition, at the end of the reporting period, liquidity requirements imposed in the local jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the end of the reporting period is that the entity cannot pay more than CU50,000 to redeem the members' shares.

Classification

- B26. As in example 4, the entity classifies CU750,000 as equity instruments and CU150,000 as a financial liability. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 23 and AG49 of IPSAS 28 apply in this case.

Example 6*Facts*

- B27. The entity's governing charter prohibits it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been CU12,000 and no member's shares have been redeemed.

Classification

- B28. The entity classifies CU12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity instruments. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7*Facts*

- B29. The entity is a co-operative bank. Local law governing the operations of co-operative banks state that at least 50 percent of the entity's total "outstanding liabilities" (a term defined in the regulations to include members' share accounts) has to be in the form of members' paid-in capital. The effect of the regulation is that if all of a co-operative's outstanding liabilities are in the form of members' shares, it is able to redeem them all. On December 31, 20X1 the entity has total outstanding liabilities of CU200,000, of which CU125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the entity's charter.

Classification

- B30. In this example members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 23 and AG49 of IPSAS 28. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, i.e., they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (CU125,000) if it repaid all of its other liabilities (CU75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, i.e., the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Appendix C

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 28.

Introduction

- BC1. This Basis for Conclusions summarizes the International Public Sector Accounting Standards Board's (IPSASB) considerations in reaching the conclusions in IPSAS 28, *Financial Instruments: Presentation*. As this Standard is primarily drawn from IAS 32, *Financial Instruments: Presentation* issued by the International Accounting Standards Board (IASB), the Basis for Conclusions outlines only those areas where the IPSAS 28 departs from the main requirements of IAS 32.
- BC2. This project on financial instruments is a key part of the IPSASB's convergence program, which aims to converge IPSASs with International Financial Reporting Standards (IFRSs). The IPSASB acknowledges that there are other aspects of financial instruments, in so far as they relate to the public sector, which are not addressed in IAS 32. These may be addressed by future projects of the IPSASB. In particular, the IPSASB acknowledges that future projects may be required to address:
- Certain transactions undertaken by central banks; and
 - Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature.
- BC3. In developing this Standard, the IPSASB agreed to retain the existing text of IAS 32, making changes to ensure consistency with the terminology and presentational requirements of other IPSASs, and deal with any public sector specific issues through additional Application Guidance.
- BC4. In September 2007, the IASB issued amendments to IAS 1, *Presentation of Financial Statements* which introduced "comprehensive income" into the presentation of financial statements. As the IPSASB has not yet considered comprehensive income, along with some of the other amendments to IAS 1, those amendments have not been included in IPSAS 28.

Scope

Insurance and Financial Guarantee Contracts

- BC5. IAS 32 excludes all insurance contracts from the scope of IAS 32, except for financial guarantee contracts where the issuer applies IAS 39, *Financial Instruments: Recognition and Measurement* in recognizing and measuring such contracts. The scope of IPSAS 28 also excludes all insurance contracts, except that:

- Financial guarantee contracts are to be treated as financial instruments unless an entity elects to treat such contracts as insurance contracts in accordance with the relevant international or national accounting standard dealing with insurance contracts; and
- Contracts that are insurance contracts but involve the transfer of financial risk may be treated as financial instruments in accordance with IPSAS 28, IPSAS 29 and IPSAS 30.

Treating Financial Guarantees as Financial Instruments

- BC6. Under IAS 32, financial guarantee contracts should be treated as financial instruments, unless an issuer elects to apply IFRS 4 to those contracts. Unlike in the private sector, many financial guarantee contracts are issued in the public sector by way of a non-exchange transaction, i.e., at no or nominal consideration. So as to enhance the comparability of financial statements and, given the significance of financial guarantee contracts issued by way of non-exchange transactions in the public sector, the IPSASB had proposed that such guarantees should be treated as financial instruments and entities should not be permitted to treat them as insurance contracts.
- BC7. In response to this proposal, some respondents agreed that the treatment of financial guarantee contracts issued through non-exchange transactions as financial instruments, rather than as insurance contracts, is appropriate because the business models for exchange and non-exchange insurance contracts are different. Others argued that entities should be allowed to treat such guarantees as insurance contracts or financial instruments using an election similar to that in IFRS 4.
- BC8. The IPSASB concluded that the same approach should be applied to financial guarantee contracts, regardless of whether they are issued through exchange or non-exchange transactions, because the underlying liability that should be recognized in an entity's financial statements does not differ. The IPSASB agreed that entities should be permitted a choice of treating financial guarantee contracts, either as insurance contracts or financial instruments, subject to certain conditions.
- BC9. In evaluating the circumstances under which an entity may elect to treat financial guarantee contracts as insurance contracts, the IPSASB considered the requirements of IFRS 4. The election to treat financial guarantee contracts as financial instruments or insurance contracts under IFRS 4 is available only to those entities that previously explicitly asserted that they deem such contracts to be insurance contracts. The IPSASB, however, recognized that not all entities that have adopted accrual accounting apply IFRS 4. It acknowledged that it should also consider scenarios where, for example, entities applied accrual accounting but did not recognize assets and liabilities relating to insurance contracts, as well as entities that previously did not apply accrual accounting. Consequently, the IPSASB agreed that the existing

requirements in IFRS 4 were too onerous and would need to be modified in the context of this Standard.

BC10. The IPSASB therefore agreed that entities that previously:

- (a) Applied insurance accounting and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, could continue to treat those guarantees as insurance contracts or as financial instruments; and
- (b) Did not apply insurance accounting would be allowed a choice of treating financial guarantee contracts either as insurance contracts or financial instruments when they adopt this Standard.

In both instances, the election is irrevocable.

BC11. The IPSASB considered whether entities should be allowed to elect to treat financial guarantees as insurance contracts on a contract-by-contract basis or, whether entities should be required to make a general accounting policy choice. It was agreed that the choice should be made on an individual contract basis to allow entities within an economic entity to treat financial guarantees as insurance contracts or financial instruments, based on the nature of their businesses.

BC12. The IPSASB agreed, as a precondition for allowing entities to treat financial guarantees as insurance contracts, that the accounting practices applied by entities for insurance contracts should meet certain requirements. The IPSASB agreed that if entities elected to treat financial guarantee contracts as insurance contracts, that they must apply either IFRS 4 or a national accounting standard that requires insurance liabilities to be measured at a minimum value. That minimum value is determined as if the insurance liabilities were within the scope of IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* using the current estimates of cash flows arising from an entity's insurance contracts and of any related cash flows.

Option to Treat Insurance Contracts that Transfer Financial Risk as Financial Instruments

BC13. IPSAS 15 allowed entities to account for contracts that are insurance contracts that result in the transfer of financial risk, as financial instruments. In the absence of an IPSAS on insurance contracts, the IPSASB concluded that it should allow, but not require, entities to apply IPSAS 28 to such contracts.

Identifying Contractual Financial Guarantees

BC14. Financial instruments in IPSAS 28 are defined as: "...any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity." As arrangements in the public sector may arise through statutory powers, the IPSASB developed additional application

guidance to identify when financial guarantees are contractual. The IPSASB concluded that, to be within the scope of IPSAS 28, financial guarantees should have the key features of a contractual arrangement. The IPSASB also concluded that an entity should distinguish the right to issue guarantees, which is often conferred on an entity through statutory or similar means, and the actual issuing of the guarantee in favour of a third party, irrespective of whether that party is explicitly or implicitly identified. A statutory right to issue guarantees, of itself, is not within the scope of this Standard.

Definitions

Contractual Arrangements

- BC15. The IPSASB noted that, in certain jurisdictions, public sector entities are precluded from entering into formal contracts, but do enter into arrangements that have the substance of contracts. These arrangements may be known by another term, e.g., a “government order.” To assist entities in identifying contracts, which either have the substance or legal form of a contract, the IPSASB considered it appropriate to issue additional Application Guidance explaining the factors an entity should consider in assessing whether an arrangement is contractual or non-contractual.
- BC16. Consideration was given as to whether the term “binding arrangement” should be used to describe the arrangements highlighted in paragraph BC15. The term “binding arrangement” has not been defined, but has been used in IPSASs to describe arrangements that are binding on the parties, but do not take the form of a documented contract, such as an arrangement between two government departments that do not have the power to contract. The IPSASB concluded that the term “binding arrangements,” as used in IPSASs, embraces a wider set of arrangements than those identified in paragraph BC15 and therefore concluded that it should not be used in this IPSAS.

Contractual Non-Exchange Revenue Transactions

- BC17. IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* prescribes the initial recognition, initial measurement and disclosure of assets and liabilities arising out of non-exchange revenue transactions. The IPSASB considered the interaction between this Standard and IPSAS 23.
- BC18. In considering whether assets and liabilities that arise from non-exchange revenue transactions are financial assets and financial liabilities, the IPSASB identified that the following basic requirements should be fulfilled:
- The arrangement is contractual in nature; and
 - The arrangement gives rise to a contractual right or obligation to receive or deliver cash or another financial asset, or exchange financial assets under favorable or unfavorable conditions.

- BC19. The IPSASB concluded that assets arising from non-exchange revenue transactions could meet these requirements. In particular, it noted that the nature of arrangements with donors may be contractual in nature, and may be settled by transferring cash or another financial asset from the donor to the recipient. In these instances, assets arising from non-exchange revenue transactions are financial assets.
- BC20. The IPSASB agreed that, for financial assets arising from non-exchange transactions, an entity should apply the requirements of IPSAS 23 in conjunction with IPSAS 28. In particular, an entity considers the principles in IPSAS 28 in considering whether an inflow of resources from a non-exchange revenue transaction results in a liability or a transaction that evidences a residual interest in the net assets of the entity, i.e., an equity instrument.
- BC21. The IPSASB considered whether liabilities arising from non-exchange revenue transactions are financial liabilities. Liabilities are recognized in IPSAS 23 when an entity receives an inflow of resources that is subject to specific conditions. Conditions on a transfer of resources are imposed on an entity by a transferor and require that the resources are used in a certain way, often to provide goods and services to third parties, or are returned to the transferor. This gives rise to an obligation to perform in terms of the agreement. At initial recognition, an entity recognizes the resources as an asset and, where they are subject to conditions, recognizes a corresponding liability.
- BC22. The IPSASB considered whether the liability initially recognized is in the nature of a financial liability or another liability, e.g., a provision. The IPSASB agreed that, at the time the asset is recognized, the liability is not usually a financial liability as the entity's obligation is to fulfil the terms and conditions of the arrangement by utilizing the resources as intended, usually by providing goods and services to third parties over a period of time. If after initial recognition, the entity cannot fulfil the terms of the arrangement and is required to return the resources to the transferor, an entity would assess at this stage whether the liability is a financial liability considering the requirements set out in paragraph BC18 and the definitions of a financial instrument and a financial liability. In rare circumstances, a financial liability may arise from conditions imposed on a transfer of resources as part of a non-exchange revenue transaction. The IPSASB may consider such a scenario as part of a future project.
- BC23. The IPSASB also noted that other liabilities may arise from non-exchange revenue transactions after initial recognition. For example, an entity may receive resources under an arrangement that requires the resources to be returned only after the occurrence or non-occurrence of a future event. An entity assesses whether other liabilities arising from non-exchange revenue transactions are financial liabilities by considering whether the requirements

in paragraph BC18 have been fulfilled and the definitions of a financial instrument and a financial liability have been met.

Other

Interpretations Developed by the International Financial Reporting Interpretations Committee

- BC24. The IPSASB considered whether International Financial Reporting Interpretations Committee Interpretation (IFRIC) 2, *Members' Shares in Co-operative Entities and Similar Instruments* and International Financial Reporting Interpretations Committee Interpretation (IFRIC) 11, *IFRS 2—Group and Treasury Share Transactions* were relevant for the types of instruments entered into by governments and entities in the public sector.
- BC25. When this Standard was issued, the IPSASB considered that IFRIC 11 is not relevant for the types of instruments entered into in the public sector as it deals with share-based payment transactions. While share-based payments may be common in [Government Business Enterprises (GBE's)] (the term in square brackets is no longer used following the issue of *The Applicability of IPSASs* in April 2016), they do not occur frequently in entities that are not GBE's. As a result, the IPSASB has not included any principles from IFRIC 11 in IPSAS 28.
- BC26. IFRIC 2 provides guidance on the application of IAS 32 to members' shares in co-operative entities and similar instruments. There is a strong link between IAS 32 and IFRIC 2 in relation to puttable financial instruments and obligations arising on liquidation. As the text of IAS 32 that deals with puttable financial instruments and obligations arising on liquidation has been retained in IPSAS 28, IFRIC 2 provides additional guidance to users of IPSAS 28 in applying those principles to members' interests in co-operative entities. Therefore, the principles and examples from IFRIC 2 have been included in IPSAS 28 as an authoritative appendix.

Revision of IPSAS 28 as a result of IASB's *Improvements to IFRSs* issued in May 2012

- BC27. The IPSASB reviewed the revisions to IAS 32 included in the *Improvements to IFRSs* issued by the IASB in May 2012 and generally concurred that there was no public sector specific reason for not adopting the amendments.

Revision of IPSAS 28 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

- BC28. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

- (a) Removes the standard paragraphs about the applicability of IPSASs to “public sector entities other than GBEs” from the scope section of each Standard;
- (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and
- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

Illustrative Examples

These examples accompany, but are not part of, IPSAS 28.

Accounting for Contracts on Equity Instruments of an Entity

IE1. The following examples illustrate the application of paragraphs 13–32 and IPSAS 29 to the accounting for contracts on an entity’s own equity instruments. In these examples, monetary amounts are denominated in “currency units” (CU).

Example 1: Forward to Buy Shares

IE2. This example illustrates the journal entries for forward purchase contracts on an entity’s own shares that will be settled (a) net in cash, (b) net in shares, or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (i.e., the “carry return” is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	February 1, 20X2
Maturity date	January 31, 20X3
Market price per share on February, 1 20X2	CU100
Market price per share on December, 31 20X2	CU110
Market price per share on January, 31 20X3	CU106
Fixed forward price to be paid on January, 31 20X3	CU104
Present value of forward price on February, 1 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on February, 1 20X2	CU0
Fair value of forward on December, 31 20X2	CU6,300
Fair value of forward on January, 31 20X3	CU2,000

(a) Cash for Cash (“Net Cash Settlement”)

IE3. In this subsection, the forward purchase contract on the entity’s own shares will be settled net in cash, i.e., there is no receipt or delivery of the entity’s own shares upon settlement of the forward contract.

On February 1, 20X2, Entity A enters into a contract with Entity B to receive the fair value of 1,000 of Entity A's own outstanding ordinary shares as of January 31, 20X3 in exchange for a payment of CU104,000 in cash (i.e., CU104 per share) on January 31, 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

February 1, 20X2

The price per share when the contract is agreed on February 1, 20X2 is CU100. The initial fair value of the forward contract on February 1, 20X2 is zero.

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

December 31, 20X2

On December 31, 20X2, the market price per share has increased to CU110 and, as a result, the fair value of the forward contract has increased to CU6,300.

Dr	Forward asset	CU6,300	
	Cr	Gain	CU6,300

To record the increase in the fair value of the forward contract.

January 31, 20X3

On January 31, 20X3, the market price per share has decreased to CU106. The fair value of the forward contract is CU2,000 ($[(CU106 \times 1,000) - CU104,000]$).

On the same day, the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 to Entity B and Entity B has an obligation to deliver CU106,000 ($CU106 \times 1,000$) to Entity A, so Entity B pays the net amount of CU2,000 to Entity A.

Dr	Loss	CU4,300	
	Cr	Forward asset	CU4,300

To record the decrease in the fair value of the forward contract (i.e., $CU4,300 = CU6,300 - CU2,000$).

Dr	Cash	CU2,000	
	Cr	Forward asset	CU2,000

To record the settlement of the forward contract.

(b) Shares for Shares (“Net Share Settlement”)

- IE4. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a) above, except for recording the settlement of the forward contract, as follows:

January 31, 20X3

The contract is settled net in shares. Entity A has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) worth of its shares to Entity B and Entity B has an obligation to deliver CU106,000 ($\text{CU106} \times 1,000$) worth of shares to Entity A. Thus, Entity B delivers a net amount of CU2,000 ($\text{CU106,000} - \text{CU104,000}$) worth of shares to Entity A, i.e., 18.9 shares ($\text{CU2,000}/\text{CU106}$).

Dr	Net assets/equity	CU2,000	
	Cr	Forward asset	CU2,000

To record the settlement of the forward contract.

(c) Cash for Shares ("Gross Physical Settlement")

- IE5. Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of Entity A's shares. Similarly to (a) and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has an obligation to pay CU104,000 in cash to Entity B ($\text{CU104} \times 1,000$) and Entity B has an obligation to deliver 1,000 of Entity A's outstanding shares to Entity A in one year. Entity A records the following journal entries.

February 1, 20X2

Dr	Net assets/equity	CU100,000	
	Cr	Liability	CU100,000

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IPSAS 29, paragraph AG82).

December 31, 20X2

Dr	Interest expense	CU3,660	
	Cr	Liability	CU3,660

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

January 31, 20X3

Dr	Interest expense	CU340	
	Cr	Liability	CU340

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

Entity A delivers CU104,000 in cash to Entity B and Entity B delivers 1,000 of Entity A's shares to Entity A.

Dr	Liability	CU104,000	
	Cr Cash		CU104,000

To record the settlement of the obligation to redeem Entity A's own shares for cash.

(d) Settlement Options

- IE6. The existence of settlement options (such as net in cash, net in shares, or by an exchange of cash and shares) has the result that the forward repurchase contract is a financial asset or a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognizes a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the forward contract as a derivative.

Example 2: Forward to Sell Shares

- IE7. This example illustrates the journal entries for forward sale contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares, or (c) by receiving cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (i.e., the "carry return" is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	February 1, 20X2
Maturity date	January 31, 20X3
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU110
Market price per share on January 31, 20X3	CU106
Fixed forward price to be paid on January 31, 20X3	CU104
Present value of forward price on February 1, 20X2	CU100

Number of shares under forward contract	1,000
Fair value of forward on February 1, 20X2	CU0
Fair value of forward on December 31, 20X2	(CU6,300)
Fair value of forward on January 31, 20X3	(CU2,000)

(a) **Cash for Cash (“Net Cash Settlement”)**

IE8. On February 1, 20X2, Entity A enters into a contract with Entity B to pay the fair value of 1,000 of Entity A’s own outstanding ordinary shares as of January 31, 20X3 in exchange for CU104,000 in cash (i.e., CU104 per share) on January 31, 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

February 1, 20X2

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

December 31, 20X2

Dr	Loss	CU6,300	
	Cr	Forward liability	CU6,300

To record the decrease in the fair value of the forward contract.

January 31, 20X3

Dr	Forward liability	CU4,300	
	Cr	Gain	CU4,300

To record the increase in the fair value of the forward contract (i.e., CU4,300 = CU6,300 – CU2,000).

The contract is settled net in cash. Entity B has an obligation to deliver CU104,000 to Entity A, and Entity A has an obligation to deliver CU106,000 (CU106 × 1,000) to Entity B. Thus, Entity A pays the net amount of CU2,000 to Entity B.

Dr	Forward liability	CU2,000	
	Cr	Cash	CU2,000

To record the settlement of the forward contract.

(b) Shares for Shares (“Net Share Settlement”)

- IE9. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A’s journal entries are the same as those shown in (a), except:

January 31, 20X3

The contract is settled net in shares. Entity A has a right to receive CU104,000 ($\text{CU}104 \times 1,000$) worth of its shares and an obligation to deliver CU106,000 ($\text{CU}106 \times 1,000$) worth of its shares to Entity B. Thus, Entity A delivers a net amount of CU2,000 ($\text{CU}106,000 - \text{CU}104,000$) worth of its shares to Entity B, i.e., 18.9 shares ($\text{CU}2,000/\text{CU}106$).

Dr	Forward liability	CU2,000	
	Cr	Net assets/equity	CU2,000

To record the settlement of the forward contract. The issue of the entity’s own shares is treated as a transaction in net assets/equity.

(c) Shares for Cash (“Gross Physical Settlement”)

- IE10. Assume the same facts as in (a), except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of the entity’s own shares. Similarly to (a) and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has a right to receive CU104,000 in cash ($\text{CU}104 \times 1,000$) and an obligation to deliver 1,000 of its own shares in one year. Entity A records the following journal entries.

February 1, 20X2

No entry is made on February 1. No cash is paid or received because the forward has an initial fair value of zero. A forward contract to deliver a fixed number of Entity A’s own shares in exchange for a fixed amount of cash or another financial asset meets the definition of an equity instrument because it cannot be settled otherwise than through the delivery of shares in exchange for cash.

December 31, 20X2

No entry is made on December 31, because no cash is paid or received and a contract to deliver a fixed number of Entity A’s own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

January 31, 20X3

On January 31, 20X3, Entity A receives CU104,000 in cash and delivers 1,000 shares.

Dr	Cash	CU104,000	
	Cr	Net assets/equity	CU104,000

To record the settlement of the forward contract.

(d) Settlement Options

- IE11. The existence of settlement options (such as net in cash, net in shares, or by an exchange of cash and shares) has the result that the forward contract is a financial asset or a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognizes a derivative asset or liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 3: Purchased Call Option on Shares

- IE12. This example illustrates the journal entries for a purchased call option right on the entity's own shares that will be settled (a) net in cash, (b) net in shares, or (c) by delivering cash in exchange for the entity's own shares. It also discusses the effect of settlement options (see (d) below):

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3 (European terms, i.e., it can be exercised only at maturity)
Exercise right holder	Reporting entity (Entity A)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU104
Market price per share on January 31, 20X3	CU104
Fixed exercise price to be paid on January 31, 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU3,000
Fair value of option on January 31, 20X3	CU2,000

(a) Cash for Cash ("Net Cash Settlement")

- IE13. On February 1, 20X2, Entity A enters into a contract with Entity B that gives Entity B the obligation to deliver, and Entity A the right to receive the fair

value of 1,000 of Entity A's own ordinary shares as of January 31, 20X3 in exchange for CU102,000 in cash (i.e., CU102 per share) on January 31, 20X3, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

February 1, 20X2

The price per share when the contract is agreed on February 1, 20X2 is CU100. The initial fair value of the option contract on February 1, 20X2 is CU5,000, which Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU102 exceeds the market price per share of CU100 and it would therefore not be economic for Entity A to exercise the option. In other words, the call option is out of the money.

Dr	Call option asset	CU5,000	
	Cr	Cash	CU5,000

To recognize the purchased call option.

December 31, 20X2

On December 31, 20X2, the market price per share has increased to CU104. The fair value of the call option has decreased to CU3,000, of which CU2,000 is intrinsic value ($[(CU104 - CU102) \times 1,000]$), and CU1,000 is the remaining time value.

Dr	Loss	CU2,000	
	Cr	Call option asset	CU2,000

To record the decrease in the fair value of the call option.

January 31, 20X3

On January 31, 20X3, the market price per share is still CU104. The fair value of the call option has decreased to CU2,000, which is all intrinsic value ($[(CU104 - CU102) \times 1,000]$) because no time value remains.

Dr	Loss	CU1,000	
	Cr	Call option asset	CU1,000

To record the decrease in the fair value of the call option.

On the same day, Entity A exercises the call option and the contract is settled net in cash. Entity B has an obligation to deliver CU104,000 ($CU104 \times 1,000$) to Entity A in exchange for CU102,000 ($CU102 \times 1,000$) from Entity A, so Entity A receives a net amount of CU2,000.

Dr	Cash	CU2,000	
	Cr	Call option asset	CU2,000

To record the settlement of the option contract.

(b) Shares for Shares (“Net Share Settlement”)

- IE14. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A’s journal entries are the same as those shown in (a) except for recording the settlement of the option contract as follows:

January 31, 20X3

Entity A exercises the call option and the contract is settled net in shares. Entity B has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) worth of Entity A’s shares to Entity A in exchange for CU102,000 ($\text{CU102} \times 1,000$) worth of Entity A’s shares. Thus, Entity B delivers the net amount of CU2,000 worth of shares to Entity A, i.e., 19.2 shares ($\text{CU2,000}/\text{CU104}$).

Dr	Net assets/equity	CU2,000	
	Cr	Call option asset	CU2,000

To record the settlement of the option contract. The settlement is accounted for as a treasury share transaction (i.e., no gain or loss).

(c) Cash for Shares (“Gross Physical Settlement”)

- IE15. Assume the same facts as in (a) except that settlement will be made by receiving a fixed number of shares and paying a fixed amount of cash, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity A has a right to receive 1,000 of Entity A’s own outstanding shares in exchange for CU102,000 ($\text{CU102} \times 1,000$) in cash, if Entity A exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr	Net assets/equity	CU5,000	
	Cr	Cash	CU5,000

To record the cash paid in exchange for the right to receive Entity A’s own shares in one year for a fixed price. The premium paid is recognized in net assets/equity.

December 31, 20X2

No entry is made on December 31, because no cash is paid or received and a contract that gives a right to receive a fixed number of Entity A’s own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

January 31, 20X3

Entity A exercises the call option and the contract is settled gross. Entity B has an obligation to deliver 1,000 of Entity A’s shares in exchange for CU102,000 in cash.

Dr	Net assets/equity	CU102,000	
	Cr Cash		CU102,000

To record the settlement of the option contract.

(d) Settlement Options

- IE16. The existence of settlement options (such as net in cash, net in shares, or by an exchange of cash and shares) has the result that the call option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognizes a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 4: Written Call Option on Shares

- IE17. This example illustrates the journal entries for a written call option obligation on the entity's own shares that will be settled (a) net in cash, (b) net in shares, or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3
	(European terms, i.e., it can be exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU104
Market price per share on January 31, 20X3	CU104
Fixed exercise price to be paid on January 31, 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU3,000
Fair value of option on January 31, 20X3	CU2,000

(a) Cash for Cash (“Net Cash Settlement”)

- IE18. Assume the same facts as in Example 3(a) above except that Entity A has written a call option on its own shares instead of having purchased a call option on them. Accordingly, on February 1, 20X2 Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A’s own ordinary shares as of January 31, 20X3 in exchange for CU102,000 in cash (i.e., CU102 per share) on January 31, 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

February 1, 20X2

Dr	Cash	CU5,000	
	Cr	Call option obligation	CU5,000

To recognize the written call option.

December 31, 20X2

Dr	Call option obligation	CU2,000	
	Cr	Gain	CU2,000

To record the decrease in the fair value of the call option.

January 31, 20X3

Dr	Call option obligation	CU1,000	
	Cr	Gain	CU1,000

To record the decrease in the fair value of the option.

On the same day, Entity B exercises the call option and the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 ($CU104 \times 1,000$) to Entity B in exchange for CU102,000 ($CU102 \times 1,000$) from Entity B, so Entity A pays a net amount of CU2,000.

Dr	Call option obligation	CU2,000	
	Cr	Cash	CU2,000

To record the settlement of the option contract.

(b) Shares for Shares (“Net Share Settlement”)

- IE19. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A’s journal entries are the same as those shown in (a), except for recording the settlement of the option contract, as follows:

December 31, 20X3

Entity B exercises the call option and the contract is settled net in shares. Entity A has an obligation to deliver CU104,000 ($\text{CU104} \times 1,000$) worth of Entity A's shares to Entity B in exchange for CU102,000 ($\text{CU102} \times 1,000$) worth of Entity A's shares. Thus, Entity A delivers the net amount of CU2,000 worth of shares to Entity B, i.e., 19.2 shares ($\text{CU2,000}/\text{CU104}$).

Dr	Call option obligation	CU2,000	
	Cr	Net assets/equity	CU2,000

To record the settlement of the option contract. The settlement is accounted for as a transaction in net assets/equity.

(c) Cash for Shares ("Gross Physical Settlement")

- IE20. Assume the same facts as in (a) except that settlement will be made by delivering a fixed number of shares and receiving a fixed amount of cash, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity B has a right to receive 1,000 of Entity A's own outstanding shares in exchange for CU102,000 ($\text{CU102} \times 1,000$) in cash, if Entity B exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr	Cash	CU5,000	
	Cr	Net assets/equity	CU5,000

To record the cash received in exchange for the obligation to deliver a fixed number of Entity A's own shares in one year for a fixed price. The premium received is recognized in net assets/equity. Upon exercise, the call would result in the issue of a fixed number of shares in exchange for a fixed amount of cash.

December 31, 20X2

No entry is made on December 31 because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

January 31, 20X3

Entity B exercises the call option and the contract is settled gross. Entity A has an obligation to deliver 1,000 shares in exchange for CU102,000 in cash.

Dr	Cash	CU102,000	
	Cr	Net assets/equity	CU102,000

To record the settlement of the option contract.

(d) Settlement Options

- IE21. The existence of settlement options (such as net in cash, net in shares, or by an exchange of cash and shares) has the result that the call option is a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognizes a derivative liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 5: Purchased Put Option on Shares

- IE22. This example illustrates the journal entries for a purchased put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares, or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3
	(European terms, i.e., it can be exercised only at maturity)
Exercise right holder	Reporting entity (Entity A)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU95
Market price per share on January 31, 20X3	CU95
Fixed exercise price to be paid on January 31, 20X3	CU98
Number of shares under option contract	1,000
Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU4,000
Fair value of option on January 31, 20X3	CU3,000

(a) Cash for Cash ("Net Cash Settlement")

- IE23. On February 1, 20X2, Entity A enters into a contract with Entity B that gives Entity A the right to sell, and Entity B the obligation to buy the fair value of 1,000 of Entity A's own outstanding ordinary shares as of January 31, 20X3 at a strike price of CU98,000 (i.e., CU98 per share) on January 31, 20X3, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

February, 1 20X2

The price per share when the contract is agreed on February 1, 20X2 is CU100. The initial fair value of the option contract on February 1, 20X2 is CU5,000, which Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU98 is less than the market price per share of CU100. Therefore it would not be economic for Entity A to exercise the option. In other words, the put option is out of the money.

Dr	Put option asset	CU5,000	
	Cr Cash		CU5,000

To recognize the purchased put option.

December 31, 20X2

On December 31, 20X2 the market price per share has decreased to CU95. The fair value of the put option has decreased to CU4,000, of which CU3,000 is intrinsic value $([CU98 - CU95] \times 1,000)$ and CU1,000 is the remaining time value.

Dr	Loss	CU1,000	
	Cr Put option asset		CU1,000

To record the decrease in the fair value of the put option.

January 31, 20X3

On January 31, 20X3 the market price per share is still CU95. The fair value of the put option has decreased to CU3,000, which is all intrinsic value $([CU98 - CU95] \times 1,000)$ because no time value remains.

Dr	Loss	CU1,000	
	Cr Put option asset		CU1,000

To record the decrease in the fair value of the option.

On the same day, Entity A exercises the put option and the contract is settled net in cash. Entity B has an obligation to deliver CU98,000 to Entity A and Entity A has an obligation to deliver CU95,000 $(CU95 \times 1,000)$ to Entity B, so Entity B pays the net amount of CU3,000 to Entity A.

Dr	Cash	CU3,000	
	Cr Put option asset		CU3,000

To record the settlement of the option contract.

(b) Shares for Shares (“Net Share Settlement”)

- IE24. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A’s journal entries are the same as shown in (a), except:

January 31, 20X3

Entity A exercises the put option and the contract is settled net in shares. In effect, Entity B has an obligation to deliver CU98,000 worth of Entity A’s shares to Entity A, and Entity A has an obligation to deliver CU95,000 worth of Entity A’s shares ($\text{CU}95 \times 1,000$) to Entity B, so Entity B delivers the net amount of CU3,000 worth of shares to Entity A, i.e., 31.6 shares ($\text{CU}3,000/\text{CU}95$).

Dr	Net assets/equity	CU3,000	
	Cr	Put option asset	CU3,000

To record the settlement of the option contract.

(c) Cash for Shares (“Gross Physical Settlement”)

- IE25. Assume the same facts as in (a) except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of Entity A’s shares, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity B has an obligation to pay CU98,000 in cash to Entity A ($\text{CU}98 \times 1,000$) in exchange for 1,000 of Entity A’s outstanding shares, if Entity A exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr	Net assets/equity	CU5,000	
	Cr	Cash	CU5,000

To record the cash received in exchange for the right to deliver Entity A’s own shares in one year for a fixed price. The premium paid is recognized directly in net assets/equity. Upon exercise, it results in the issue of a fixed number of shares in exchange for a fixed price.

December 31, 20X2

No entry is made on December 31, because no cash is paid or received and a contract to deliver a fixed number of Entity A’s own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of Entity A.

January 31, 20X3

Entity A exercises the put option and the contract is settled gross. Entity B has an obligation to deliver CU98,000 in cash to Entity A in exchange for 1,000 shares.

Dr	Cash	CU98,000	
	Cr	Net assets/equity	CU98,000

To record the settlement of the option contract.

(d) Settlement Options

- IE26. The existence of settlement options (such as net in cash, net in shares, or by an exchange of cash and shares) has the result that the put option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognizes a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 6: Written Put Option on Shares

- IE27. This example illustrates the journal entries for a written put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares, or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	February 1, 20X2
Exercise date	January 31, 20X3
	(European terms, i.e., it can be exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on February 1, 20X2	CU100
Market price per share on December 31, 20X2	CU95
Market price per share on January 31, 20X3	CU95
Fixed exercise price to be paid on January 31, 20X3	CU98
Present value of exercise price on February 1, 20X2	CU95
Number of shares under option contract	1,000
Fair value of option on February 1, 20X2	CU5,000
Fair value of option on December 31, 20X2	CU4,000
Fair value of option on January 31, 20X3	CU3,000

(a) Cash for Cash (“Net Cash Settlement”)

- IE28. Assume the same facts as in Example 5(a) above, except that Entity A has written a put option on its own shares instead of having purchased a put option on its own shares. Accordingly, on February, 1 20X2, Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A’s outstanding ordinary shares as of January 31, 20X3 in exchange for CU98,000 in cash (i.e., CU98 per share) on January 31, 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

February 1, 20X2

Dr	Cash	CU5,000	
	Cr	Put option liability	CU5,000
<i>To recognize the written put option.</i>			

December 31, 20X2

Dr	Put option liability	CU1,000	
	Cr	Gain	CU1,000
<i>To record the decrease in the fair value of the put option.</i>			

January 31, 20X3

Dr	Put option liability	CU1,000	
	Cr	Gain	CU1,000
<i>To record the decrease in the fair value of the put option.</i>			

On the same day, Entity B exercises the put option and the contract is settled net in cash. Entity A has an obligation to deliver CU98,000 to Entity B, and Entity B has an obligation to deliver CU95,000 ($CU95 \times 1,000$) to Entity A. Thus, Entity A pays the net amount of CU3,000 to Entity B.

Dr	Put option liability	CU3,000	
	Cr	Cash	CU3,000
<i>To record the settlement of the option contract.</i>			

(b) Shares for Shares (“Net Share Settlement”)

- IE29. Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A’s journal entries are the same as those in (a), except for the following:

January 31, 20X3

Entity B exercises the put option and the contract is settled net in shares. In effect, Entity A has an obligation to deliver CU98,000 worth of shares

to Entity B, and Entity B has an obligation to deliver CU95,000 worth of Entity A's shares ($\text{CU}95 \times 1,000$) to Entity A. Thus, Entity A delivers the net amount of CU3,000 worth of Entity A's shares to Entity B, i.e., 31.6 shares ($3,000/95$).

Dr	Put option liability	CU3,000	
	Cr	Net assets/equity	CU3,000

To record the settlement of the option contract. The issue of Entity A's own shares is accounted for as a transaction in net assets/equity.

(c) Cash for Shares ("Gross Physical Settlement")

- IE30. Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of shares, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity A has an obligation to pay CU98,000 in cash to Entity B ($\text{CU}98 \times 1,000$) in exchange for 1,000 of Entity A's outstanding shares, if Entity B exercises its option. Entity A records the following journal entries.

February 1, 20X2

Dr	Cash	CU5,000	
	Cr	Net assets/equity	CU5,000

To recognize the option premium received of CU5,000 in net assets/equity.

Dr	Net assets/equity	CU95,000	
	Cr	Liability	CU95,000

To recognize the present value of the obligation to deliver CU98,000 in one year, i.e., CU95,000, as a liability.

December 31, 20X2

Dr	Interest expense	CU2,750	
	Cr	Liability	CU2,750

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

January 31, 20X3

Dr	Interest expense	CU250	
	Cr	Liability	CU250

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

On the same day, Entity B exercises the put option and the contract is settled gross. Entity A has an obligation to deliver CU98,000 in cash to Entity B in exchange for CU95,000 worth of shares ($\text{CU}95 \times 1,000$).

Dr	Liability	CU98,000	
	Cr	Cash	CU98,000

To record the settlement of the option contract.

(d) Settlement Options

- IE31. The existence of settlement options (such as net in cash, net in shares, or by an exchange of cash and shares) has the result that the written put option is a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognizes a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the put option as a derivative liability.

Entities such as Mutual Funds and Co-operatives Whose Share Capital is not Net Assets/Equity

Example 7: Entities with No Net Assets/Equity

- IE32. The following example illustrates a format of a statement of financial performance and statement of financial position that may be used by entities such as mutual funds that do not have net assets/equity. Other formats are possible.

Statement of Financial Performance for the year ended December 31, 20X1

	20X1	20X0
	CU	CU
Revenue	2,956	1,718
Total Revenue	2,956	1,718
Expenses (classified by nature or function)	(644)	(614)
Finance costs		
– other finance costs	(47)	(47)
– distributions to unitholders	(50)	(50)
Total Expenses	(741)	(711)
Surplus for the year	2,215	1,007
Change in net assets attributable to unitholders	2,215	1,007

Statement of Financial Position at December 31, 20X1

		20X1		20X0
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IPSAS 1)	91,374		78,484	
Total non-current assets		91,374		78,484
Current assets (classified in accordance with IPSAS 1)	1,422		1,769	
Total current assets		1,422		1,769
Total assets		92,796		80,253
LIABILITIES				
Current liabilities (classified in accordance with IPSAS 1)	647		66	
Total current liabilities		(647)		(66)
Non-current liabilities excluding net assets attributable to unitholders (classified in accordance with IPSAS 1)	280		136	
		(280)		(136)
Net assets attributable to unitholders		91,869		80,051

Example 8: Entities with Some Net Assets/Equity

- IE33. The following example illustrates a format of a statement of financial performance and statement of financial position that may be used by entities whose share capital is not net assets/equity because the entity has an obligation to repay the share capital on demand. Other formats are possible.

Statement of Financial Performance for the year ended December 31, 20X1

	20X1	20X0
	CU	CU
Revenue	472	498
Total Revenue	472	498
Expenses (classified by nature or function)	(367)	(396)
Finance costs		
– other finance costs	(4)	(4)
– distributions to members	(50)	(50)
Total Expenses	(421)	(450)
Surplus for the year	51	48
Change in net assets attributable to members	51	48

Statement of Financial Position at December 31, 20X1

	20X1	20X0
	CU	CU
ASSETS		
Non-current assets (classified in accordance with IPSAS 1)	908	830
Total non-current assets	908	830
Current assets (classified in accordance with IPSAS 1)	383	350
Total current assets	383	350
Total assets	1,291	1,180
LIABILITIES		
Current liabilities (classified in accordance with IPSAS 1)	372	338
Share capital repayable on demand	202	161

Statement of Financial Position at December 31, 20X1

Total current liabilities		(574)	(499)
Total assets less current liabilities		717	681
Non-current liabilities (classified in accordance with IPSAS 1)	187		196
		(187)	(196)
OTHER COMPONENTS OF NET ASSETS/ EQUITY^(a)			
Reserves, e.g., revaluation surplus, accumulated surplus, etc.	530		485
		530	485
		717	681
MEMORANDUM NOTE – Total members' interests			
Share capital repayable on demand		202	161
Reserves		530	485
		732	646

(a) In this example, the entity has no obligation to deliver a share of its reserves to its members.

Accounting for Compound Financial Instruments*Example 9: Separation of a Compound Financial Instrument on Initial Recognition*

- IE34. Paragraph 33 describes how the components of a compound financial instrument are separated by the entity on initial recognition. The following example illustrates how such a separation is made.
- IE35. An entity issues 2,000 convertible bonds at the start of year 1. The bonds have a three-year term, and are issued at par with a face value of CU1,000 per bond, giving total proceeds of CU2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 percent. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9 percent.

- IE36. The liability component is measured first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the net assets/equity component. The present value of the liability component is calculated using a discount rate of 9 percent, the market interest rate for similar bonds having no conversion rights, as shown below.

	CU
Present value of the principal – CU2,000,000 payable at the end of three years	1,544,367
Present value of the interest – CU120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Net assets/equity component (by deduction)	151,878
Proceeds of the bond issue	2,000,000

Example 10: Separation of a Compound Financial Instrument with Multiple Embedded Derivative Features

- IE37. The following example illustrates the application of paragraph 36 to the separation of a compound financial instrument with multiple embedded derivative features into the liability and net assets/equity component.
- IE38. Assume that the proceeds received on the issue of a callable convertible bond are CU60. The value of a similar bond without a call or equity conversion option is CU57. Based on an option pricing model, it is determined that the value to the entity of the embedded call feature in a similar bond without an equity conversion option is CU2. In this case, the value allocated to the liability component under paragraph 36 is CU55 (CU57 – CU2) and the value allocated to the net assets/equity component is CU5 (CU60 – CU55).

Example 11: Repurchase of a Convertible Instrument

- IE39. The following example illustrates how an entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of the liability and the net assets/equity components in the financial statements, i.e., no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.
- IE40. On January 1, 20X0, Entity A issued a 10 percent convertible debenture with a face value of CU1,000 maturing on December 31, 20X9. The debenture is convertible into ordinary shares of Entity A at a conversion price of CU25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 percent.
- IE41. In the financial statements of Entity A the carrying amount of the debenture was allocated on issue as follows:

	CU
Liability component	
Present value of 20 half-yearly interest payments of CU50, discounted at 11%	597
Present value of CU1,000 due in 10 years, discounted at 11%, compounded half-yearly	343
	<u>940</u>
Net assets/equity component	
(difference between CU1,000 total proceeds and CU940 allocated above)	60
Total proceeds	<u><u>1,000</u></u>

IE42. On January 1, 20X5 the convertible debenture has a fair value of CU1,700.

IE43. Entity A makes a tender offer to the holder of the debenture to repurchase the debenture for CU1,700, which the holder accepts. At the date of repurchase, Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 percent.

IE44. The repurchase price is allocated as follows:

	Carrying value	Fair value	Difference
Liability component:	CU	CU	CU
Present value of 10 remaining half-yearly interest payments of CU50, discounted at 11% and 8%, respectively	377	405	
Present value of CU1,000 due in 5 years, discounted at 11% and 8%, compounded half-yearly, respectively	585	676	
	962	1,081	(119)
Net assets/equity component	60	619 ^(a)	(559)
Total	1,022	1,700	(678)

(a) This amount represents the difference between the fair value amount allocated to the liability component and the repurchase price of CU1,700.

IE45. Entity A recognizes the repurchase of the debenture as follows:

Dr	Liability component	CU962	
Dr	Debt settlement expense (surplus or deficit)	CU119	
	Cr Cash		CU1,081

To recognize the repurchase of the liability component.

Dr	Net assets/equity	CU619	
	Cr Cash		CU619

To recognize the cash paid for the net assets/equity component.

IE46. The net assets/equity component remains as net assets/equity, but may be transferred from one line item within net assets/equity to another.

Example 12: Amendment of the Terms of a Convertible Instrument to Induce Early Conversion

IE47. The following example illustrates how an entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

IE48. On January 1, 20X0, Entity A issued a 10 percent convertible debenture with a face value of CU1,000 with the same terms as described in Example 9. On January 1, 20X1, to induce the holder to convert the convertible debenture promptly, Entity A reduces the conversion price to CU20 if the debenture is converted before March 1, 20X1 (i.e., within 60 days).

IE49. Assume the market price of Entity A's ordinary shares on the date the terms are amended is CU40 per share. The fair value of the incremental consideration paid by Entity A is calculated as follows:

Number of ordinary shares to be issued to debenture holders under amended conversion terms:

Face amount	CU1,000	
New conversion price	<u>/CU20</u>	per share
Number of ordinary shares to be issued on conversion	<u>50</u>	shares

*Number of ordinary shares to be issued to debenture holders under **original** conversion terms:*

Face amount	CU1,000	
Original conversion price	<u>/CU25</u>	per share
Number of ordinary shares to be issued on conversion	40	Shares

<i>Number of incremental ordinary shares issued upon conversion</i>	10	Shares
---	----	--------

*Value of **incremental** ordinary shares issued upon conversion*

CU40 per share x 10 incremental shares	<u>CU400</u>
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- IE50. The incremental consideration of CU400 is recognized as a loss in surplus or deficit.

Comparison with IAS 32

IPSAS 28, *Financial Instruments: Presentation* is drawn primarily from IAS 32, *Financial Instruments: Presentation* (issued originally in 2003, including amendments up to December 31, 2008). The main differences between IPSAS 28 and IAS 32 are as follows:

- IAS 32 allows entities to treat financial guarantee contracts as insurance contracts where entities have previously asserted that such contracts are insurance contracts. IPSAS 28 allows a similar election, except that entities need not have explicitly asserted that financial guarantees are insurance contracts.
- In certain instances, IPSAS 28 uses different terminology from IAS 32. The most significant examples are the use of the terms “statement of financial performance” and “net assets/equity.” The equivalent terms in IAS 32 are “statement of comprehensive income or separate income statement (if presented)” and “equity.”
- IPSAS 28 does not distinguish between “revenue” and “income.” IAS 32 distinguishes between “revenue” and “income,” with “income” having a broader meaning than the term “revenue.”
- IPSAS 28 contains additional Application Guidance dealing with the identification of arrangements that are, in substance, contractual.
- IPSAS 28 contains additional Application Guidance on when assets and liabilities arising from non-exchange revenue transactions are financial assets or financial liabilities.
- Principles from IFRIC 2, *Members’ Shares in Co-operative Entities and Similar Instruments* have been included as an Appendix in IPSAS 28.
- The transitional provisions in IPSAS 28 differ from those in IAS 32. This is because IPSAS 28 provides transitional provisions for those entities applying this Standard for the first time or those applying accrual accounting for the first time.

IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

Acknowledgment

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

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IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

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

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

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

Table of Amended Paragraphs in IPSAS 29

Paragraph Affected	How Affected	Affected By
Introduction section	Deleted	Improvements to IPSASs October 2011
2	Amended	IPSAS 40 January 2017 IPSAS 39 July 2016 IPSAS 37 January 2015 IPSAS 35 January 2015 IPSAS 32 October 2011
7	Deleted	The Applicability of IPSASs April 2016
8	Deleted	The Applicability of IPSASs April 2016

Paragraph Affected	How Affected	Affected By
17	Amended	IPSAS 35 January 2015
89	Amended	IPSAS 35 January 2015
114	Deleted	IPSAS 33 January 2015
115	Deleted	IPSAS 33 January 2015
116	Deleted	IPSAS 33 January 2015
117	Deleted	IPSAS 33 January 2015
118	Deleted	IPSAS 33 January 2015
119	Deleted	IPSAS 33 January 2015
120	Deleted	IPSAS 33 January 2015
121	Deleted	IPSAS 33 January 2015
122	Deleted	IPSAS 33 January 2015
123	Deleted	IPSAS 33 January 2015
125A	New	IPSAS 32 October 2011
125B	New	IPSAS 33 January 2015
125C	New	IPSAS 37 January 2015 IPSAS 35 January 2015
125D	New	Improvements to IPSASs April 2016
125E	New	The Applicability of IPSASs April 2016
125F	New	IPSAS 39 July 2016
125G	New	IPSAS 40 January 2017
126	Amended	IPSAS 33 January 2015
AG35	Amended	IPSAS 40 January 2017
AG51	Amended	IPSAS 35 January 2015
AG52	Amended	IPSAS 35 January 2015
AG53	Amended	IPSAS 35 January 2015
AG131	Amended	IPSAS 40 January 2017
B4	Amended	IPSAS 40 January 2017
C2	Amended	IPSAS 37 January 2015

IPSAS 29—FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

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

Objective

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

Scope

2. **This Standard shall be applied by all entities to all types of financial instruments, except:**
 - (a) **Those interests in controlled entities, associates and joint ventures that are accounted for in accordance with IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements* IPSAS 36, *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 34, IPSAS 35 or IPSAS 36 require or permit an entity to account for an interest in a controlled entity, associate, or joint venture in accordance with some or all of the requirements of this Standard. Entities shall also apply this Standard to derivatives on an interest in a controlled entity, associate, or joint venture unless the derivative meets the definition of an equity instrument of the entity in IPSAS 28.**
 - (b) **Rights and obligations under leases to which IPSAS 13, *Leases* applies. However:**
 - (i) **Lease receivables recognized by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 17–39, 67, 68, 72, and Appendix A paragraphs AG51–AG67 and AG117–AG126);**
 - (ii) **Finance lease payables recognized by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 41–44 and Appendix A paragraphs AG72–AG80); and**
 - (iii) **Derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 11–15 and Appendix A paragraphs AG40–AG46).**
 - (c) **Employers' rights and obligations under employee benefit plans, to which IPSAS 39, *Employee Benefits* applies.**
 - (d) **Financial instruments issued by the entity that meet the definition of an equity instrument in IPSAS 28 (including options and**

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

- (e) **Rights and obligations arising under:**
 - (i) **An insurance contract, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 10; or**
 - (ii) **A contract that is within the scope of the relevant international or national accounting standard dealing with insurance contracts because it contains a discretionary participation feature.**

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

- (f) **Any forward contracts between an acquirer and seller to buy or sell an acquired operation that will result in a public sector combination at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.**
- (g) **Loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 17–44 and Appendix A paragraphs AG51–AG80).**
- (h) **Financial instruments, contracts and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share based payment applies, except for contracts within the scope of paragraphs 4–6 of this Standard, to which this Standard applies.**

- (i) **Rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognizes as a provision in accordance with IPSAS 19, or for which, in an earlier period, it recognized a provision in accordance with IPSAS 19.**
 - (j) **The initial recognition and initial measurement of rights and obligations arising from non-exchange revenue transactions, to which IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* applies.**
 - (k) **Rights and obligations under service concession arrangements to which IPSAS 32, *Service Concession Assets: Grantor* applies. However, financial liabilities recognized by a grantor under the financial liability model are subject to the derecognition provisions of this Standard (see paragraphs 41–44 and Appendix A paragraphs AG72–AG80).**
3. **The following loan commitments are within the scope of this Standard:**
- (a) **Loan commitments that the entity designates as financial liabilities at fair value through surplus or deficit. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.**
 - (b) **Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in installments (e.g., a mortgage construction loan that is paid out in installments in line with the progress of construction).**
 - (c) **Commitments to provide a loan at a below-market interest rate. Paragraph 49(d) specifies the subsequent measurement of liabilities arising from these loan commitments.**
4. **This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements.**
5. **There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:**

- (a) When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;
- (b) When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);
- (c) When, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and
- (d) When the non-financial item that is the subject of the contract is readily convertible to cash.

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

- 6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.
- 7. [Deleted]
- 8. [Deleted]

Definitions

- 9. The terms defined in IPSAS 28 are used in this Standard with the meanings specified in paragraph 9 of IPSAS 28. IPSAS 28 defines the following terms:
 - Financial instrument;
 - Financial asset;
 - Financial liability;

- Equity instrument;

and provides guidance on applying those definitions.

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

Definition of a derivative

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

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

Definitions of four categories of financial instruments

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

- (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if:
 - (i) It is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
 - (ii) On initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - (iii) It is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
- (b) Upon initial recognition it is designated by the entity as at fair value through surplus or deficit. An entity may use this designation only

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

- (i) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as “an accounting mismatch”) that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases; or
- (ii) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in IPSAS 20, *Related Party Disclosures*), for example the entity’s governing body and chief executive officer.

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

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably¹ measured (see paragraph 48(c) and Appendix A paragraphs AG113 and AG114), shall not be designated as at fair value through surplus or deficit.

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

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

- (a) Those that the entity upon initial recognition designates as at fair value through surplus or deficit;
- (b) Those that the entity designates as available for sale; and

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

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

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

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

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

- (a) Those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through surplus or deficit;
- (b) Those that the entity upon initial recognition designates as available for sale; or
- (c) Those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale.

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

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

Definition of a financial guarantee contract

A **financial guarantee contract** is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs

because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Definitions relating to recognition and measurement

The amortized cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

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

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

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

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

Definitions relating to hedge accounting

A **firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A **forecast transaction** is an uncommitted but anticipated future transaction.

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

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

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

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

Embedded Derivatives

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

- (a) **The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG43 and AG46);**
- (b) **A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and**
- (c) **The hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in surplus or deficit (i.e., a derivative that is embedded in a financial asset or financial liability at fair value through surplus or deficit is not separated).**

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

13. **Notwithstanding paragraph 12, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through surplus or deficit unless:**
 - (a) **The embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or**
 - (b) **It is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortized cost.**
14. **If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through surplus or deficit. Similarly, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of fair value through surplus or deficit category, that reclassification is prohibited. In such circumstances the hybrid (combined) contract remains classified as at fair value through surplus or deficit in its entirety.**
15. **If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (e.g., because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be**

determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 14 applies and the hybrid (combined) instrument is designated as at fair value through surplus or deficit.

Recognition and Derecognition

Initial Recognition

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

Derecognition of a Financial Asset

17. In consolidated financial statements, paragraphs 18–25 and Appendix A paragraphs AG49–AG67 are applied at a consolidated level. Hence, an entity first consolidates all controlled entities in accordance with IPSAS 35 and then applies paragraphs 18–25 and Appendix A paragraphs AG49–AG67 to the resulting economic entity.
18. **Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 19–25, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.**
 - (a) **Paragraphs 19–25 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.**
 - (i) **The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 19–25 are applied to the interest cash flows.**
 - (ii) **The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of all cash flows of a debt instrument, paragraphs 19–25 are applied to 90 percent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate**

share of the cash flows provided that the transferring entity has a fully proportionate share.

- (iii) **The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 percent share of interest cash flows from a financial asset, paragraphs 19–25 are applied to 90 percent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.**
- (b) **In all other cases, paragraphs 19–25 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 percent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 percent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 percent of the principal amount of the receivables, paragraphs 19–25 are applied to the financial asset (or a group of similar financial assets) in its entirety.**

In paragraphs 19–28, the term “financial asset” refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

- 19. **An entity shall derecognize a financial asset when, and only when:**
 - (a) **The contractual rights to the cash flows from the financial asset expire or are waived; or**
 - (b) **It transfers the financial asset as set out in paragraphs 20 and 21 and the transfer qualifies for derecognition in accordance with paragraph 22.**

(See paragraph 40 for regular way sales of financial assets).
- 20. **An entity transfers a financial asset if, and only if, it either:**
 - (a) **Transfers the contractual rights to receive the cash flows of the financial asset; or**
 - (b) **Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 21.**

21. When an entity retains the contractual rights to receive the cash flows of a financial asset (the “original asset”), but assumes a contractual obligation to pay those cash flows to one or more entities (the “eventual recipients”), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met:
- (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
 - (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
 - (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in IPSAS 2, *Cash Flow Statements*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.
22. When an entity transfers a financial asset (see paragraph 20), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:
- (a) If the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.
 - (b) If the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognize the financial asset.
 - (c) If the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:
 - (i) If the entity has not retained control, it shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.

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

23. The transfer of risks and rewards (see paragraph 22) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g., because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (e.g., because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 21).
24. Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison is made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.
25. Whether the entity has retained control (see paragraph 22(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

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

26. **If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognize either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognized at its fair value. If the fee to be received is expected to be more than adequate**

compensation for the servicing, a servicing asset shall be recognized for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 29.

27. **If, as a result of a transfer, a financial asset is derecognized in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognize the new financial asset, financial liability or servicing liability at fair value.**
28. **On derecognition of a financial asset in its entirety, the difference between:**
 - (a) **The carrying amount; and**
 - (b) **The sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognized directly in net assets/equity (see paragraph 64(b));**

shall be recognized in surplus or deficit.

29. **If the transferred asset is part of a larger financial asset (e.g., when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 18(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognized. The difference between:**
 - (a) **The carrying amount allocated to the part derecognized; and**
 - (b) **The sum of (i) the consideration received for the part derecognized (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognized directly in net assets/equity (see paragraph 64(b));**

shall be recognized in surplus or deficit. A cumulative gain or loss that had been recognized in net assets/equity is allocated between the part that continues to be recognized and the part that is derecognized, based on the relative fair values of those parts.

30. **When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognized and the part that is derecognized, the fair value of the part that continues to be recognized needs to be determined. When the entity has a history of selling parts similar to the part that continues to be recognized or other market transactions exist for**

such parts, recent prices of actual transactions provide the best estimate of its fair value. When there are no price quotes or recent market transactions to support the fair value of the part that continues to be recognized in an exchange transaction, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognized.

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

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

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

32. **If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognize the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:**
- (a) **When the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ("the guarantee amount").**
 - (b) **When the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG63).**
 - (c) **When the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.**

33. When an entity continues to recognize an asset to the extent of its continuing involvement, the entity also recognizes an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:
- (a) The amortized cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortized cost; or
 - (b) Equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.
34. The entity shall continue to recognize any revenue arising on the transferred asset to the extent of its continuing involvement and shall recognize any expense incurred on the associated liability.
35. For the purpose of subsequent measurement, recognized changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 64, and shall not be offset.
36. If an entity's continuing involvement is in only a part of a financial asset (e.g., when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognize under continuing involvement, and the part it no longer recognizes on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 30 apply. The difference between:
- (a) The carrying amount allocated to the part that is no longer recognized; and
 - (b) The sum of (i) the consideration received for the part no longer recognized and (ii) any cumulative gain or loss allocated to it that had been recognized directly in net assets/equity (see paragraph 64(b));

shall be recognized in surplus or deficit. A cumulative gain or loss that had been recognized in net assets/equity is allocated between the part that continues to be recognized and the part that is no longer recognized on the basis of the relative fair values of those parts.

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

All Transfers

38. **If a transferred asset continues to be recognized, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any revenue arising from the transferred asset with any expense incurred on the associated liability (see IPSAS 28 paragraph 47).**
39. **If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:**
- (a) **If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.**
 - (b) **If the transferee sells collateral pledged to it, it shall recognize the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.**
 - (c) **If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the transferee shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.**
 - (d) **Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognize the collateral as an asset.**

Regular Way Purchase or Sale of a Financial Asset

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

Derecognition of a Financial Liability

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

42. **An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.**
43. **The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognized in surplus or deficit. Where an obligation is waived by the lender or assumed by a third party as part of a non-exchange transaction, an entity applies IPSAS 23.**
44. If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognized and the part that is derecognized based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognized and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognized shall be recognized in surplus or deficit.

Measurement

Initial Measurement of Financial Assets and Financial Liabilities

45. **When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through surplus or deficit, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.**
46. When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortized cost, the asset is recognized initially at its fair value on the trade date (see Appendix A paragraphs AG68–AG71).

Subsequent Measurement of Financial Assets

47. For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 10:
 - (a) Financial assets at fair value through surplus or deficit;
 - (b) Held-to-maturity investments;
 - (c) Loans and receivables; and

- (d) Available-for-sale financial assets.

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

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

- (a) **Loans and receivables as defined in paragraph 10, which shall be measured at amortized cost using the effective interest method;**
- (b) **Held-to-maturity investments as defined in paragraph 10, which shall be measured at amortized cost using the effective interest method; and**
- (c) **Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG113 and AG114).**

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

Subsequent Measurement of Financial Liabilities

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

- (a) **Financial liabilities at fair value through surplus or deficit. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.**
- (b) **Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 31 and 33 apply to the measurement of such financial liabilities.**

- (c) **Financial guarantee contracts as defined in paragraph 10. After initial recognition, an issuer of such a contract shall (unless paragraph 49(a) or (b) applies) measure it at the higher of:**
 - (i) **The amount determined in accordance with IPSAS 19; and**
 - (ii) **The amount initially recognized (see paragraph 45) less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.**
- (d) **Commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 49(a) applies) measure it at the higher of:**
 - (i) **The amount determined in accordance with IPSAS 19; and**
 - (ii) **The amount initially recognized (see paragraph 45) less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.**

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

Fair Value Measurement Considerations

- 50. **In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, IPSAS 28 or IPSAS 30, an entity shall apply paragraphs AG101–AG115 of Appendix A.**
- 51. The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal operating considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data.

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

Reclassifications

53. **An entity:**

- (a) **Shall not reclassify a derivative out of the fair value through surplus or deficit category while it is held or issued;**
- (b) **Shall not reclassify any financial instrument out of the fair value through surplus or deficit category if upon initial recognition it was designated by the entity as at fair value through surplus or deficit; and**
- (c) **May, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term (notwithstanding that the financial asset may have been acquired or incurred principally for the purpose of selling or repurchasing it in the near term), reclassify that financial asset out of the fair value through surplus or deficit category if the requirements in paragraph 55 or 57 are met.**

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

54. The following changes in circumstances are not reclassifications for the purposes of paragraph 53:
- (a) A derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such; and
 - (b) A derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.
55. A financial asset to which paragraph 53(c) applies (except a financial asset of the type described in paragraph 57) may be reclassified out of the fair value through surplus or deficit category only in rare circumstances.
56. If an entity reclassifies a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 55, the financial asset shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognized in surplus or deficit shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable.
57. A financial asset to which paragraph 53(c) applies that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified

out of the fair value through surplus or deficit category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

58. A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available-for-sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.
59. If an entity reclassifies a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 57 or out of the available-for-sale category in accordance with paragraph 58, it shall reclassify the financial asset at its fair value on the date of reclassification. For a financial asset reclassified in accordance with paragraph 57, any gain or loss already recognized in surplus or deficit shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable. For a financial asset reclassified out of the available-for-sale category in accordance with paragraph 58, any previous gain or loss on that asset that has been recognized directly in net assets/equity in accordance with paragraph 64(b) shall be accounted for in accordance with paragraph 63.
60. **If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 64(b).**
61. **Whenever sales or reclassification of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in paragraph 10, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 64(b).**
62. **If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 48(c) and 49), the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 64.**
63. **If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 48(c) and 49) or because the “two preceding financial years” referred to in paragraph 10 have passed, it becomes appropriate to carry a**

financial asset or financial liability at cost or amortized cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortized cost, as applicable. Any previous gain or loss on that asset that has been recognized directly in net assets/equity in accordance with paragraph 64(b) shall be accounted for as follows:

- (a) In the case of a financial asset with a fixed maturity, the gain or loss shall be amortized to surplus or deficit over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortized cost and maturity amount shall also be amortized over the remaining life of the financial asset using the effective interest method, similar to the amortization of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognized directly in net assets/equity is recognized in surplus or deficit in accordance with paragraph 76.**
- (b) In the case of a financial asset that does not have a fixed maturity, the gain or loss shall remain in net assets/equity until the financial asset is sold or otherwise disposed of, when it shall be recognized in surplus or deficit. If the financial asset is subsequently impaired any previous gain or loss that has been recognized directly in net assets/equity is recognized in surplus or deficit in accordance with paragraph 76.**

Gains and Losses

64. A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 99–113), shall be recognized, as follows.

- (a) A gain or loss on a financial asset or financial liability classified as at fair value through surplus or deficit shall be recognized in surplus or deficit.**
- (b) A gain or loss on an available-for-sale financial asset shall be recognized directly in net assets/equity through the statement of changes in net assets/equity (see IPSAS 1, except for impairment losses (see paragraphs 76–79) and foreign exchange gains and losses (see Appendix A paragraph AG116), until the financial asset is derecognized, at which time the cumulative gain or loss previously recognized in net assets/equity shall be recognized in surplus or deficit. However, interest calculated using the effective interest method (see paragraph 10) is recognized in surplus or deficit (see IPSAS 9). Dividends or similar distributions on an available-for-sale equity instrument are recognized in surplus or**

deficit when the entity's right to receive payment is established (see IPSAS 9).

65. **For financial assets and financial liabilities carried at amortized cost (see paragraphs 48 and 49), a gain or loss is recognized in surplus or deficit when the financial asset or financial liability is derecognized or impaired, and through the amortization process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 87–94 and Appendix A paragraphs AG131–AG141) the accounting for the gain or loss shall follow paragraphs 99–113.**
66. **If an entity recognizes financial assets using settlement date accounting (see paragraph 40 and Appendix A paragraphs AG68 and AG71), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognized for assets carried at cost or amortized cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognized in surplus or deficit or in net assets/equity, as appropriate under paragraph 64.**

Impairment and Uncollectibility of Financial Assets

67. **An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 72 (for financial assets carried at amortized cost), paragraph 75 (for financial assets carried at cost) or paragraph 76 (for available-for-sale financial assets) to determine the amount of any impairment loss.**
68. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a “loss event”) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognized. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:
 - (a) Significant financial difficulty of the issuer or obligor;
 - (b) A breach of contract, such as a default or delinquency in interest or principal payments;
 - (c) The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

- (d) It becoming probable that the borrower will enter bankruptcy or other financial reorganization;
 - (e) The disappearance of an active market for that financial asset because of financial difficulties; or
 - (f) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
 - (i) Adverse changes in the payment status of borrowers in the group (e.g., an increased number of delayed payments); or
 - (ii) National or local economic conditions that correlate with defaults on the assets in the group (e.g., an increase in the unemployment rate in the geographical area of the borrowers, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).
69. The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortized cost is not necessarily evidence of impairment (e.g., a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).
70. In addition to the types of events in paragraph 68, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.
71. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgment to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgment to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG122). The use of reasonable

estimates is an essential part of the preparation of financial statements and does not undermine their reliability¹.

Financial Assets Carried at Amortized Cost

72. **If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortized cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognized in surplus or deficit.**
73. An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 68). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment.
74. **If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the previously recognized impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed. The amount of the reversal shall be recognized in surplus or deficit.**

Financial Assets Carried at Cost

75. **If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted**

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

equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 48(c) and Appendix A paragraphs AG113 and AG114). Such impairment losses shall not be reversed.

Available-For-Sale Financial Assets

76. When a decline in the fair value of an available-for-sale financial asset has been recognized directly in net assets/equity and there is objective evidence that the asset is impaired (see paragraph 68), the cumulative loss that had been recognized directly in net assets/equity shall be removed from net assets/equity and recognized in surplus or deficit even though the financial asset has not been derecognized.
77. The amount of the cumulative loss that is removed from net assets/equity and recognized in surplus or deficit under paragraph 76 shall be the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss on that financial asset previously recognized in surplus or deficit.
78. Impairment losses recognized in surplus or deficit for an investment in an equity instrument classified as available for sale shall not be reversed through surplus or deficit.
79. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in surplus or deficit, the impairment loss shall be reversed, with the amount of the reversal recognized in surplus or deficit.

Hedging

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

Hedging Instruments

Qualifying Instruments

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

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

Designation of Hedging Instruments

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

- (a) Separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and
- (b) Separating the interest element and the spot price of a forward contract.

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

84. A proportion of the entire hedging instrument, such as 50 percent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.
85. A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.
86. Two or more derivatives, or proportions of them (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. However, an interest rate collar or other derivative

instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

Hedged Items

Qualifying Items

87. A hedged item can be a recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics, or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.
88. Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.
89. For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities in the same economic entity only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the economic entity except for the consolidated financial statements of an investment entity, as defined in IPSAS 35, where transactions between an investment entity and its controlled entities measured at fair value through surplus or deficit will not be eliminated in the consolidated financial statements. As an exception, the foreign currency risk of monetary item within an economic entity (e.g., a payable/receivable between two controlled entities) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IPSAS 4, *The Effects of Changes in Foreign Exchange Rates*. In accordance with IPSAS 4, foreign exchange rate gains and losses on monetary items within an economic entity are not fully eliminated on consolidation when the monetary item is transacted between two entities within the economic entity that have different functional currencies. In

addition, the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated surplus or deficit.

Designation of Financial Items as Hedged Items

90. If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).
91. In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Designation of Non-Financial Items as Hedged Items

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

Designation of Groups of Items as Hedged Items

93. Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.
94. Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (e.g., the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

Hedge Accounting

95. Hedge accounting recognizes the offsetting effects on surplus or deficit of changes in the fair values of the hedging instrument and the hedged item.
96. **Hedging relationships are of three types:**
- (a) **Fair value hedge: a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect surplus or deficit.**
 - (b) **Cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect surplus or deficit.**
 - (c) **Hedge of a net investment in a foreign operation as defined in IPSAS 4.**
97. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.
98. **A hedging relationship qualifies for hedge accounting under paragraphs 99–113 if, and only if, all of the following conditions are met.**
- (a) **At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging**

instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

- (b) The hedge is expected to be highly effective (see Appendix A paragraphs AG145–AG156) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.**
- (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect surplus or deficit.**
- (d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 48 and 49 and Appendix A paragraphs AG113 and AG114 for guidance on determining fair value).**
- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.**

Fair Value Hedges

- 99. If a fair value hedge meets the conditions in paragraph 98 during the period, it shall be accounted for as follows:**
- (a) The gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with IPSAS 4 (for a non-derivative hedging instrument) shall be recognized in surplus or deficit; and**
 - (b) The gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized in surplus or deficit. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in surplus or deficit applies if the hedged item is an available-for-sale financial asset.**
- 100. For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 99(b) may be met by presenting the gain or loss attributable to the hedged item either:**

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

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

- 101. If only particular risks attributable to a hedged item are hedged, recognized changes in the fair value of the hedged item unrelated to the hedged risk are recognized as set out in paragraph 64.
- 102. **An entity shall discontinue prospectively the hedge accounting specified in paragraph 99 if:**
 - (a) **The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy);**
 - (b) **The hedge no longer meets the criteria for hedge accounting in paragraph 98; or**
 - (c) **The entity revokes the designation.**
- 103. **Any adjustment arising from paragraph 99(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used (or, in the case of a portfolio hedge of interest rate risk, to the separate line item in the statement of financial position described in paragraph 100) shall be amortized to surplus or deficit. Amortization may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortization begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortizing using a recalculated effective interest rate is not practicable, the adjustment shall be amortized using a straight-line method. The adjustment shall be amortized fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.**
- 104. When an unrecognized firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognized as an asset or liability

with a corresponding gain or loss recognized in surplus or deficit (see paragraph 99(b)). The changes in the fair value of the hedging instrument are also recognized in surplus or deficit.

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

Cash Flow Hedges

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

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

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

- (a) The separate component of net assets/equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
 - (i) The cumulative gain or loss on the hedging instrument from inception of the hedge; and
 - (ii) The cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;
- (b) Any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognized in surplus or deficit; and
- (c) If an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 83, 84, and 98(a)), that excluded component of gain or loss is recognized in accordance with paragraph 64.

108. **If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognized directly in net assets/equity in accordance with**

paragraph 106 shall be reclassified into surplus or deficit in the same period or periods during which the hedged forecast cash flows affects surplus or deficit (such as in the periods that interest revenue or interest expense is recognized). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify into surplus or deficit the amount that is not expected to be recovered.

109. If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:
 - (a) It reclassifies the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106 into surplus or deficit in the same period or periods during which the asset acquired or liability assumed affects surplus or deficit (such as in the periods that depreciation or inventories are recognized as an expense). However, if an entity expects that all or a portion of a loss recognized directly in net assets/equity will not be recovered in one or more future periods, it shall reclassify from net assets/equity into surplus or deficit the amount that is not expected to be recovered.
 - (b) It removes the associated gains and losses that were recognized directly in net assets/equity in accordance with paragraph 106, and includes them in the initial cost or other carrying amount of the asset or liability.
110. An entity shall adopt either (a) or (b) in paragraph 109 as its accounting policy and shall apply it consistently to all hedges to which paragraph 109 relates.
111. For cash flow hedges other than those covered by paragraphs 108 and 109, amounts that had been recognized directly in net assets/equity shall be recognized in surplus or deficit in the same period or periods during which the hedged forecast cash flows affects surplus or deficit (e.g., when a forecast sale occurs).
112. In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 106–111:
 - (a) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). In this case, the cumulative gain or

loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109, or 111 applies.

- (b) The hedge no longer meets the criteria for hedge accounting in paragraph 98. In this case, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109, or 111 applies.
- (c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that has been recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall be recognized in surplus or deficit. A forecast transaction that is no longer highly probable (see paragraph 98(c)) may still be expected to occur.
- (d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognized directly in net assets/equity from the period when the hedge was effective (see paragraph 106(a)) shall remain separately recognized in net assets/equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 108, 109, or 111 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized directly in net assets/equity shall be recognized in surplus or deficit.

Hedges of a Net Investment

113. Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IPSAS 4), shall be accounted for similarly to cash flow hedges:
- (a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) shall be recognized directly in net assets/equity through the statement of changes in net assets/equity (see IPSAS 1); and
 - (b) The ineffective portion shall be recognized in surplus or deficit.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognized directly in net assets/equity

shall be recognized in surplus or deficit in accordance with paragraphs 56–57 of IPSAS 4 on disposal of the foreign operation.

Transition

- 114. [Deleted]
- 115. [Deleted]
- 116. [Deleted]
- 117. [Deleted]
- 118. [Deleted]
- 119. [Deleted]
- 120. [Deleted]
- 121. [Deleted]
- 122. [Deleted]
- 123. [Deleted]

Effective Date

- 124. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2013. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2013, it shall disclose that fact.**
- 125. **An entity shall not apply this Standard before January 1, 2013, unless it also applies IPSAS 28 and IPSAS 30.**
- 125A. **Paragraph 2 was amended by IPSAS 32, *Service Concession Arrangements: Grantor* issued in October 2011. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2014. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2014, it shall disclose that fact and at the same time apply IPSAS 32, the amendments to paragraphs 6 and 42A of IPSAS 5, the amendments to paragraphs 25–27 and 85B of IPSAS 13, the amendments to paragraphs 5, 7 and 107C of IPSAS 17 and the amendments to paragraphs 6 and 132A of IPSAS 31.**
- 125B. **Paragraphs 114, 115, 116, 117, 118, 119, 120, 121, 122, 124 and 126 were amended by IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* issued in January 2015. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is permitted. If an entity applies IPSAS 33 for a period**

beginning before January 1, 2017, the amendments shall also be applied for that earlier period.

- 125C. **IPSAS 35, *Consolidated Financial Statements* and IPSAS 37, *Joint Arrangements*, issued in January 2015, amended paragraphs 2(a), 17, 89, AG2, AG14, AG51–53 and C2. An entity shall apply those amendments when it applies IPSAS 35 and IPSAS 37.**
- 125D. **Paragraph AG8 was amended by *Improvements to IPSASs 2015* issued in April 2016. An entity shall apply this amendment for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2017 it shall disclose that fact.**
- 125E. **Paragraphs 7 and 8 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.**
- 125F. **Paragraph 2 was amended by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.**
- 125G. **Paragraphs 2, AG35, AG131 and B4 were amended by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2019. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2019 it shall disclose that fact and apply IPSAS 40 at the same time.**
- 126. **When an entity adopts the accrual basis IPSASs of accounting as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.**

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 29.

Scope (paragraphs 2–8)

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

Investments in Controlled Entities, Associates, and Joint Ventures

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

Insurance Contracts

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

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

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

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

- (a) Although a financial guarantee contract meets the definition of an insurance contract if the risk transferred is significant, the issuer applies this Standard. Nevertheless, an entity may elect, under certain circumstances, to treat financial guarantee contracts as insurance

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

- (i) The amount determined in accordance with IPSAS 19; and
 - (ii) The amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9 (see paragraph 49(c)).
- (b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts. Such guarantees are derivatives and the issuer applies this Standard to them.
- (c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies IPSAS 9 in determining when it recognizes the revenue from the guarantee and from the sale of goods.

AG5. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as “weather derivatives”). If those contracts are not insurance contracts, they are within the scope of this Standard.

Rights and Obligations Arising from Non-Exchange Revenue Transactions

AG6. Rights and obligations (assets and liabilities) may arise from non-exchange revenue transactions, for example, an entity may receive cash from a multi-lateral agency to perform certain activities. Where the performance of those activities is subject to conditions, an asset and a liability is recognized simultaneously. Where the asset is a financial asset, it is recognized in

accordance with IPSAS 23, and initially measured in accordance with IPSAS 23 and this Standard. A liability that is initially recognized as a result of conditions imposed on the use of an asset is outside the scope of this Standard and is dealt with in IPSAS 23. After initial recognition, if circumstances indicate that recognition of a liability in accordance with IPSAS 23 is no longer appropriate, an entity considers whether a financial liability should be recognized in accordance with this Standard. Other liabilities that may arise from non-exchange revenue transactions are recognized and measured in accordance with this Standard if they meet the definition of a financial liability in IPSAS 28.

Definitions (paragraphs 9 and 10)

Designation as at Fair Value through Surplus or Deficit

- AG7. Paragraph 10 of this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through surplus or deficit provided that doing so results in more relevant information.
- AG8. The decision of an entity to designate a financial asset or financial liability as at fair value through surplus or deficit is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 17(b) of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors* requires the chosen policy to result in the financial statements providing faithfully representative and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. In the case of designation as at fair value through surplus or deficit, paragraph 10 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 10, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

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

- AG9. Under IPSAS 29, measurement of a financial asset or financial liability and classification of recognized changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an "accounting mismatch") when, for example, in the absence of designation as at fair value through surplus or deficit, a financial asset would be classified as available for sale (with most changes in fair value recognized directly in net assets/equity) and a liability the entity considers related would be measured at amortized cost

(with changes in fair value not recognized). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through surplus or deficit.

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

- (a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realized and/or unrealized investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through surplus or deficit means that changes in the fair value of the financial assets are recognized in surplus or deficit in the same period as related changes in the value of the liabilities.
- (b) An entity has liabilities under insurance contracts whose measurement incorporates current information, and financial assets it considers related that would otherwise be classified as available for sale or measured at amortized cost.
- (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through surplus or deficit (i.e., are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 98 are not met.
- (d) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:
 - (i) The entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale with fixed rate debentures whose changes in fair value tend to offset each other. Reporting both the assets and the debentures at fair value through surplus or deficit corrects the inconsistency that would otherwise arise from measuring the assets at fair value

with changes reported in net assets/equity and the debentures at amortized cost.

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

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

AG12. It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through surplus or deficit if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100¹ and a number of similar financial assets that sum to CU50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (e.g., individual liabilities with a combined total of CU45) as at fair value through surplus or deficit. However, because designation as at fair value through surplus or deficit can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (e.g., changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e., percentage) of a liability.

¹ In this Standard, monetary amounts are denominated in “currency units” (CU).

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

- AG13. An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through surplus or deficit results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.
- AG14. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through surplus or deficit only if it meets the principle in paragraph 10(b)(ii).
- (a) The entity is a venture capital organization, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest, dividends or similar distributions and changes in fair value. IPSAS 36 allows such investments to be measured at fair value through surplus or deficit in accordance with this Standard. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of IPSAS 36.
 - (b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued “structured products” containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.
 - (c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximize its total return (i.e., interest, dividends or similar distributions and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, net assets/equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 10(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 10(b)(ii) may be met when the insurer’s objective is to maximize total return on the assets over the longer term even if amounts paid to holders of

participating contracts depend on other factors such as the amount of gains realized in a shorter period (e.g., a year) or are subject to the insurer's discretion.

- AG15. As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through surplus or deficit on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.
- AG16. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 10(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system within an entity as approved by the entity's key management personnel – clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 10(b)(ii).

Effective Interest Rate

- AG17. In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.
- AG18. When applying the effective interest method, an entity generally amortizes any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortization period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortized to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e., interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortized over the expected life of the instrument.

- AG19. For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognized initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.
- AG20. If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 103. The adjustment is recognized in surplus or deficit as revenue or expense. If a financial asset is reclassified in accordance with paragraph 55, 57, or 58, and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognized as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

Derivatives

- AG21. Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000² if the six-month interbank offered rate increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.
- AG22. The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g., a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g., a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held

² In this Standard, monetary amounts are denominated in "currency units" (CU).

for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 4–6).

- AG23. One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.
- AG24. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognized as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 40 and AG68–AG71).
- AG25. The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Transaction Costs

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

Financial Assets and Financial Liabilities Held for Trading

- AG27. Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.
- AG28. Financial liabilities held for trading include:
- (a) Derivative liabilities that are not accounted for as hedging instruments;

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

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

Held-to-Maturity Investments

- AG29. An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:
- (a) The entity intends to hold the financial asset for an undefined period;
 - (b) The entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources, and terms or changes in foreign currency risk; or
 - (c) The issuer has a right to settle the financial asset at an amount significantly below its amortized cost.
- AG30. A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.
- AG31. The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able

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

- AG32. A financial asset that is puttable (i.e., the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.
- AG33. For most financial assets, fair value is a more appropriate measure than amortized cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 10 precludes the use of the exception for a reasonable period of time.
- AG34. A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.
- AG35. Sales before maturity could satisfy the condition in paragraph 10 – and therefore not raise a question about the entity's intention to hold other investments to maturity – if they are attributable to any of the following:
- (a) A significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 67 and 68), the deterioration in creditworthiness is often regarded as significant.
 - (b) A change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not

a change in tax law that revises the marginal tax rates applicable to interest revenue).

- (c) A major public sector combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the public sector combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).
- (d) A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment.
- (e) A significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.
- (f) A significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.

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

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

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

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

Loans and Receivables

AG39. Any non-derivative financial asset with fixed or determinable payments (including loan assets, receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph AG103) does not qualify for classification as a loan or receivable. Financial assets that do not meet

the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 10 and AG29–AG38). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through surplus or deficit, or available for sale.

Embedded Derivatives (paragraphs 11–13)

- AG40. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess characteristics of the net assets/equity related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.
- AG41. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor, or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.
- AG42. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity instruments (see IPSAS 28) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.
- AG43. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 12(a)) in the following examples. In these examples, assuming the conditions in paragraph 12(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.
- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.
 - (b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder

(from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under IPSAS 28, in which case it is excluded from the scope of this Standard).

- (c) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.
- (d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the value of equity instruments – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (e) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the price of a commodity (such as oil – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- (f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under IPSAS 28).
- (g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument or the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the element of net assets/equity under IPSAS 28.
- (h) Credit derivatives that are embedded in a host debt instrument and allow one party (the "beneficiary") to transfer the credit risk of a particular reference asset, which it may not own, to another party (the "guarantor") are not closely related to the host debt instrument.

Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

- AG44. An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a “puttable instrument”). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through surplus or deficit, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 12 because the host contract is a debt instrument under paragraph AG40 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG43(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.
- AG45. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.
- AG46. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.
- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognized investment or the embedded derivative could at least double the holder’s initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.
 - (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g., a commodity) that establish a cap and a floor on the price to be paid or

received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

- (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g., a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because IPSAS 4 requires foreign currency gains and losses on monetary items to be recognized in surplus or deficit.
- (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
 - (i) The functional currency of any substantial party to that contract;
 - (ii) The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
 - (iii) A currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local transactions or external trade).
- (e) An embedded prepayment option in an interest – only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.
- (f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales, or (iii) contingent rentals based on variable interest rates.
- (g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking

feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

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

Instruments Containing Embedded Derivatives

- AG47. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 12 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through surplus or deficit. For that reason this Standard permits the entire instrument to be designated as at fair value through surplus or deficit.
- AG48. Such designation may be used whether paragraph 12 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 13 would not justify designating the hybrid (combined) instrument as at fair value through surplus or deficit in the cases set out in paragraph 12(a) and (b) because doing so would not reduce complexity or increase reliability.

Recognition and Derecognition (paragraphs 16–44)

Initial Recognition (paragraph 16)

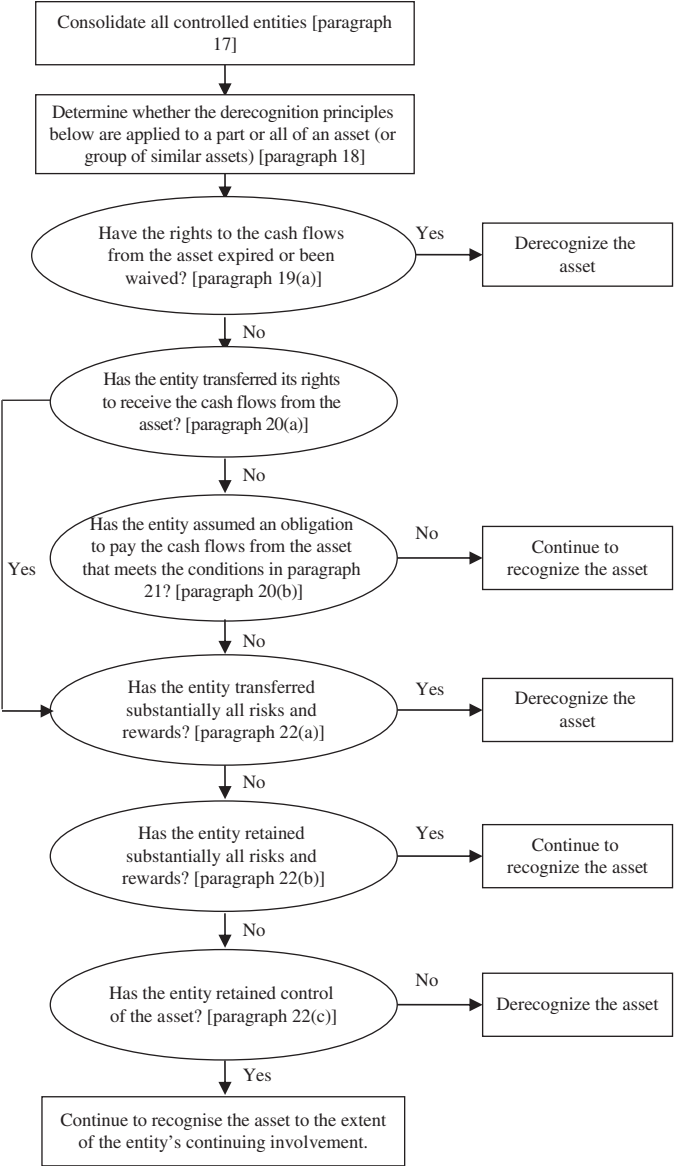
- AG49. As a consequence of the principle in paragraph 16, an entity recognizes all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG64). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognize the transferred asset as its asset (see paragraph AG65).
- AG50. The following are examples of applying the principle in paragraph 16:
- (a) Unconditional receivables and payables are recognized as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
 - (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally

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

- (c) A forward contract that is within the scope of this Standard (see paragraphs 2–6) is recognized as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognized as an asset or liability.
- (d) Option contracts that are within the scope of this Standard (see paragraphs 2–6) are recognized as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

Derecognition of a Financial Asset (paragraphs 17–39)

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



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

- AG52. The situation described in paragraph 20(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 21 and 22 are met.
- AG53. In applying paragraph 21, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a controlled entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

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

- AG54. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:
- (a) An unconditional sale of a financial asset;
 - (b) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
 - (c) A sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).
- AG55. Examples of when an entity has retained substantially all the risks and rewards of ownership are:
- (a) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
 - (b) A securities lending agreement;
 - (c) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
 - (d) A sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
 - (e) A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

- AG56. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognize the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the Transfer of Control

- AG57. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.
- AG58. The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:
- (a) A contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and
 - (b) An ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:
 - (i) The transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e., it must be a unilateral ability); and
 - (ii) The transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or "strings" to the transfer (e.g., conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).
- AG59. That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling

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

Transfers that Qualify for Derecognition

- AG60. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 29, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognized and the part that continues to be recognized. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognized at fair value.
- AG61. In estimating the fair values of the part that continues to be recognized and the part that is derecognized for the purposes of applying paragraph 29, an entity applies the fair value measurement requirements in paragraphs 50–52 and AG101–AG115 in addition to paragraph 30.

Transfers that do not Qualify for Derecognition

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

Continuing Involvement in Transferred Assets

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

All assets

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

Assets measured at amortized cost

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

Assets measured at fair value

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

and the carrying amount of the transferred asset is CU80 (i.e., its fair value).

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

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

All Transfers

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

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

Examples

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

- (a) Repurchase agreements and securities lending. If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its statement of financial position, for example, as a loaned asset or repurchase receivable.
- (b) Repurchase agreements and securities lending—assets that are substantially the same. If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognized because the transferor retains substantially all the risks and rewards of ownership.
- (c) Repurchase agreements and securities lending—right of substitution. If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognized because the transferor retains substantially all the risks and rewards of ownership.
- (d) Repurchase right of first refusal at fair value. If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognizes the asset because it has transferred substantially all the risks and rewards of ownership.
- (e) Wash sale transaction. The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original

transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognized.

- (f) Put options and call options that are deeply in the money. If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (g) Put options and call options that are deeply out of the money. A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognized. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money. If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognized. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money. If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognized to the extent of the transferor's continuing involvement (see paragraph AG64). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognized.

- (j) Assets subject to a fair value put or call option or a forward repurchase agreement. A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
- (k) Cash settled call or put options. An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG59 and (g), (h) and (i) above).
- (l) Removal of accounts provision. A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.
- (m) Clean-up calls. An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.
- (n) Subordinated retained interests and credit guarantees. An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognized

in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.

- (o) Total return swaps. An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
- (p) Interest rate swaps. An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) Amortizing interest rate swaps. An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortizing interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortizes so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognize all of the transferred asset or continues to recognize the transferred asset to the extent of its continuing involvement. Conversely, if the amortization of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

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

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

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

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

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

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

	<i>Estimated 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
Total	10,100		10,000

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

In addition, the entity recognizes the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognizes an asset of CU1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of CU1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, i.e., CU1,000 plus the fair value of the subordination of CU65). The entity uses all of the above information to account for the transaction as follows:

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

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

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

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

- AG68. A regular way purchase or sale of financial assets is recognized using either trade date accounting or settlement date accounting as described in paragraphs AG70 and AG71. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraph 10. For this purpose assets that are held for trading form a separate category from assets designated at fair value through surplus or deficit.
- AG69. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- AG70. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date.

Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

- AG71. The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognized for assets carried at cost or amortized cost; it is recognized in surplus or deficit for assets classified as financial assets at fair value through surplus or deficit; and it is recognized in net assets/equity for assets classified as available for sale.

Derecognition of a Financial Liability (paragraphs 41–44)

- AG72. A financial liability (or part of it) is extinguished when the debtor either:

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

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

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

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

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

- AG77. Lenders will sometimes waive their right to collect debt owed by a public sector entity, for example, a national government may cancel a loan owed by a local government. This waiver of debt would constitute a legal release of the debt owing by the borrower to the lender. Where an entity's obligations have been waived as part of a non-exchange transaction it applies the derecognition requirements of this Standard as well as paragraphs 84 to 87 of IPSAS 23.
- AG78. Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognize a new liability if the derecognition criteria in paragraphs 17–39 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognized, and the entity recognizes a new liability relating to the transferred assets.
- AG79. For the purpose of paragraph 42, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 percent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognized as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.
- AG80. In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:
- (a) Recognizes a new financial liability based on the fair value of its obligation for the guarantee; and
 - (b) Recognizes a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Measurement (paragraphs 45–86)

Non-Exchange Revenue Transactions

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

- (a) Initially recognized in accordance with IPSAS 23;
- (b) Initially measured:
 - (i) At fair value using the principles in IPSAS 23; and
 - (ii) Taking account of transaction costs that are directly attributable to the acquisition of the financial asset in accordance with paragraph 45 of this Standard, where the asset is subsequently measured other than at fair value through surplus or deficit.

(See paragraphs IE46 to IE50 accompanying this Standard).

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

- AG82. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received, see also paragraph AG108). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG106–AG112). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of revenue unless it qualifies for recognition as some other type of asset.
- AG83. If an entity originates a loan that bears an off-market interest rate (e.g., 5 percent when the market rate for similar loans is 8 percent), and receives an up-front fee as compensation, the entity recognizes the loan at its fair value, i.e., net of the fee it receives. The entity accretes the discount to surplus or deficit using the effective interest rate method.

Concessionary Loans

- AG84. Concessionary loans are granted to or received by an entity at below market terms. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education and housing loans granted to low income families. Entities may receive concessionary loans, for example, from development agencies and other government entities.
- AG85. The granting or receiving of a concessionary loan is distinguished from the waiver of debt owing to or by an entity. This distinction is important because it affects whether the below market conditions are considered in the initial recognition or measurement of the loan rather than as part of the subsequent measurement or derecognition.

- AG86. The intention of a concessionary loan at the outset is to provide or receive resources at below market terms. A waiver of debt results from loans initially granted or received at market related terms where the intention of either party to the loan has changed subsequent to its initial issue or receipt. For example, a government may lend money to a not-for-profit entity with the intention that the loan be repaid in full on market terms. However, the government may subsequently write-off part of the loan. This is not a concessionary loan as the intention of the loan at the outset was to provide credit to an entity at market related rates. An entity would treat the subsequent write-off of the loan as a waiver of debt and apply the derecognition requirements of IPSAS 29.
- AG87. As concessionary loans are granted or received at below market terms, the transaction price on initial recognition of the loan may not be its fair value. At initial recognition, an entity therefore analyzes the substance of the loan granted or received into its component parts, and accounts for those components using the principles in paragraphs AG88 and AG89 below.
- AG88. An entity firstly assesses whether the substance of the concessionary loan is in fact a loan, a grant, a contribution from owners or a combination thereof, by applying the principles in IPSAS 28 and paragraphs 42–58 of IPSAS 23. If an entity has determined that the transaction, or part of the transaction, is a loan, it assesses whether the transaction price represents the fair value of the loan on initial recognition. An entity determines the fair value of the loan by using the principles in AG101–AG115. Where an entity cannot determine fair value by reference to an active market, it uses a valuation technique. Fair value using a valuation technique could be determined by discounting all future cash receipts using a market related rate of interest for a similar loan (see AG82).
- AG89. Any difference between the fair value of the loan and the transaction price (the loan proceeds) is treated as follows:
- (a) Where the loan is received by an entity, the difference is accounted for in accordance with IPSAS 23.
 - (b) Where the loan is granted by an entity, the difference is treated as an expense in surplus or deficit at initial recognition, except where the loan is a transaction with owners, in their capacity as owners. Where the loan is a transaction with owners in their capacity as owners, for example, where a controlling entity provides a concessionary loan to a controlled entity, the difference may represent a capital contribution, i.e., an investment in an entity, rather than an expense.

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

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

Non-Exchange Revenue Transactions

AG91. [Deleted]

Valuing Financial Guarantees Issued Through a Non-Exchange Transaction

- AG92. Only contractual financial guarantees (or guarantees that are in substance, contractual) are within the scope of this Standard (See AG3 and AG4 of IPSAS 28). Non-contractual guarantees are not within the scope of this Standard as they do not meet the definition of a financial instrument. This Standard prescribes recognition and measurement requirements only for the issuer of financial guarantee contracts.
- AG93. In paragraph 10 a “financial guarantee contract” is defined as “a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.” Under the requirements of this Standard, financial guarantee contracts, like other financial assets and financial liabilities, are required to be initially recognized at fair value. Paragraphs 50–52 of this Standard provide commentary and guidance on determining fair value and this is complemented by Application Guidance in paragraphs AG101–AG115. Subsequent measurement for financial guarantee contracts is at the higher of the amount determined in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognized less, when appropriate, cumulative amortization in accordance with IPSAS 9, *Revenue from Exchange Transactions*.
- AG94. In the public sector, guarantees are frequently provided by way of non-exchange transactions, i.e., at no or nominal consideration. This type of guarantee is provided generally to further the entity’s economic and social objectives. Such purposes include supporting infrastructure projects, supporting corporate entities at times of economic distress, guaranteeing the bond issues of entities in other tiers of governments and the loans of employees to finance motor vehicles that are to be used for performance of their duties as employees. Where there is consideration for a financial guarantee, an entity should determine whether that consideration arises from an exchange transaction and whether the consideration represents a fair value. If the consideration does represent a fair value, entities should recognize the financial guarantee at the amount of the consideration. Subsequent measurement should be at the higher of the amount determined in accordance with IPSAS 19 and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9. Where the entity concludes that the consideration is not a fair value, an entity determines the carrying value at initial recognition in the same way as if no consideration had been paid.

- AG95. At initial recognition, where no fee is charged or where the consideration is not fair value, an entity firstly considers whether there are quoted prices available in an active market for financial guarantee contracts directly equivalent to that entered into. Evidence of an active market includes recent arm's length market transactions between knowledgeable willing parties, and reference to the current fair value of another financial guarantee contract that is substantially the same as that provided at nil or nominal consideration by the issuer. The fact that a financial guarantee contract has been entered into at no consideration by the debtor to the issuer is not, of itself, conclusive evidence of the absence of an active market. Guarantees may be available from commercial issuers, but a public sector entity may agree to enter into a financial guarantee contract for a number of non-commercial reasons. For example, if a debtor is unable to afford a commercial fee, and initiation of a project in fulfillment of one of the entity's social or policy objectives would be put at risk unless a financial guarantee contract is issued, it may approach a public sector entity or government to issue a financial guarantee contract
- AG96. Where there is no active market for a directly equivalent guarantee contract; the entity considers whether a valuation technique other than observation of an active market is available and provides a reliable measure of fair value. Such a valuation technique may rely on mathematical models which consider financial risk. For example, National Government W guarantees a bond issue of Municipality X. As Municipality X has a government guarantee backing its bond issue, its bonds have a lower coupon than if they were not secured by a government guarantee. This is because the guarantee lowers the risk profile of the bonds for investors. The guarantee fee could be determined by using the credit spread between what the coupon rate would have been had the issue not been backed by a government guarantee and the rate with the guarantee in place. Where a fair value is obtainable either by observation of an active market or through another valuation technique, the entity recognizes the financial guarantee at that fair value in the statement of financial position and recognizes an expense of an equivalent amount in the statement of financial performance. When using a valuation technique that is not based on observation of an active market an entity needs to satisfy itself that the output of any model is reliable and understandable.
- AG97. If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition. The entity assesses whether a present obligation has arisen as a result of a past event related to a financial guarantee contract whether it is probable that such a present obligation will result in a cash outflow in accordance with the terms of the contract and whether a reliable estimate can be made of the outflow. It is possible that a present obligation related to a financial guarantee contract will arise at initial recognition where, for example, an entity enters into a financial guarantee contract to guarantee

loans to a large number of small enterprises and, based on past experience, is aware that a proportion of these enterprises will default.

Subsequent Measurement of Financial Assets (paragraphs 47 and 48)

- AG98. If a financial instrument that was previously recognized as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 49.
- AG99. The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognized at CU102. The end of the reporting period occurs one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognized in net assets/equity. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortized to surplus or deficit using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognized in surplus or deficit when the asset is derecognized or becomes impaired.
- AG100. Instruments that are classified as loans and receivables are measured at amortized cost without regard to the entity's intention to hold them to maturity.

Fair Value Measurement Considerations (paragraphs 50–52)

- AG101. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.
- AG102. This Standard uses the terms “bid price” and “asking price” (sometimes referred to as “current offer price”) in the context of quoted market prices, and the term “the bid-ask spread” to include only transaction costs. Other adjustments to arrive at fair value (e.g., for counterparty credit risk) are not included in the term “bid-ask spread.”

Active Market: Quoted Price

- AG103. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing

seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument (i.e., without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

- AG104. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (e.g., a change in the risk-free interest rate following the most recent price quote for a government bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (e.g., because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.
- AG105. If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

No Active Market: Valuation Technique

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

participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

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

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

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

AG110. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (i.e.,

similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

- AG111. The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.
- AG112. In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

No Active Market: Equity Instruments

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

(b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

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

Inputs to Valuation Techniques

AG115. An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

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

- (c) Foreign currency exchange prices. Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.
- (d) Commodity prices. There are observable market prices for many commodities.
- (e) Equity prices. Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.
- (f) Volatility (i.e., magnitude of future changes in price of the financial instrument or other item). Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.
- (g) Prepayment risk and surrender risk. Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount – see paragraph 52).
- (h) Servicing costs for a financial asset or a financial liability. Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

Gains and Losses (paragraphs 64–66)

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

4 (e.g., equity instruments), the gain or loss that is recognized directly in net assets/equity under paragraph 64(b) includes any related foreign exchange component. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognized in surplus or deficit.

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

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

- AG117. Impairment of a financial asset carried at amortized cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortized cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 72 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortized cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.
- AG118. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.
- AG119. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognizes an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period (paragraph 47 of IPSAS 19 contains guidance on how to determine the best estimate in a range of possible outcomes).
- AG120. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (e.g., on the basis of a credit risk evaluation or grading process that

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

- AG121. Impairment losses recognized on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.
- AG122. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.
- AG123. As an example of applying paragraph AG122, an entity may determine, on the basis of historical experience, that one of the main causes of default on loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognized for these "incurred but not reported" losses. However, it would not be appropriate to recognize an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.

- AG124. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.
- AG125. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g., for smaller balance loans) as long as they are consistent with the requirements in paragraphs 72–74 and AG120–AG124. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest Revenue after Impairment Recognition

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

Hedging (paragraphs 80–113)

Hedging Instruments (paragraphs 81–86)

Qualifying Instruments (paragraphs 81 and 82)

- AG127. The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the surplus or deficit exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (e.g., a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce surplus or deficit exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.
- AG128. A held-to-maturity investment carried at amortized cost may be designated as a hedging instrument in a hedge of foreign currency risk.
- AG129. An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity

instrument (see paragraphs 48(c) and 49) cannot be designated as a hedging instrument.

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

Hedged items (paragraphs 87–94)

Qualifying items (paragraphs 87–89)

- AG131. A firm commitment to acquire an entity or an integrated set of activities in a public sector combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general operational risks.
- AG132. An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognizes in surplus or deficit the investor's share of the associate's surplus or deficit, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated controlled entity cannot be a hedged item in a fair value hedge because consolidation recognizes in surplus or deficit the controlled entity's surplus or deficit, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.
- AG133. Paragraph 89 states that in consolidated financial statements the foreign currency risk of a highly probable forecast transaction within the economic entity may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated surplus or deficit. For this purpose an entity can be a controlling entity, controlled entity, associate, joint venture or branch. If the foreign currency risk of a forecast transaction within the economic entity does not affect consolidated surplus or deficit, the transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same economic entity unless there is a related external transaction. However, when the foreign currency risk of a forecast transaction within the economic entity will affect consolidated surplus or deficit, the transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same economic entity if there is an onward sale of the inventory to a party external to the economic entity. Similarly, a forecast sale of property, plant and equipment within the economic entity from the entity that constructed it to the entity that will use the property, plant and equipment in its operations may affect consolidated surplus or deficit. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity

and the amount initially recognized for the plant and equipment may change if the forecast transaction within the economic entity is denominated in a currency other than the functional currency of the purchasing entity.

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

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

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

AG136. If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below a market related interest rate, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at a market related rate and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g., only for changes that are attributable to changes in the market rate). For example, in the case of a financial liability whose effective interest rate is 100 basis points below the market rate, an entity can designate as the hedged item the entire liability (i.e., principal plus interest at the market rate minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in the market rate. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG140.

AG137. In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the

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

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

- (a) All of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or
- (b) Some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all or only some risks (i.e., a “portion” of the cash flows of the financial instrument may be designated for changes attributable to all or only some risks).

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

- (a) For a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark interest rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable.
- (b) Inflation is not separately identifiable and reliably measurable and cannot be designated as a risk or a portion of a financial instrument unless the requirements in (c) are met.
- (c) A contractually specified inflation portion of the cash flows of a recognized inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation portion.

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

AG140. Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brent Crude oil using a forward contract to purchase Light Sweet Crude oil on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 98 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (e.g., a transaction in Brent Crude oil) and the hedging instrument (e.g., a transaction in Light Sweet Crude oil). If there is a valid statistical relationship between the two variables (i.e., between the unit prices of Brent Crude oil and Light Sweet Crude oil), the slope of the regression line can be used to establish the hedge ratio that will maximize expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximizes expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognized in surplus or deficit during the term of the hedging relationship.

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

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

Hedge Accounting (paragraphs 95–113)

- AG142. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.
- AG143. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e., a hedge of a future transaction where the future cash flows being hedged are the future interest payments).
- AG144. A hedge of a firm commitment (e.g., a hedge of the change in fuel price relating to an unrecognized contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 97 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Assessing Hedge Effectiveness

- AG145. A hedge is regarded as highly effective only if both of the following conditions are met:
- (a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG140.
 - (b) The actual results of the hedge are within a range of 80–125 percent. For example, if actual results are such that the loss on the hedging instrument is CU120 and the gain on the cash instrument is CU100, offset can be measured by $120/100$, which is 120 percent, or by $100/120$, which is 83 percent. In this example, assuming the hedge meets the condition in (a), the entity would conclude that the hedge has been highly effective.
- AG146. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual financial statements.
- AG147. This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk

management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

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

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

- (a) The forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;
- (b) The fair value of the forward contract at inception is zero; and
- (c) Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and recognized in surplus or deficit or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

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

- AG151. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general operational risks, and must ultimately affect the entity's surplus or deficit. A hedge of the risk of obsolescence of a physical asset or the risk of legislative changes relating to the rehabilitation of damage to the environment is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.
- AG152. Paragraph 83(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.
- AG153. If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG135, a designated one-sided risk does not include the time value of an option. Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.
- AG154. In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.
- AG155. In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.
- AG156. If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before

the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

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

- (a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios (e.g., the entity may group its available-for-sale assets into a separate portfolio), in which case it applies the guidance below to each portfolio separately.
- (b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.
- (c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG169(b).
- (d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g., a swap rate).
- (e) The entity designates one or more hedging instruments for each repricing time period.
- (f) Using the designations made in (c)–(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.
- (g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognizes

the change in fair value of the hedged item as a gain or loss in surplus or deficit and in one of two line items in the statement of financial position as described in paragraph 100. The change in fair value need not be allocated to individual assets or liabilities.

- (h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognizes it as a gain or loss in surplus or deficit. The fair value of the hedging instrument(s) is recognized as an asset or liability in the statement of financial position.
- (i) Any ineffectiveness will be recognized in surplus or deficit as the difference between the change in fair value referred to in (g) and that referred to in (h) (effectiveness is measured using the same materiality considerations as in other IPSASs).

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

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

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

AG161. As an example of the designation set out in paragraph AG157(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the

net position of CU20, it designates as the hedged item assets in the amount of CU20 (a portion of the assets is designated as the Standard permits an entity to designate any amount of the available qualifying assets or liabilities, i.e., in this example any amount of the assets between CU0 and CU100). The designation is expressed as an “amount of a currency” (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn – i.e., all of the CU100 of assets in the above example – must be:

- (a) Items whose fair value changes in response to changes in the interest rate being hedged; and
- (b) Items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because paragraph 52 of the Standard specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG169(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 percent $(CU30 / (CU100 - CU40) = 50 \text{ percent})$ of the liabilities with no demand feature.

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

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

- (b) How the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.
- (c) The number and duration of repricing time periods.
- (d) How often the entity will test effectiveness and which of the two methods in paragraph AG169 it will use.
- (e) The methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph AG169(b).
- (f) When the entity tests effectiveness using the method described in paragraph AG169(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

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

AG163. The hedging instrument referred to in paragraph AG157(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG157(d). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because paragraph 86 of the Standard and paragraph AG127 do not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph AG157(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because paragraph 84 of the Standard does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

AG164. When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG157(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 90 of the Standard permits an

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

AG165. The Standard does not specify the techniques used to determine the amount referred to in paragraph AG157(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

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

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

- (a) Actual repricing dates being different from those expected, or expected repricing dates being revised;
- (b) Items in the hedged portfolio becoming impaired or being derecognized;
- (c) The payment dates of the hedging instrument and the hedged item being different; and
- (d) Other causes (e.g., when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

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

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

- (a) If the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behavior.
- (b) When the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behavior can be predicted more accurately.
- (c) When the repricing time periods used are narrower (e.g., 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduce the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.
- (d) The greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g., because of changes in prepayment expectations).

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

- (a) As the difference between the change in the fair value of the hedging instrument (see paragraph AG157(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or
- (b) Using the following approximation. The entity:
 - (i) Calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.

- (ii) Applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.
- (iii) Calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG157(g).
- (iv) Recognizes ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG157(h)).

AG170. When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph AG164), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG169(b) (ii) and hence when measuring effectiveness. Once ineffectiveness has been recognized as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG169(b) are then repeated at the next date it tests effectiveness.

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

AG172. In addition, any amount relating to a particular time period that has not been derecognized when the time period expires is recognized in surplus or deficit at that time (see paragraph 100). For example, assume an entity schedules

items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item in the statement of financial position was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets attributable to period 1 have been either realized or rescheduled into other periods. Therefore, CU7 is derecognized from the statement of financial position and recognized in surplus or deficit. CU8 and CU10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG157(g).

- AG173. As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first repricing time period expires, CU100 of assets are derecognized because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG157(g) that relates to the first time period is removed from the statement of financial position, plus 10 percent of the amount that relates to the second time period.
- AG174. If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognized, the amount included in the separate line item referred to in paragraph AG157(g) that relates to the reduction shall be amortized in accordance with paragraph 104.
- AG175. An entity may wish to apply the approach set out in paragraphs AG157–AG174 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with IPSAS 29. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 112(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG157–AG174 prospectively to subsequent accounting periods.

Appendix B

Reassessment of Embedded Derivatives

This Appendix is an integral part of IPSAS 29.

Introduction

- B1. IPSAS 29 paragraph 11 describes an embedded derivative as “a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.”
- B2. IPSAS 29 paragraph 12 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if, and only if:
 - (a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
 - (b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
 - (c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in surplus or deficit (i.e., a derivative that is embedded in a financial asset or financial liability at fair value through surplus or deficit is not separated).
- B3. IPSAS 29 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives under the Standard. This appendix addresses whether:
 - (a) IPSAS 29 requires such an assessment to be made only when the entity first becomes a party to the contract, or if the assessment should be reconsidered throughout the life of the contract.
 - (b) A first-time adopter makes its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts this Standard for the first time.
- B4. This appendix applies to all embedded derivatives within the scope of IPSAS 29 except the acquisition of contracts with embedded derivatives in a public sector combination or their possible reassessment at the date of acquisition.

Application of IPSAS 29 to the Reassessment of Embedded Derivatives

- B5. An entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is

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

- B6. The assessment whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on reclassification of a financial asset out of the fair value through surplus or deficit category in accordance with paragraph B5 shall be made on the basis of the circumstances that existed when the entity first became a party to the contract.
- B7. On first time adoption of IPSAS 29, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph B5.

Appendix C

Hedges of a Net Investment in a Foreign Operation

This Appendix is an integral part of IPSAS 29.

Introduction

- C1. Many reporting entities have investments in foreign operations (as defined in IPSAS 4, paragraph 10). Such foreign operations may be controlled entities, associates, joint ventures or branches. IPSAS 4 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognize foreign exchange differences directly in net assets/equity until it disposes of the foreign operation.
- C2. Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements. This will be the case for consolidated financial statements, financial statements in which investments such as associates or joint venters are accounted for using the equity method and financial statements that include a branch or joint operations as defined in IPSAS 37. The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.
- C3. IPSAS 29 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognized directly in net assets/equity and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.
- C4. This appendix applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with IPSAS 29. It should not be applied by analogy to other types of hedge accounting. This appendix refers to such an entity as a controlling entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a controlling entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.
- C5. This appendix provides guidance on:

- (a) Identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation, given that an entity with many foreign operations may be exposed to a number of foreign currency risks. It specifically addresses:
 - (i) Whether the controlling entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the controlling entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the controlling entity's consolidated financial statements and the functional currency of the foreign operation; and
 - (ii) If the controlling entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate controlling entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate controlling entity (i.e., whether the fact that the net investment in the foreign operation is held through an intermediate controlling entity affects the economic risk to the ultimate controlling entity).
- (b) Where in an economic entity the hedging instrument can be held. It specifically addresses:
 - (i) IPSAS 29 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This appendix addresses whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.
 - (ii) This appendix also addresses where, within an economic entity, hedging instruments that are hedges of a net investment in a foreign operation can be held to qualify for hedge accounting i.e., whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity within the economic entity, regardless of its functional currency, can hold the hedging instrument.
- (c) How an entity should determine what amount of the gain or loss recognized in net assets/equity should be recognized directly in

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

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

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

Nature of the Hedged Risk and Amount of the Hedged Item for which a Hedging Relationship may be Designated

- C6. Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the controlling entity's functional currency.
- C7. In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the controlling entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a controlling entity depends on whether any lower level controlling entity of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the controlling entity's consolidated financial statements.
- C8. The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any controlling entity (the immediate, intermediate or ultimate controlling entity) of that foreign operation. The fact that the net investment is held through an intermediate controlling entity does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate controlling entity.

- C9. An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one controlling entity within the economic entity (e.g., both a direct and an indirect controlling entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate controlling entity. A hedging relationship designated by one controlling entity in its consolidated financial statements need not be maintained by another higher level controlling entity. However, if it is not maintained by the higher level controlling entity, the hedge accounting applied by the lower level controlling entity must be reversed before the higher level controlling entity's hedge accounting is recognized.

Where the Hedging Instrument can be Held

- C10. A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the economic entity (except the foreign operation that itself is being hedged), as long as the designation, documentation and effectiveness requirements of IPSAS 29 paragraph 98 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the economic entity should be clearly documented because of the possibility of different designations at different levels of the economic entity.
- C11. For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the controlling entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognized in surplus or deficit, directly in net assets/equity, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognized in surplus or deficit or directly in net assets/equity. As part of the application of hedge accounting, the total effective portion of the change is included directly in net assets/equity. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

Disposal of a Hedged Foreign Operation

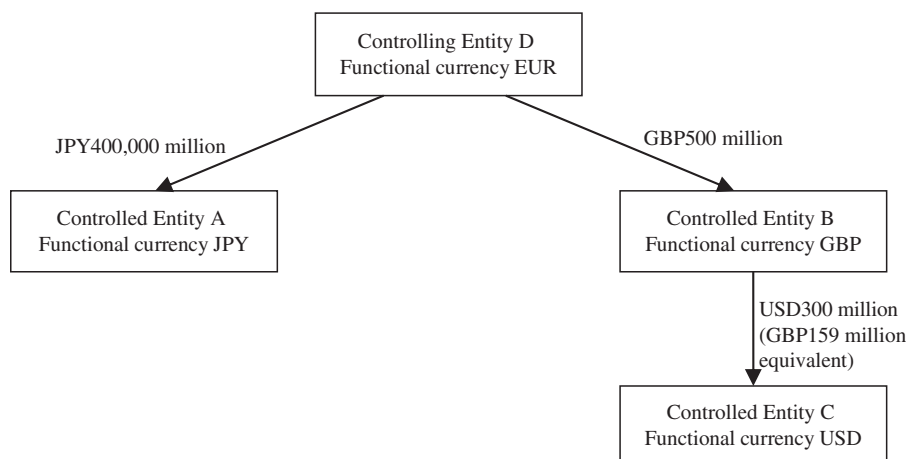
- C12. When a foreign operation that was hedged is disposed of, the amount reclassified to surplus or deficit from the foreign currency translation reserve in the consolidated financial statements of the controlling entity in respect of the hedging instrument is the amount that IPSAS 29 paragraph 113 requires

to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.

- C13. The amount recognized in surplus or deficit upon transfer from the foreign currency translation reserve in the consolidated financial statements of a controlling entity in respect of the net investment in that foreign operation in accordance with IPSAS 4 paragraph 57 is the amount included in that controlling entity's foreign currency translation reserve in respect of that foreign operation. In the ultimate controlling entity's consolidated financial statements, the aggregate net amount recognized in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate controlling entity uses the direct or the step-by-step method of consolidation, this may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation.
- C14. The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate controlling entity. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate controlling entity(ies) and then translated into the functional currency of the ultimate controlling entity (or the presentation currency if different).
- C15. The use of the step-by-step method of consolidation may result in a different amount being recognized in surplus or deficit from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by IPSAS 4. However, it is an accounting policy choice that should be followed consistently for all net investments.

Example

- C16. The following example illustrates the application of the preceding paragraphs using the entity structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with IPSAS 29, although this testing is not discussed. Controlling Entity D, being the ultimate controlling entity, presents its consolidated financial statements in its functional currency of euro (EUR). Each of the controlled entities i.e., Controlled Entity A, Controlled Entity B and Controlled Entity C, is wholly owned. Controlling Entity D £500 million net investment in Controlled Entity B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Controlled Entity B's US\$300 million net investment in Controlled Entity C (functional currency US dollars (USD)). In other words, Controlled Entity B's net assets other than its investment in Controlled Entity C are £341 million.



Nature of Hedged Risk for which a Hedging Relationship may be Designated (paragraphs C6–C9)

- C17. Controlling Entity D can hedge its net investment in each of Controlled Entities A, B and C for the foreign exchange risk between their respective functional currencies (Japanese yen (JPY), pounds sterling and US dollars) and euro. In addition, Controlled Entity D can hedge the USD/GBP foreign exchange risk between the functional currencies of Controlled Entity B and Controlled Entity C. In its consolidated financial statements, Controlled Entity B can hedge its net investment in Controlled Entity C for the foreign exchange risk between their functional currencies of US dollars and pounds sterling. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Controlling Entity D could designate the forward foreign exchange risk.

Amount of Hedged item for which a Hedging Relationship may be Designated (paragraphs C6–C9)

- C18. Controlling Entity D wishes to hedge the foreign exchange risk from its net investment in Controlled Entity C. Assume that Controlled Entity A has an external borrowing of US\$300 million. The net assets of Controlled Entity A at the start of the reporting period are ¥400,000 million including the proceeds of the external borrowing of US\$300 million.
- C19. The hedged item can be an amount of net assets equal to or less than the carrying amount of Controlling Entity D's net investment in Controlled

Entity C (US\$300 million) in its consolidated financial statements. In its consolidated financial statements Controlling Entity D can designate the US\$300 million external borrowing in Controlled Entity A as a hedge of the EUR/USD spot foreign exchange risk associated with its net investment in the US\$300 million net assets of Controlled Entity C. In this case, both the EUR/USD foreign exchange difference on the US\$300 million external borrowing in Controlled Entity A and the EUR/USD foreign exchange difference on the US\$300 million net investment in Controlled Entity C are included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements after the application of hedge accounting.

C20. In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Controlled Entity A would be recognized in Controlling Entity D's consolidated financial statements as follows:

- USD/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit; and
- JPY/EUR spot foreign exchange rate change directly in net assets/equity.

Instead of the designation in paragraph C19, in its consolidated financial statements Controlling Entity D can designate the US\$300 million external borrowing in Controlled Entity A as a hedge of the GBP/USD spot foreign exchange risk between Controlled Entity C and Controlled Entity B. In this case, the total USD/EUR foreign exchange difference on the US\$300 million external borrowing in Entity A would instead be recognized in Controlled Entity D's consolidated financial statements as follows:

- The GBP/USD spot foreign exchange rate change in the foreign currency translation reserve relating to Controlled Entity C;
- GBP/JPY spot foreign exchange rate change, translated to euro, in surplus or deficit; and
- JPY/EUR spot foreign exchange rate change directly in net assets/equity.

C21. Controlling Entity D cannot designate the US\$300 million external borrowing in Controlled Entity A as a hedge of both the EUR/USD spot foreign exchange risk and the GBP/USD spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Controlled Entity B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the economic entity comprising Controlled Entity B and Controlled Entity C.

Where in an Economic Entity can the Hedging Instrument be Held (paragraphs C10 and C11)?

- C22. As noted in paragraph C20, the total change in value in respect of foreign exchange risk of the US\$300 million external borrowing in Controlled Entity A would be recorded in both surplus or deficit (USD/JPY spot risk) and directly in net assets/equity (EUR/JPY spot risk) in Controlling Entity D's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in paragraph C19 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Controlling Entity D against the US dollar functional currency of Controlled Entity C, in accordance with the hedge documentation. The method of consolidation (i.e., direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts Recognized in Surplus or Deficit on Disposal of a Foreign Operation (paragraphs C12 and C13)

- C23. When Controlled Entity C is disposed of, the amounts are recognized in surplus or deficit in Controlling Entity D's consolidated financial statements upon transfer from its foreign currency translation reserve (FCTR) are:
- (a) In respect of the US\$300 million external borrowing of Controlled Entity A, the amount that IPSAS 29 requires to be identified, i.e., the total change in value in respect of foreign exchange risk that was recognized directly in net assets/equity as the effective portion of the hedge; and
 - (b) In respect of the US\$300 million net investment in Controlled Entity C, the amount determined by the entity's consolidation method. If Controlling Entity D uses the direct method, its FCTR in respect of Controlled Entity C will be determined directly by the EUR/USD foreign exchange rate. If Controlling Entity D uses the step-by-step method, its FCTR in respect of Controlled Entity C will be determined by the FCTR recognized by Controlled Entity B reflecting the GBP/USD foreign exchange rate, translated to Controlling Entity D's functional currency using the EUR/GBP foreign exchange rate. Controlling Entity D's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be recognized in surplus or deficit when it disposes of Controlled Entity C to be the amount that it would have recognized if it had always used the direct method, depending on its accounting policy.

Hedging More Than One Foreign Operation (paragraphs C7, C9, and C11)

- C24. The following examples illustrate that in the consolidated financial statements of Controlling Entity D, the risk that can be hedged is always the risk between its functional currency (euro) and the functional currencies of Controlled Entities B and C. No matter how the hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements when both foreign operations are hedged are US\$300 million for EUR/USD risk and £341 million for EUR/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Controlling Entity D's consolidated surplus or deficit. Of course, it would be possible for Controlling Entity D to designate US\$300 million only for changes in the USD/GBP spot foreign exchange rate or £500 million only for changes in the GBP/EUR spot foreign exchange rate.

Entity D Holds Both USD and GBP Hedging Instruments

- C25. Controlling Entity D may wish to hedge the foreign exchange risk in relation to its net investment in Controlled Entity B as well as that in relation to Controlled Entity C. Assume that Controlling Entity D holds suitable hedging instruments denominated in US dollars and pounds sterling that it could designate as hedges of its net investments in Controlled Entity B and Controlled Entity C. The designations Controlling Entity D can make in its consolidated financial statements include, but are not limited to, the following:
- (a) US\$300 million hedging instrument designated as a hedge of the US\$300 million of net investment in Controlled Entity C with the risk being the spot foreign exchange exposure (EUR/USD) between Controlling Entity D and Controlled Entity C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between Controlling Entity D and Controlled Entity B.
 - (b) US\$300 million hedging instrument designated as a hedge of the US\$300 million of net investment in Controlled Entity C with the risk being the spot foreign exchange exposure (GBP/USD) between Controlled Entity B and Controlled Entity C and up to £500 million hedging instrument designated as a hedge of £500 million of the net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (EUR/GBP) between Controlling Entity D and Controlled Entity B.
- C26. The EUR/USD risk from Controlling Entity D's net investment in Controlled Entity C is a different risk from the EUR/GBP risk from Controlling Entity

D's net investment in Controlled Entity B. However, in the case described in paragraph C25(a), by its designation of the USD hedging instrument it holds, Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in Controlled Entity C. If Controlling Entity D also designated a GBP instrument it holds as a hedge of its £500 million net investment in Controlled Entity B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in Controlled Entity C, would be hedged twice for GBP/EUR risk in Controlling Entity D's consolidated financial statements.

- C27. In the case described in paragraph C25(b), if Controlling Entity D designates the hedged risk as the spot foreign exchange exposure (GBP/USD) between Controlled Entity B and Controlled Entity C, only the GBP/USD part of the change in the value of its US\$300 million hedging instrument is included in Controlling Entity D's foreign currency translation reserve relating to Controlled Entity C. The remainder of the change (equivalent to the GBP/EUR change on £159 million) is included in Controlling Entity D's consolidated surplus or deficit, as in paragraph C20. Because the designation of the USD/GBP risk between Controlled entities B and C does not include the GBP/EUR risk, Controlled Entity D is also able to designate up to £500 million of its net investment in Controlled Entity B with the risk being the spot foreign exchange exposure (GBP/EUR) between Controlling Entity D and Controlled Entity B.

Entity B Holds the USD Hedging Instrument

- C28. Assume that Controlled Entity B holds US\$300 million of external debt, the proceeds of which were transferred to Controlling Entity D by an inter-entity loan denominated in pounds sterling. Because both its assets and liabilities increased by £159 million, Controlled Entity B's net assets are unchanged. Controlled Entity B could designate the external debt as a hedge of the GBP/USD risk of its net investment in Controlled Entity C in its consolidated financial statements. Controlling Entity D could maintain Controlled Entity B's designation of that hedging instrument as a hedge of its US\$300 million net investment in Controlled Entity C for the GBP/USD risk (see paragraph C9) and Controlling Entity D could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in Controlled Entity B. The first hedge, designated by Controlled Entity B, would be assessed by reference to Controlled Entity B's functional currency (pounds sterling) and the second hedge, designated by Controlling Entity D, would be assessed by reference to Controlling Entity D's functional currency (euro). In this case, only the GBP/USD risk from Controlling Entity D's net investment in Controlled Entity C has been hedged in Controlling Entity D's consolidated financial statements by the USD hedging instrument, not the entire EUR/USD risk. Therefore, the entire EUR/GBP risk from Controlling Entity D's

£500 million net investment in Controlled Entity B may be hedged in the consolidated financial statements of Controlling Entity D.

- C29. However, the accounting for Controlled Entity D's £159 million loan payable to Controlled Entity B must also be considered. If Controlling Entity D's loan payable is not considered part of its net investment in Controlled Entity B because it does not satisfy the conditions in IPSAS 4 paragraph 18, the GBP/EUR foreign exchange difference arising on translating it would be included in Controlling Entity D's consolidated surplus or deficit. If the £159 million loan payable to Controlled Entity B is considered part of Controlling Entity D's net investment, that net investment would be only £341 million and the amount Controlling Entity D could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.
- C30. If Controlling Entity D reversed the hedging relationship designated by Controlled Entity B, Controlling Entity D could designate the US\$300 million external borrowing held by Controlled Entity B as a hedge of its US\$300 million net investment in Controlled Entity C for the EUR/USD risk and designate the GBP hedging instrument it holds itself as a hedge of only up to £341 million of the net investment in Controlled Entity B. In this case the effectiveness of both hedges would be computed by reference to Controlling Entity D's functional currency (euro). Consequently, both the USD/GBP change in value of the external borrowing held by Controlled Entity B and the GBP/EUR change in value of Controlling Entity D's loan payable to Controlled Entity B (equivalent to USD/EUR in total) would be included in the foreign currency translation reserve in Controlling Entity D's consolidated financial statements. Because Controlling Entity D has already fully hedged the EUR/USD risk from its net investment in Controlled Entity C, it can hedge only up to £341 million for the EUR/GBP risk of its net investment in Controlled Entity B.

Appendix D

Amendments to Other IPSASs

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 29.

Introduction

- BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in IPSAS 29, *Financial Instruments: Recognition and Measurement*. As this Standard is based on IAS 39, *Financial Instruments: Recognition and Measurement* issued by the IASB, the Basis for Conclusions outlines only those areas where IPSAS 29 departs from the main requirements of IAS 39.
- BC2. This project on financial instruments forms part of the IPSASB's convergence program which aims to converge IPSASs with IFRSs. The IPSASB acknowledges that there are other aspects of financial instruments, insofar as they relate to the public sector, which are not addressed in IAS 39. These will be addressed by future projects of the IPSASB. In particular, the IPSASB acknowledges that future projects are required to address:
- Certain transactions undertaken by central banks; and
 - Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature.
- BC3. In developing this Standard, the IPSASB agreed to retain the existing text of IAS 39 wherever consistent with existing IPSASs, and deal with certain public sector specific issues through additional application guidance.
- BC4. In September 2007, the IASB issued amendments to IAS 1, *Presentation of Financial Statements* which introduced "comprehensive income" into the presentation of financial statements. As the IPSASB has not yet considered comprehensive income, along with some of the other amendments proposed in IAS 1, those amendments have not been included in IPSAS 29. The text of IAS 39 as published at December 31, 2008, including certain amendments made by the IASB to IAS 39 in April 2009 as part of its improvements project, have been included in the text of IPSAS 29. The IPSASB acknowledged that IFRS 9, *Financial Instruments* was issued in November 2009. The IPSASB also recognized that the IASB plans further significant modifications to IAS 39. The IPSASB therefore decided to consider any modifications to IASB requirements for financial instruments as part of a future project.¹

¹ In January 2015 the IPSASB introduced the concept of investment entities in IPSAS 35 and required investment entities, as defined in that Standard, to measure their investments in controlled entities, other than those providing investment-related services or activities, at fair value through surplus or deficit.

Scope

BC5. Assets and liabilities may arise out of contractual non-exchange revenue transactions. The initial recognition and measurement of assets and liabilities arising out of non-exchange revenue transactions is addressed in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. IPSAS 23 does not provide requirements and guidance for the subsequent measurement or derecognition of these assets and liabilities. The IPSASB considered the interaction between this Standard and IPSAS 23 for assets and liabilities that arise out of non-exchange revenue transactions that meet the definition of financial assets and financial liabilities.

BC6. The IPSASB agreed that where an asset acquired in a non-exchange transaction is a financial asset, an entity:

- Initially recognizes the asset using IPSAS 23; and
- Initially measures the asset using IPSAS 23 and, considers the requirements in this Standard to determine the appropriate treatment for any transaction costs incurred to acquire the asset.

As IPSAS 23 does not prescribe subsequent measurement or derecognition requirements for assets acquired in a non-exchange transaction, this Standard is applied to those assets if they are financial assets.

BC7. For liabilities, the IPSASB agreed that liabilities arising from conditions imposed on a transfer of resources in accordance with IPSAS 23 are initially recognized and initially measured using that IPSAS, as these liabilities usually do not meet the definition of a financial liability at initial recognition (see IPSAS 28). After initial recognition, if circumstances indicate that the liability is a financial liability, an entity assesses if the liability recognized in accordance with IPSAS 23 should be derecognized and a financial liability recognized in accordance with this Standard.

BC8. The IPSASB agreed that other liabilities that arise from non-exchange revenue transactions, for example, the return of resources based on a restriction on the use of an asset, are recognized and measured in accordance with this Standard if they meet the definition of a financial liability.

Initial Measurement

BC9. The IPSASB acknowledged that there is an interaction between IPSAS 23 and this Standard for assets acquired through a non-exchange transaction that also meet the definition of a financial asset. IPSAS 23 requires that assets acquired in a non-exchange revenue transaction are measured initially at fair value. This Standard requires financial assets to be measured initially at fair value, plus transaction costs, if the asset is not subsequently measured at fair value through surplus or deficit. The two measurement approaches are broadly consistent, except for the treatment of transaction costs.

BC10. The IPSASB concluded that it would be inappropriate for financial assets arising from non-exchange transactions to be measured differently from those arising from exchange transactions. Consequently, the IPSASB agreed that assets acquired in a non-exchange transaction should be measured initially at fair value using the requirements in IPSAS 23, but that this Standard should also be considered where transaction costs are incurred to acquire the asset.

Concessionary Loans

BC11. Concessionary loans can either be granted or received by an entity. They pose particular accounting issues because their terms are not market related. The IPSASB therefore considered how the off-market portion of a concessionary loan should be accounted for. In ED 38, the IPSASB proposed that an entity should account for concessionary loans by analyzing the substance of the transaction into its component parts and accounting for each component separately and that the IPSASB therefore determined that the off-market portion of a concessionary loan should be accounted for as follows:

- The issuer of a concessionary loan accounts for the off-market portion of the loan as an expense in the year the loan is issued; and
- The recipient of a concessionary loan accounts for the off-market portion of the loan in accordance with IPSAS 23.

BC12. Some respondents to ED 38 disagreed with the proposed treatment of concessionary loans because they do not believe that fair value is an appropriate measurement basis, while others disagreed with the proposed treatment of the off-market portion of concessionary loans as an expense.

BC13. Respondents who disagreed with fair value as a measurement basis cited both conceptual and practical difficulties in measuring concessionary loans at fair value. At a conceptual level, it was noted that some concessionary loans issued by public sector entities may not be available in an orderly market because of the risk profiles of the borrowers, e.g., small business loans, or loans granted by governments in their capacity as a lender of last resort. For loans that would not ordinarily be found in an orderly market, respondents argued that while it may be possible to obtain a fair value, that fair value does not provide a faithful representation of the transaction. They argued that because an orderly market for such transactions does not exist, the transaction price on initial measurement represents the fair value of the loan. Those respondents who cited practical difficulties in determining fair value noted that, because of these difficulties, fair values are often determined using estimates. In their view the use of such estimates would make the information potentially unreliable. As a means of overcoming these practical difficulties, respondents suggested that, as an alternative to fair value, nominal cost or the lender's borrowing rate should be used as a measurement basis.

- BC14. The IPSASB takes the view that the use of fair value enables the most faithfully representative determination of the concession element of a concessionary loan. Also, because the loans granted at no or low interest are not unique to the public sector, the IPSASB was not persuaded that there is a public sector specific reason to depart from the fair value principles in IAS 39. They also noted that IPSAS 30 requires specific disclosures on the measurement of financial instruments, including those instances where unobservable market inputs have been used. Consequently, the IPSASB decided to retain fair value as a measurement basis for concessionary loans.
- BC15. Respondents who disagreed with expensing the off-market portion of the concessionary loan, noted that because the off-market portion represents a subsidy, it may be more appropriate to recognize an asset initially and recognize an expense subsequently by reducing this asset as and when the conditions of the subsidy are met or on a time proportion basis. The IPSASB, however, considered that the initial granting of the loan results in a commitment of resources, in the form of a loan and a subsidy, on day one. The IPSASB was of the view that initial recognition of this subsidy as an expense on recognition of the transaction provides the most useful information for accountability purposes.

Financial Guarantees Issued Through a Non-Exchange Transaction

- BC16. The IPSASB acknowledged that in the public sector financial guarantee contracts are frequently issued through a non-exchange transaction, i.e., they are issued for no consideration or for nominal consideration, often in order to further the issuer's broad social policy objectives, rather than for commercial purposes. While entities may issue guarantees at below fair value in the private sector, this is not common and is for commercial reasons, such as when a controlling entity issues a guarantee to a holder on behalf of a controlled entity. In the public sector the maximum credit risk exposure of such guarantees may be extremely large. Such guarantees are generally issued because an active market does not exist and, in some cases, it would be impossible for the guarantee to be provided by a private sector issuer because of the maximum extent of the credit risk exposure. The IPSASB considered the approach to measurement at initial recognition, and subsequent to initial recognition, for such financial guarantee contracts.
- BC17. Where the financial guarantee contract is entered into for consideration, the IPSASB considered whether the amount of such consideration should be deemed to be a fair value. Application Guidance in IAS 39 states that "the fair value of a financial instrument on initial recognition is normally the transaction price." In the public sector the IPSASB considered that in many cases the transaction price related to a financial guarantee contract will not reflect fair value and that recognition at such an amount would be an inaccurate and misleading reflection of the issuer's exposure to financial risk. The IPSASB concluded that where there is consideration for a financial

guarantee, an entity should determine whether that consideration arises from an exchange transaction and therefore represents a fair value. If the consideration does represent a fair value, the IPSASB concluded that entities should recognize the financial guarantee at the amount of the consideration and that subsequent measurement should be at the higher of the amount determined in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9, *Revenue from Exchange Transactions*. Where the transaction price is not a fair value, an entity should be required to determine measurement at initial recognition in the same way as if no consideration had been paid.

BC18. The IPSASB therefore considered the approach to the determination of measurement at initial recognition for financial guarantee contracts provided for no consideration or for a consideration that is not a fair value. The IPSASB identified a valuation hierarchy that could be used in initially measuring a financial guarantee contract provided for no consideration or for consideration that is not a fair value:

- An entity assesses whether the fair value of the financial guarantee contract can be determined by observing a price in an active market;
- Where a price cannot be determined by observing a price in an active market, an entity uses a valuation technique; and
- If fair value cannot be determined for a financial guarantee contract, an entity measures a financial guarantee contract at initial recognition and subsequently in accordance with IPSAS 19.

BC19. There may be cases where an active market exists for financial guarantee contracts equivalent to or similar to that issued. In such cases a fair value should be estimated through observation of that active market. Where no active market exists, the IPSASB considered whether an entity should be required to move immediately to an approach based on IPSAS 19. The IPSASB noted that many valuation techniques are highly complex and, as noted in paragraphs AG107 and AG108 may give rise to a range of outcomes. It is arguable that the cost of developing such techniques exceeds the benefits to users of the information provided. An approach based on IPSAS 19 may provide a more reliable and understandable measure of an issuer's risk exposure as a result of entering into a financial guarantee contract. The IPSASB also acknowledged that where an entity does not recognize a liability in accordance with IPSAS 19, the entity makes the disclosures required for contingent liabilities in IPSAS 19 unless an outflow of resources is remote. The information provided to users on risk exposure related to financial guarantees provided at nil or nominal consideration also includes the credit risk disclosures in IPSAS 30, *Financial Instruments: Disclosures*. Conversely, the IPSASB acknowledged that there are current IPSASs that require the use of experts, such as actuaries,

to develop valuation techniques that are inherently complex, such as IPSAS 39, *Employee Benefits*. On balance the IPSASB concluded that, in the absence of an active market, entities should be permitted to use a valuation technique that does not rely on an observable market where they are satisfied that such a technique provides a reliable and understandable method of determining a fair value for a financial guarantee contract entered into by an issuer by means of a non-exchange transaction. This is particularly the case for non-standard guarantees where there is limited data available on defaults and credit risk.

Revision of IPSAS 29 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

BC20. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

- (a) Removes the standard paragraphs about the applicability of IPSASs to “public sector entities other than GBEs” from the scope section of each Standard;
- (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and
- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 29.

Section A: Scope

A.1 *Practice of Settling Net: Forward Contract to Purchase a Commodity*

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

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of oil, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the oil and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under IPSAS 29. Instead, it is accounted for as an executory contract.

A.2 *Option to Put a Non-Financial Asset*

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for CU150 million. The current value of the building is CU175 million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (IPSAS 29, paragraph 4 and IPSAS 29, paragraph AG22).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery (IPSAS 29, paragraph 6). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from IPSAS 29 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract rather than an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building and selling it within a short

period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative.

Section B: Definitions

B.1 *Definition of a Derivative: Examples of Derivatives and Underlyings*

What are examples of common derivative contracts and the identified underlying?

IPSAS 29 defines a derivative as follows:

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

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

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity instruments of another entity)
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity instruments of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity instruments of another entity)

The above list provides examples of contracts that normally qualify as derivatives under IPSAS 29. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions of IPSAS 29 may apply, for example, if it is a weather derivative (see IPSAS 29.AG5), a contract to buy or sell a non-financial item such as commodity (see IPSAS 29.4 and IPSAS 29.AG22) or a contract settled in an entity's own shares (see IPSAS 28.25–IPSAS 28.29). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.2 *Definition of a Derivative: Settlement at a Future Date, Interest Rate Swap with Net or Gross Settlement*

For the purpose of determining whether an interest rate swap is a derivative financial instrument under IPSAS 29, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 percent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a CU100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 percent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.3 *Definition of a Derivative: Prepaid Interest Rate Swap (Fixed Rate Payment Obligation Prepaid at Inception or Subsequently)*

If a party prepays its obligation under a pay-fixed, receive-variable interest rate swap at inception, is the swap a derivative financial instrument?

Yes.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 percent per year. Entity S prepays its fixed obligation under the swap of CU50 million (CU100 million \times 10 percent \times 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the CU100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfills the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” provision of IPSAS 29. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under IPSAS 29.

B.4 *Definition of a Derivative: Prepaid Pay-Variable, Receive-Fixed Interest Rate Swap*

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criterion of a derivative.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 percent times the swap’s notional amount, i.e., CU10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 percent on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criterion of IPSAS 29. Therefore, the contract is not accounted for as a derivative under IPSAS 29. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.5 *Definition of a Derivative: Offsetting Loans*

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under IPSAS 29?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

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

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IPSAS 29.10 does not require net settlement.

B.6 *Definition of a Derivative: Option Not Expected to be Exercised*

The definition of a derivative in IPSAS 29.10 requires that the instrument “is settled at a future date.” Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.7 *Definition of a Derivative: Foreign Currency Contract Based on Sales Volume*

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

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. IPSAS 29 does not exclude from its scope derivatives that are based on sales volume.

B.8 *Definition of a Derivative: Prepaid Forward*

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is CU50 per share; the one-year forward price of T is CU55 per share. XYZ is required to prepay the forward contract at inception with a CU50 million payment. The initial investment in the forward contract of CU50 million is less than the notional amount applied to the underlying, one million shares at the forward price of CU55 per share, i.e., CU55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T’s shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.9 *Definition of a Derivative: Initial Net Investment*

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing

house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.10 *Definition of Held for Trading: Portfolio with a Recent Actual Pattern of Short-Term Profit-Taking*

The definition of a financial asset or financial liability held for trading states that “a financial asset or financial liability is classified as held for trading if it is ... part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.” What is a “portfolio” for the purposes of applying this definition?

Although the term “portfolio” is not explicitly defined in IPSAS 29, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (IPSAS 29.10). If there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.11 *Definition of Held for Trading: Balancing a Portfolio*

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

It depends on Entity A’s intentions and past practice. If the portfolio manager is authorized to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available for sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

B.12 *Definition of Held-to-Maturity Financial Assets: Index-Linked Principal*

Entity A purchases a five-year equity-index-linked note with an original issue price of CU10 at a market price of CU12 at the time of purchase. The note requires no interest payments before maturity. At maturity, the note requires payment of the original issue price of CU10 plus a supplemental redemption amount that depends on whether a specified share price index exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the share index at maturity and the level of the share index when the note was issued divided by

the level of the share index at the time of issue. Entity A has the positive intention and ability to hold the note to maturity. Can Entity A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of CU10 and fixed maturity and Entity A has the positive intention and ability to hold it to maturity (IPSAS 29.10). However, the equity index feature is a call option not closely related to the debt host, which must be separated as an embedded derivative under IPSAS 29.12. The purchase price of CU12 is allocated between the host debt instrument and the embedded derivative. For example, if the fair value of the embedded option at acquisition is CU4, the host debt instrument is measured at CU8 on initial recognition. In this case, the discount of CU2 that is implicit in the host bond (principal of CU10 minus the original carrying amount of CU8) is amortized to surplus or deficit over the term to maturity of the note using the effective interest method.

B.13 *Definition of Held-to-Maturity Financial Assets: Index-Linked Interest*

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes. However, the commodity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (IPSAS 29.12). IPSAS 29.14 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

B.14 *Definition of Held-to-Maturity Financial Assets: Sale Following Rating Downgrade*

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily. A downgrade is likely to indicate a decline in the issuer's creditworthiness. IPSAS 29 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in IPSAS 29 and therefore not raise a question about the entity's intention to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in IPSAS 29. A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class could often be regarded as reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be regarded as significant.

B.15 *Definition of Held-to-Maturity Financial Assets: Permitted Sales*

Would sales of held-to-maturity financial assets due to a change in management compromise the classification of other financial assets as held to maturity?

Yes. A change in management is not identified under IPSAS 29.AG35 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held to maturity. Sales in response to such a change in management would, therefore, call into question the entity's intention to hold investments to maturity.

To illustrate: Entity X has a portfolio of financial assets that is classified as held to maturity. In the current period, at the direction of the governing body, the senior management team has been replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in order to carry out an expansion strategy designated and approved by the governing body. Although the previous management team had been in place since the entity's inception and Entity X had never before undergone a major restructuring, the sale nevertheless calls into question Entity X's intention to hold remaining held-to-maturity financial assets to maturity.

B.16 *Definition of Held-to-Maturity Investments: Sales in Response to Entity-Specific Capital Requirements*

In some countries, regulators of banks or other industries may set entity-specific capital requirements that are based on an assessment of the risk in that particular entity. IPSAS 29.AG35(e) indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the industry's capital requirements may do so under IPSAS 29 without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in entity-specific capital requirements imposed by regulators (i.e., capital requirements applicable to a particular entity, but not to the industry) raise such doubt?

Yes, such sales "taint" the entity's intention to hold other financial assets as held to maturity unless it can be demonstrated that the sales fulfill the condition in IPSAS 29.10 in that they result from an increase in capital requirements, which is an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

B.17 *Definition of Held-to-Maturity Financial Assets: Pledged Collateral, Repurchase Agreements (repos), and Securities Lending Agreements*

An entity cannot have a demonstrated ability to hold to maturity an investment if it is subject to a constraint that could frustrate its intention to hold the financial asset to maturity. Does this mean that a debt instrument that has been pledged as collateral, or transferred to another party under a repo or securities lending transaction, and continues to be recognized cannot be classified as a held-to-maturity investment?

No. An entity's intention and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or securities lending agreement. However, an entity does not have the positive intention and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments.

B.18 *Definition of Held-to-Maturity Financial Assets: "Tainting"*

In response to unsolicited tender offers, Entity A sells a significant amount of financial assets classified as held to maturity on economically favorable terms. Entity A does not classify any financial assets acquired after the date of the sale as held to maturity. However, it does not reclassify the remaining held-to-maturity investments since it maintains that it still intends to hold them to maturity. Is Entity A in compliance with IPSAS 29?

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held to maturity (HTM) results in the conditions in IPSAS 29.10 and IPSAS 29. AG35 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as available-for-sale financial assets. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under IPSAS 29.60. IPSAS 29.10 makes it clear that at least two full financial years must pass before an entity can again classify financial assets as HTM.

B.19 *Definition of Held-to-Maturity Investments: Sub-Categorization for the Purpose of Applying the "Tainting" Rule*

Can an entity apply the conditions for held-to-maturity classification in IPSAS 29.10 separately to different categories of held-to-maturity financial assets, such as debt instruments denominated in US dollars and debt instruments denominated in euro?

No. The "tainting rule" in IPSAS 29.10 is clear. If an entity has sold or reclassified more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

B.20 *Definition of Held-to-Maturity Investments: Application of the "Tainting" Rule on Consolidation*

Can an entity apply the conditions in IPSAS 29.10 separately to held-to-maturity financial assets held by different entities in an economic entity, for example, if separate entities are in different countries with different legal or economic environments?

No. If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in IPSAS 29.10 are met.

B.21 *Definition of Loans and Receivables: Equity Instrument*

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes. If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met. IPSAS 27.13–IPSAS 27.27 provide guidance about the classification of a financial instrument as a liability or as an equity instrument from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under IPSAS 28, it cannot be classified within loans and receivables by the holder.

B.22 *Definition of Loans and Receivables: Banks' Deposits in Other Banks*

Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit fall within loans and receivables under IPSAS 29.10?

Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

B.23 *Definition of Amortized Cost: Perpetual Debt Instruments with Fixed or Market-Based Variable Rate*

Sometimes entities purchase or issue debt instruments that are required to be measured at amortized cost and in respect of which the issuer has no obligation to repay the principal amount. Interest may be paid either at a fixed rate or at a variable rate. Would the difference between the initial amount paid or received and zero ("the maturity amount") be amortized immediately on initial recognition for the purpose of determining amortized cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayments of principal, there is no amortization of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortized cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (IPSAS 29.10).

B.24 *Definition of Amortized Cost: Perpetual Debt Instruments with Decreasing Interest Rate*

If the stated rate of interest on a perpetual debt instrument decreases over time, would amortized cost equal the principal amount in each period?

No. From an economic perspective, some or all of the interest payments are repayments of the principal amount. For example, the interest rate may be stated as 16 percent for the first ten years and as zero percent in subsequent periods. In that case, the initial amount is amortized to zero over the first ten years using the effective interest method, since a portion of the interest payments represents repayments of the principal amount. The amortized cost is zero after year 10 because the present value of the stream of future cash payments in subsequent periods is zero (there are no further cash payments of either principal or interest in subsequent periods).

B.25 *Example of Calculating Amortized Cost: Financial Asset*

Financial assets that are excluded from fair valuation and have a fixed maturity should be measured at amortized cost. How is amortized cost calculated?

Under IPSAS 29, amortized cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortized cost is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a principal amount of CU1,250 and carries fixed interest of 4.7 percent that is paid annually ($\text{CU1,250} \times 4.7 \text{ percent} = \text{CU59}$ per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 percent annually. The table below provides information about the amortized cost, interest revenue and cash flows of the debt instrument in each reporting period.

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Amortized cost at the beginning of the year	Interest revenue	Cash flows	Amortized cost at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086	109	59	1,136
20X3	1,136	113	59	1,190
20X4	1,190	119	1,250 + 59	–

On the first day of 20X2 the entity revises its estimate of cash flows. It now expects that 50 percent of the principal will be prepaid at the end of 20X2 and the remaining 50 percent at the end of 20X4. In accordance with IPSAS 29.AG20, the opening balance of the debt instrument in 20X2 is adjusted. The adjusted amount is calculated by discounting the amount the entity expects to receive in 20X2 and subsequent years using the original effective interest rate (10 percent). This results in the new opening balance in 20X2 of CU1,138. The adjustment of CU52 (CU1,138 – CU1,086) is recorded in surplus or deficit in 20X2. The table below provides information about the amortized cost, interest revenue and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a) Amortized cost at the beginning of the year	(b = a × 10%) Interest revenue	(c) Cash flows	(d = a + b – c) Amortized cost at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086 + 52	114	625 + 59	568
20X3	568	57	30	595
20X4	595	60	625 + 30	–

If the debt instrument becomes impaired, say, at the end of 20X3, the impairment loss is calculated as the difference between the carrying amount (CU595) and the present value of estimated future cash flows discounted at the original effective interest rate (10 percent).

B.26 *Example of Calculating Amortized Cost: Debt Instruments with Stepped Interest Payments*

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively (“stepped interest”) over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at CU1,250 and has a maturity amount of CU1,250, would the amortized cost equal CU1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount (IPSAS 29.10).

The following example illustrates how amortized cost is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument (“stepped interest”).

On January 1, 2000, Entity A issues a debt instrument for a price of CU1,250. The principal amount is CU1,250 and the debt instrument is repayable on December 31, 2004. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 percent in 2000 (CU75), 8.0 percent in 2001 (CU100),

10.0 percent in 2002 (CU125), 12.0 percent in 2003 (CU150), and 16.4 percent in 2004 (CU205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 percent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining amortized cost in each period. In each period, the amortized cost at the beginning of the period is multiplied by the effective interest rate of 10 percent and added to the amortized cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortized cost in each period is as follows:

Year	(a) Amortized cost at the beginning of the year	(b = a × 10%) Interest revenue	(c) Cash flows	(d = a + b – c) Amortized cost at the end of the year
20X0	1,250	125	75	1,300
20X1	1,300	130	100	1,330
20X2	1,330	133	125	1,338
20X3	1,338	134	150	1,322
20X4	1,322	133	1,250 + 205	–

B.27 *Regular Way Contracts: No Established Market*

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. IPSAS 29.10 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in IPSAS 29.10, is not limited to a formal stock exchange or organized over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.28 *Regular Way Contracts: Forward Contract*

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for CU10 per share. The contract is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.29 *Regular Way Contracts: Which Customary Settlement Provisions Apply?*

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases one million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.30 *Regular Way Contracts: Share Purchase by Call Option*

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.31 *Recognition and Derecognition of Financial Liabilities Using Trade Date or Settlement Date Accounting*

IPSAS 29 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. IPSAS 29 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in IPSAS 29.18 and IPSAS 29.41 apply. IPSAS 29.16 states that financial liabilities are recognized on the date the entity "becomes a party to the contractual provisions of the instrument." Such contracts generally are not recognized unless one of the parties has performed or the contract is a derivative contract not

exempted from the scope of IPSAS 29. IPSAS 29.41 specifies that financial liabilities are derecognized only when they are extinguished, i.e., when the obligation specified in the contract is discharged or cancelled or expires.

Section C: Embedded Derivatives

C.1 *Embedded Derivatives: Separation of Host Debt Instrument*

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the entity makes its own judgment of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of CU40,000 annually and a principal payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid instrument.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid instrument. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid instrument could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid instrument. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 *Embedded Derivatives: Separation of Embedded Option*

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid instrument. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid instrument?

No. The economic behavior of a hybrid instrument with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid instrument) should be based on the stated terms of the option feature documented in the hybrid instrument. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid instrument.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid instrument being exercised generally is not zero, it would be inconsistent with the likely economic behavior of the hybrid instrument to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behavior of the hybrid instrument, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid instrument. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid instrument, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid instrument.

C.3 *Embedded Derivatives: Accounting for a Convertible Bond*

What is the accounting treatment of an investment in a bond (financial asset) that is convertible into equity instruments of the issuing entity or another entity before maturity?

An investment in a convertible bond that is convertible before maturity generally cannot be classified as a held-to-maturity investment because that would be inconsistent with paying for the conversion feature – the right to convert into equity instruments before maturity.

An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative.

If the bond is classified as available for sale (i.e., fair value changes recognized in net assets/equity until the bond is sold), the equity conversion option (the embedded derivative) is separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognized in surplus or deficit unless the option is part of a cash flow hedging relationship.

If the convertible bond is measured at fair value with changes in fair value recognized in surplus or deficit, separating the embedded derivative from the host bond is not permitted.

C.4 *Embedded Derivatives: Equity Kicker*

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an “equity kicker”) in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognized in surplus or deficit (IPSAS 29.12(c)), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (IPSAS 29.12(a)). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (IPSAS 29.12(b) and IPSAS 29.10(a)). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. IPSAS 29.AG21 states that a derivative could require a payment as a result of some

future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.5 Embedded Derivatives: Identifying Debt or Equity Instruments as Host Contracts

Entity A purchases a five-year “debt” instrument issued by Entity B with a principal amount of CU1 million that is indexed to the share price of Entity C. At maturity, Entity A will receive from Entity B the principal amount plus or minus the change in the fair value of 10,000 shares of Entity C. The current share price is CU110. No separate interest payments are made by Entity B. The purchase price is CU1 million. Entity A classifies the debt instrument as available for sale. Entity A concludes that the instrument is a hybrid instrument with an embedded derivative because of the equity-indexed principal. For the purposes of separating an embedded derivative, is the host contract an equity instrument or a debt instrument?

The host contract is a debt instrument because the hybrid instrument has a stated maturity, i.e., it does not meet the definition of an equity instrument (IPSAS 28.9 and IPSAS 28.14). It is accounted for as a zero coupon debt instrument. Thus, in accounting for the host instrument, Entity A imputes interest on CU1 million over five years using the applicable market interest rate at initial recognition. The embedded non-option derivative is separated so as to have an initial fair value of zero (see Question C.1).

C.6 Embedded Derivatives: Synthetic Instruments

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since IPSAS 29.AG46(a) requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity’s analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument (“synthetic instrument” accounting) for the purpose of applying IPSAS 29. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.5, which had no substance apart from the resulting interest rate swap.

C.7 Embedded Derivatives: Purchases and Sales Contracts in Foreign Currency Instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world, and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under IPSAS 29?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contract as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in surplus or deficit unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 Embedded Foreign Currency Derivatives: Unrelated Foreign Currency Provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IPSAS 29 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (IPSAS 29.4 and IPSAS 29.AG22). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under IPSAS 29.12, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (IPSAS 29.AG46(d)).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from IPSAS 29.AG45(d) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under IPSAS 29.12.

C.9 Embedded Foreign Currency Derivatives: Currency of International Commerce

IPSAS 29.AG46(d) refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.10 Embedded Derivatives: Holder Permitted, But Not Required, to Settle Without Recovering Substantially all of its Recognized Investment

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recognized investment and the issuer does not have such a right (e.g., a puttable debt instrument), does the contract satisfy the condition in IPSAS 29.AG46(a) that the holder would not recover substantially all of its recognized investment?

No. The condition that “the holder would not recover substantially all of its recognized investment” is not satisfied if the terms of the combined instrument permit, but do not require, the investor to settle the combined instrument in a manner that causes it not to recover substantially all of its recognized investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that “the holder would not recover substantially all of its recognized investment” applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognized investment.

C.11 Embedded Derivatives: Reliable Determination of Fair Value

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No. In this case, the entire combined contract is treated as a financial instrument held for trading (IPSAS 29.14). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The entity might conclude, however, that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment.

Section D: Recognition and Derecognition

D.1 *Initial Recognition*

D.1.1 Recognition: Cash Collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (e.g., a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognize the cash collateral it has received as an asset?

Yes. The ultimate realization of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realized by Entity A. Therefore, Entity A recognizes the cash as an asset and a payable to Entity B while Entity B derecognizes the cash and recognizes a receivable from Entity A.

D.2 *Regular Way Purchase or Sale of a Financial Asset*

D.2.1 Trade Date vs. Settlement Date: Amounts to be Recorded for a Purchase

How are the trade date and settlement date accounting principles in the Standard applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a purchase of a financial asset. On December 29, 20X1, an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On December 31, 20X1 (financial year-end) and on January 4, 20X2 (settlement date) the fair value of the asset is CU1,002 and CU1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

Settlement Date Accounting			
Balances	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X1			
Financial asset	—	—	—
Financial liability	—	—	—
December 31, 20X1			
Receivable	—	2	2
Financial asset	—	—	—
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(2)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(2)
January 4, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,003	1,003
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(3)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(3)

Trade Date Accounting			
Balances	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/ equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
December 31, 20X1			
Receivable	—	—	—
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Net assets/equity (fair value adjustment)	—	(2)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(2)
January 4, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,003	1,003
Financial liability	—	—	—
Net assets/equity (fair value adjustment)	—	(3)	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	(3)

D.2.2 Trade Date vs. Settlement Date: Amounts to be Recorded for a Sale

How are the trade date and settlement date accounting principles in the Standard applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a sale of a financial asset. On December 29, 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its amortized cost is CU1,000. On December 31, 20X2 (financial year-end), the fair value of the asset is CU1,012. On January 4, 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement Date Accounting			
Balances	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/ equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,010	1,010
Net assets/equity (fair value adjustment)	—	10	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	10
December 31, 20X2			
Receivable	—	—	—
Financial asset	1,000	1,010	1,010
Net assets/equity (fair value adjustment)	—	10	—
Accumulated surplus or deficit (through surplus or deficit)	—	—	10
January 4, 20X3			
Net assets/equity (fair value adjustment)	—	—	—
Accumulated surplus or deficit (through surplus or deficit)	10	10	10

Trade Date Accounting			
Balances	Held-to-maturity investments carried at amortized cost	Available-for-sale assets remeasured to fair value with changes in net assets/equity	Assets at fair value through surplus or deficit remeasured to fair value with changes in surplus or deficit
December 29, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	—	—	—
Equity (fair value adjustment)	—	—	—
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
December 31, 20X2			
Receivable	1,010	1,010	1,010
Financial asset	—	—	—
Net assets/equity (fair value adjustment)	—	—	—
Accumulated surplus or deficit (through surplus or deficit)	10	10	10
January 4, 20X3			
Net assets/equity (fair value adjustment)	—	—	—
Accumulated surplus or deficit (through surplus or deficit)	10	10	10

D.2.3 Settlement Date Accounting: Exchange of Non-Cash Financial Assets

If an entity recognizes sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognized in accordance with IPSAS 29.66?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under IPSAS 29.66 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognized on the trade date as described in IPSAS 29.AG70. In that case, the entity recognizes a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on December 29, 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is carried at amortized cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both assets have a fair value of CU1,010 on December, 29, while the amortized cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for loans and receivables and trade date accounting for assets held for trading. On December 31, 20X2 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On January, 4 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

December 29, 20X2

Dr	Bond B	CU1,010	
	Cr Payable		CU1,010

December 31, 20X2

Dr	Trading loss	CU1	
	Cr Bond B		CU1

January 4, 20X3

Dr	Payable	CU1,010	
Dr	Trading loss	CU2	
	Cr Note Receivable A		CU1,000
	Cr Bond B		CU2
	Cr Realization gain		CU10

Section E: Measurement

E.1 *Initial Measurement of Financial Assets and Financial Liabilities*

E.1.1 **Initial Measurement: Transaction Costs**

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value through surplus or deficit. How should this requirement be applied in practice?

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

For financial instruments that are carried at amortized cost, such as held-to-maturity investments, loans and receivables, and financial liabilities that are not at fair value through surplus or deficit, transaction costs are included in the calculation of amortized

cost using the effective interest method and, in effect, amortized through surplus or deficit over the life of the instrument.

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

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.2 *Fair Value Measurement Considerations*

E.2.1 **Fair Value Measurement Considerations for Investment Funds**

IPSAS 29.AG104 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors on the basis of mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets on the basis of mid-market prices?

No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in IPSAS 29.AG104 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognized in its statement of financial position and the prices used for the net asset value calculation.

E.2.2 **Fair Value Measurement: Large Holding**

Entity A holds 15 percent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is CU100. Daily trading volume is 0.1 percent of outstanding shares. Because Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price, Entity A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A would be able to obtain a price of CU105, i.e., a 5 percent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

Under IPSAS 29.AG103, a published price quotation in an active market is the best estimate of fair value. Therefore, Entity A uses the published price quotation (CU100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

E.3 *Gains and Losses*E.3.1 **Available-For-Sale Financial Assets: Exchange of Shares**

Entity A holds a small number of shares in Entity B. The shares are classified as available for sale. On December 20, 20X0, the fair value of the shares is CU120 and the cumulative gain recognized in net assets/equity is CU20. On the same day, Entity B is acquired by Entity C. As a result, Entity A receives shares in Entity C in exchange for those it had in Entity B of equal fair value. Under IPSAS 29.64(b), should Entity A reclassify the cumulative gain of CU20 recognized in net assets/equity to surplus or deficit?

Yes. The transaction qualifies for derecognition under IPSAS 29. IPSAS 29.64(b) requires the cumulative gain or loss on an available-for-sale financial asset that has been recognized in net assets/equity to be recognized in surplus or deficit when the asset is derecognized. In the exchange of shares, Entity A disposes of the shares it had in Entity B and receives shares in Entity C.

E.3.2 **IPSAS 29 and IPSAS 4 Available-For-Sale Financial Assets: Separation of Currency Component**

For an available-for-sale monetary financial asset, the entity recognizes changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit in accordance with IPSAS 4.27(a) and IPSAS 4.32 and other changes in the carrying amount in net assets/equity in accordance with IPSAS 29. How is the cumulative gain or loss that is recognized in net assets/equity determined?

It is the difference between the amortized cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity. For the purpose of applying IPSAS 4.32 the asset is treated as an asset measured at amortized cost in the foreign currency.

To illustrate: on December 31, 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a principal amount of FC1,250, carries fixed interest of 4.7 percent that is paid annually ($FC1,250 \times 4.7 \text{ percent} = FC59$ per year), and has an effective interest rate of 10 percent. Entity A classifies the bond as available for sale, and thus recognizes gains and losses in net assets/equity. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 ($= FC1,000 \times 1.5$).

Dr	Bond	LC1,500	
	Cr	Cash	LC1,500

On December 31, 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 ($= FC1,060 \times 2$). The amortized cost is FC1,041 ($= LC2,082$). In this case, the cumulative gain or loss to be recognized and accumulated in net assets/equity is the difference between the fair value and the amortized cost on December 31, 20X2, i.e., LC38 ($= LC2,120 - LC2,082$).

Interest received on the bond on December 31, 20X2 is FC59 (= LC118). Interest revenue determined in accordance with the effective interest method is FC100 (= $1,000 \times 10$ percent). The average exchange rate during the year is FC1 to LC1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (IPSAS 4.25). Thus, reported interest revenue is LC175 (= $FC100 \times 1.75$) including accretion of the initial discount of LC72 (= $[FC100 - FC59] \times 1.75$). Accordingly, the exchange difference on the bond that is recognized in surplus or deficit is LC510 (= $LC2,082 - LC1,500 - LC72$). Also, there is an exchange gain on the interest receivable for the year of LC15 (= $FC59 \times [2.00 - 1.75]$).

Dr	Bond	LC620	
Dr	Cash	LC118	
	Cr Interest revenue		LC175
	Cr Exchange gain		LC525
	Cr Fair value change in net assets/equity		LC38

On December 31, 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 (= $FC1,070 \times 2.50$). The amortized cost is FC1,086 (= $LC2,715$). The cumulative gain or loss to be accumulated in net assets/equity is the difference between the fair value and the amortized cost on December 31, 20X3, i.e., negative LC40 (= $LC2,675 - LC2,715$). Thus, the amount recognized in net assets/equity equals the change in the difference during 20X3 of LC78 (= $LC40 + LC38$).

Interest received on the bond on December 31, 20X3 is FC59 (= LC148). Interest revenue determined in accordance with the effective interest method is FC104 (= $FC1,041 \times 10$ percent). The average exchange rate during the year is FC1 to LC2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (IPSAS 4.25). Thus, recognized interest revenue is LC234 (= $FC104 \times 2.25$) including accretion of the initial discount of LC101 (= $[FC104 - FC59] \times 2.25$). Accordingly, the exchange difference on the bond that is recognized in surplus or deficit is LC532 (= $LC2,715 - LC2,082 - LC101$). Also, there is an exchange gain on the interest receivable for the year of LC15 (= $FC59 \times [2.50 - 2.25]$).

Dr	Bond	LC555	
Dr	Cash	LC148	
Dr	Fair value change in net assets/equity	LC78	
	Cr Interest revenue		LC234
	Cr Exchange gain		LC547

E.3.3 IPSAS 29 and IPSAS 4 Exchange Differences Arising on Translation of Foreign Entities: Net Assets/Equity or, Surplus or Deficit?

IPSAS 4.37 and IPSAS 4.57 states that all exchange differences resulting from translating the financial statements of a foreign operation should be recognized in net assets/equity until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets classified as at fair value through surplus or deficit and financial assets that are available for sale.

IPSAS 29.64 requires that changes in fair value of financial assets classified as at fair value through surplus or deficit should be recognized in surplus or deficit and changes in fair value of available-for-sale investments should be recognized in net assets/equity.

If the foreign operation is a controlled entity whose financial statements are consolidated with those of its controlling entity, in the consolidated financial statements how are IPSAS 29.64 and IPSAS 4.44 applied?

IPSAS 29 applies in the accounting for financial instruments in the financial statements of a foreign operation and IPSAS 4 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign controlled entity (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under IPSAS 29.

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 ($= \text{LCY}100 \times 2.00$) in the consolidated financial statements.

At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognizes the trading asset at LCY110 in its statement of financial position and recognizes a fair value gain of LCY10 in its surplus or deficit. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 ($= \text{LCY}110 \times 3.00$) in the currency of Country X. Therefore, Entity A recognizes the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of changes in net assets/equity of B "at the exchange rates at the dates of the transactions" (IPSAS 4.44(b)). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ($[(3.00 + 2.00) / 2 = 2.50]$, in accordance with IPSAS 4.25). Therefore, while the fair value of the trading asset has increased by LCX130 ($= \text{LCX}330 - \text{LCX}200$), Entity A recognizes

only LCX25 ($= \text{LCY10} \times 2.5$) of this increase in consolidated surplus or deficit to comply with IPSAS 4.44(b). The resulting exchange difference, i.e., the remaining increase in the fair value of the debt instrument ($\text{LCX130} - \text{LCX25} = \text{LCX105}$), is accumulated in net assets/equity until the disposal of the net investment in the foreign operation in accordance with IPSAS 4.57.

E.3.4 **IPSAS 29 and IPSAS 4: Interaction between IPSAS 29 and IPSAS 4**

IPSAS 29 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in surplus or deficit. IPSAS 4 includes rules about the reporting of foreign currency items and the recognition of exchange differences in surplus or deficit. In what order are IPSAS 4 and IPSAS 29 applied?

Statement of Financial Position

Generally, the measurement of a financial asset or financial liability at fair value, cost or amortized cost is first determined in the foreign currency in which the item is denominated in accordance with IPSAS 29. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IPSAS 4 (IPSAS 29.AG116). For example, if a monetary financial asset (such as a debt instrument) is carried at amortized cost under IPSAS 29, amortized cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognized using the closing rate in the entity's financial statements (IPSAS 4.27). That applies regardless of whether a monetary item is measured at cost, amortized cost or fair value in the foreign currency (IPSAS 4.28). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is carried at fair value in the foreign currency (IPSAS 4.27(c)) and at a historical rate if it is not carried at fair value under IPSAS 29 because its fair value cannot be reliably measured (IPSAS 4.27(b) and IPSAS 29.48).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IPSAS 29, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognized using a historical rate under IPSAS 4 (IPSAS 29.99), i.e., the foreign currency amount is recognized using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (IPSAS 4.27(b)).

Surplus or Deficit

The recognition of a change in the carrying amount of a financial asset or financial liability in surplus or deficit depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (e.g., most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from

translating the financial statements of a foreign operation. The issue of recognizing changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognizing a monetary item at a rate different from that at which it was initially recognized during the period, or recognized in previous financial statements, is recognized in surplus or deficit or in net assets/equity in accordance with IPSAS 4 (IPSAS 29.AG116, IPSAS 4.32 and IPSAS 4.37), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges in IPSAS 29 apply (IPSAS 29.106). Differences arising from recognizing a monetary item at a foreign currency amount different from that at which it was previously recognized are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognized in surplus or deficit or in net assets/equity in accordance with IPSAS 29. For example, although an entity recognizes gains and losses on available-for-sale monetary financial assets in net assets/equity (IPSAS 29.64(b)), the entity nevertheless recognizes the changes in the carrying amount relating to changes in foreign exchange rates in surplus or deficit (IPSAS 4.27(a)).

Any changes in the carrying amount of a non-monetary item are recognized in surplus or deficit or in net assets/equity in accordance with IPSAS 29 (IPSAS 29.AG116). For example, for available-for-sale financial assets the entire change in the carrying amount, including the effect of changes in foreign currency rates, is recognized in net assets/equity. If the non-monetary item is designated as a cash flow hedge of an unrecognized firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in IPSAS 29 apply (IPSAS 29.106).

When some portion of the change in carrying amount is recognized in net assets/equity and some portion is recognized in surplus or deficit, for example, if the amortized cost of a foreign currency bond classified as available for sale has increased in foreign currency (resulting in a gain in surplus or deficit) but its fair value has decreased in the functional currency (resulting in a loss recognized in net assets/equity), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognized in surplus or deficit or in net assets/equity.

E.4 *Impairment and Uncollectibility of Financial Assets*

E.4.1 **Objective Evidence of Impairment**

Does IPSAS 29 require that an entity be able to identify a single, distinct past causative event to conclude that it is probable that an impairment loss on a financial asset has been incurred?

No. IPSAS 29.68 states “It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have

caused the impairment.” Also, IPSAS 29.69 states that “a downgrade of an entity’s credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information.” Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors’ or issuers’ liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

E.4.2 Impairment: Future Losses

Does IPSAS 29 permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Entity A lends CU1,000 to Customer B, can it recognize an immediate impairment loss of CU10 if Entity A, based on historical experience, expects that 1 percent of the principal amount of loans given will not be collected?

No. IPSAS 29.45 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, IPSAS 29.67 requires that an impairment loss is recognized only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with IPSAS 29.45 and IPSAS 29.67 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

E.4.3 Assessment of Impairment: Principal and Interest

Because of Customer B’s financial difficulties, Entity A is concerned that Customer B will not be able to make all principal and interest payments due on a loan in a timely manner. It negotiates a restructuring of the loan. Entity A expects that Customer B will be able to meet its obligations under the restructured terms. Would Entity A recognize an impairment loss if the restructured terms are as reflected in any of the following cases?

- (a) Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.**
- (b) Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.**
- (c) Customer B will pay the full principal amount of the original loan on the original due date with interest only at a lower interest rate than the interest rate inherent in the original loan.**

- (d) **Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.**
- (e) **Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.**

IPSAS 29.67 indicates that an impairment loss has been incurred if there is objective evidence of impairment. The amount of the impairment loss for a loan measured at amortized cost is the difference between the carrying amount of the loan and the present value of future principal and interest payments discounted at the loan's original effective interest rate. In cases (a)–(d) above, the present value of the future principal and interest payments discounted at the loan's original effective interest rate will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognized in those cases.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan's original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss. However, this fact pattern is unlikely given Customer B's financial difficulties.

E.4.4 Assessment of Impairment: Fair Value Hedge

A loan with fixed interest rate payments is hedged against the exposure to interest rate risk by a receive-variable, pay-fixed interest rate swap. The hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. Should an assessment of impairment in the loan take into account the fair value adjustment for interest rate risk?

Yes. The loan's original effective interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, the original effective interest rate and amortized cost of the loan are adjusted to take into account recognized fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan.

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the estimated future cash flows of the loan discounted at the adjusted effective interest rate. When a loan is included in a portfolio hedge of interest rate risk, the entity should allocate the change in the fair value of the hedged portfolio to the loans (or groups of similar loans) being assessed for impairment on a systematic and rational basis.

E.4.5 Impairment: Provision Matrix

An entity calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix that specifies fixed provision rates for the number of days a loan has been classified as non-performing (zero percent if less than 90 days, 20 percent if 90–180 days, 50 percent if 181–365 days and 100 percent if more than 365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables under IPSAS 29.72?

Not necessarily. IPSAS 29.72 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

E.4.6 Impairment: Excess Losses

Does IPSAS 29 permit an entity to recognize impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in identified individual financial assets or identified groups of similar financial assets?

No. IPSAS 29 does not permit an entity to recognize impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics (IPSAS 29.73) on the basis of objective evidence about the existence of impairment in those assets (IPSAS 29.67). Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognized as impairment or bad debt losses under IPSAS 29. However, if an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics (IPSAS 29.73).

E.4.7 Recognition of Impairment on a Portfolio

IPSAS 29.72 requires that impairment be recognized for financial assets carried at amortized cost. IPSAS 29.73 states that impairment may be measured and recognized individually or on a portfolio basis for a group of similar financial assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortized cost, does IPSAS 29 allow non-recognition of the impairment of the first asset?

No. If an entity knows that an individual financial asset carried at amortized cost is impaired, IPSAS 29.72 requires that the impairment of that asset should be recognized. It states: "the amount of the loss is measured as the difference between *the asset's* carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original

effective interest rate” (emphasis added). Measurement of impairment on a portfolio basis under IPSAS 29.73 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

E.4.8 Impairment: Recognition of Collateral

If an impaired financial asset is secured by collateral that does not meet the recognition criteria for assets in other Standards, is the collateral recognized as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral is not recognized as an asset separate from the impaired financial asset unless it meets the recognition criteria for an asset in another Standard.

E.4.9 Impairment of Non-Monetary Available-For-Sale Financial Asset

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses recognized in net assets/equity becomes impaired, should the cumulative net loss recognized in net assets/equity, including any portion attributable to foreign currency changes, be reclassified from net assets/equity to surplus or deficit as a reclassification adjustment?

Yes. IPSAS 29.76 states that when a decline in the fair value of an available-for-sale financial asset has been recognized in net assets/equity and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognized in net assets/equity should be recognized in surplus or deficit even though the asset has not been derecognized. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognized in net assets/equity is also recognized in surplus or deficit. Any subsequent losses, including any portion attributable to foreign currency changes, are also recognized in surplus or deficit until the asset is derecognized.

E.4.10 Impairment: Whether the Available-For-Sale Reserve in Net Assets/Equity can be Negative

IPSAS 29 requires that gains and losses arising from changes in fair value on available-for-sale financial assets are recognized in net assets/equity. If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognized in net assets/equity be recognized in surplus or deficit?

Not necessarily. The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired. An entity assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of assets may be impaired, in accordance with IPSAS 29.68–70. IPSAS 29.69 states that a downgrade of an entity’s credit rating is not, of itself, evidence of impairment, although it

may be evidence of impairment when considered with other available information. Additionally, a decline in the fair value of a financial asset below its cost or amortized cost is not necessarily evidence of impairment (e.g., a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

Section F: Hedging

F.1 *Hedging Instruments*

F.1.1 Hedging the Fair Value Exposure of a Bond Denominated in a Foreign Currency

Entity J, whose functional currency is the Japanese yen, has issued 5 million five-year US dollar fixed rate debt. Also, it owns a 5 million five-year fixed rate US dollar bond which it has classified as available for sale. Can Entity J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No. IPSAS 29.81 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Entity J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

Alternatively, can the US dollar liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

Yes. However, hedge accounting is unnecessary because the amortized cost of the hedging instrument and the hedged item are both remeasured using closing rates. Regardless of whether Entity J designates the relationship as a cash flow hedge or a fair value hedge, the effect on surplus or deficit is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognized in surplus or deficit to correspond with the recognition of the change in spot rate on the hedged item in surplus or deficit as required by IPSAS 4.

F.1.2 Hedging with a Non-Derivative Financial Asset or Liability

Entity J's functional currency is the Japanese yen. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of 5 million US dollars. It has also entered into a fixed price sales commitment for 5 million US dollars that matures in two years and is not accounted for as a derivative because it meets the exemption for normal sales in paragraph 4. Can Entity J designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting?

No. IPSAS 29.81 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk.

Alternatively, can Entity J designate its US dollar liability as a cash flow hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment?

Yes. IPSAS 29 permits the designation of a non-derivative asset or liability as a hedging instrument in either a cash flow hedge or a fair value hedge of the exposure to changes in foreign exchange rates of a firm commitment (IPSAS 29.97). Any gain or loss on the non-derivative hedging instrument that is recognized in net assets/equity during the period preceding the future sale is recognized in surplus or deficit when the sale takes place (IPSAS 29.106).

Alternatively, can Entity J designate the sales commitment as the hedging instrument instead of the hedged item?

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under IPSAS 29.12 and IPSAS 29.AG46, it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

F.1.3 Hedge Accounting: Use of Written Options in Combined Hedging Instruments

Issue (a) – Does IPSAS 29.AG127 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because IPSAS 29.AG127 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) – What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

- (a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.
- (b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

F.1.4 Internal Hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different entities within an economic entity or divisions within a single legal entity. Does IPSAS 29.82 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. IPSAS 29 does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial statements for hedging transactions within an economic entity, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in IPSAS 35.40 requires that a controlling entity “Eliminate in full intra-economic entity assets and liabilities, net assets/equity, revenue, expenses and cash flows relating to transactions between entities of the economic entity”.

On the other hand, hedging transaction within an economic entity may be designated as a hedge in the individual or separate financial statements of an individual entity, if the transaction is an external transaction from the perspective of the economic entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarizes the application of IPSAS 29 to internal hedging transactions.

- IPSAS 29 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.
- Internal derivative contracts between two separate entities within an economic entity can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the economic entity.
- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.
- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the economic entity can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the economic entity.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by individual entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the treasury division of Entity A enters into an internal interest rate swap with another division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the treasury division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, IPSAS 29 does not allow hedge accounting treatment for the hedging transaction undertaken by the treasury and other divisions. IPSAS 29.82 indicates that only derivatives that involve a party external to the entity can be designated as hedging instruments and, further, that any gains or losses on transactions within an economic entity or within individual entities should be eliminated on consolidation. Therefore, transactions between different divisions within Entity A do not qualify for hedge accounting treatment in the financial statements of Entity A. Similarly, transactions between different entities within an economic entity do not qualify for hedge accounting treatment in consolidated financial statements.

However, if in addition to the internal swap in the above example the trading division enters into an interest rate swap or other contract with an external party that offsets the exposure hedged in the internal swap, hedge accounting is permitted under IPSAS 29. For the purposes of IPSAS 29, the hedged item is the loan (or group of similar loans) in the treasury division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions of them that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under IPSAS 29, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the treasury division are identified and the other conditions for hedge accounting are met. It should be noted, however, that IPSAS 29.88 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

F.1.5 Offsetting Internal Derivative Contracts Used to Manage Interest Rate Risk

If a central treasury function enters into internal derivative contracts with controlled entities and various divisions within the economic entity to manage interest rate risk on a centralized basis, can those contracts qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts?

No. An internal contract designated at the controlled entity level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in surplus or deficit (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in net assets/equity (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There is also

no basis for recognizing the gain or loss on the internal derivative in net assets/equity for one entity and recognizing it in surplus or deficit by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the controlled entity or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the controlled entity or division levels would be used to offset each other on consolidation. Accordingly, since IPSAS 29.81 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the controlled entity or division level that are not laid off with external parties must be reversed on consolidation.

It should be noted, however, that there will be no effect on surplus or deficit and net assets/equity of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at the controlled entity or division level and, in the case of cash flow hedges, where the hedged items affect surplus or deficit in the same period. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognized in surplus or deficit, and their use as cash flow hedges by two separate entities or divisions within the economic entity will also result in the fair value amounts being offset against each other in net assets/equity. However, there may be an effect on individual line items in both the consolidated statement of changes in net assets/equity and the consolidated statement of financial position, for example when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognized in a different line item in the statement of financial position or statement of changes in net assets/equity. In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, gains and losses recognized would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognized in surplus or deficit and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognized in net assets/equity.

Question F.1.4 describes the application of IPSAS 29 to internal hedging transactions.

F.1.6 Offsetting Internal Derivative Contracts Used to Manage Foreign Currency Risk

If a central treasury function enters into internal derivative contracts with controlled entities and various divisions within the economic entity to manage foreign currency risk on a centralized basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. IPSAS 35 requires all internal transactions to be eliminated in consolidated financial statements. As stated in IPSAS 29.82, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the economic entity. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the controlled entity or division level and are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on surplus or deficit or net assets/equity if (a) the internal derivatives are used in the same type of hedge relationship (i.e., fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognized in net assets/equity are recognized in surplus or deficit in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognized in surplus or deficit or in net assets/equity will offset on consolidation resulting in the same surplus or deficit and net assets/equity as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of changes in net assets/equity, and the consolidated statement of financial position, that would need to be eliminated. In addition, there is an effect on surplus or deficit and net assets/equity if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on surplus or deficit and net assets/equity for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognized in net assets/equity are recognized in surplus or deficit in different periods (because the hedged items affect surplus or deficit in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because IPSAS 29.81 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognized firm commitments. This is because an unrecognized firm commitment or forecast transaction does not qualify as a hedging instrument under IPSAS 29. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements. As a result, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an

asset or liability (basis adjustment) or recognized in net assets/equity would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument.

F.1.7 Internal Derivatives: Examples of Applying Question F.1.6

In each case, FC = foreign currency, LC = local currency (which is the entity's functional currency), and TC = treasury center.

Case 1: Offset of Fair Value Hedges

Controlled Entity A has trade receivables of FC100, due in 60 days, which it hedges using a forward contract with TC. Controlled Entity B has payables of FC50, also due in 60 days, which it hedges using a forward contract with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive LC in 60 days.

At the end of month 1, FC weakens against LC. A incurs a foreign exchange loss of LC10 on its receivables, offset by a gain of LC10 on its forward contract with TC. B makes a foreign exchange gain of LC5 on its payables offset by a loss of LC5 on its forward contract with TC. TC makes a loss of LC10 on its internal forward contract with A, a gain of LC5 on its internal forward contract with B, and a gain of LC5 on its external forward contract.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries

Dr	Foreign exchange loss	LC10	
	Cr Receivables		LC10
<i>Dr</i>	<i>Internal contract TC</i>	<i>LC10</i>	
	<i>Cr Internal gain TC</i>		<i>LC10</i>

B's entries

Dr	Payables	LC5	
	Cr Foreign exchange gain		LC5
<i>Dr</i>	<i>Internal loss TC</i>	<i>LC5</i>	
	<i>Cr Internal contract TC</i>		<i>LC5</i>

TC's entries

<i>Dr</i>	<i>Internal loss A</i>	<i>LC10</i>	
	<i>Cr Internal contract A</i>		<i>LC10</i>
<i>Dr</i>	<i>Internal contract B</i>	<i>LC5</i>	

	<i>Cr</i>	<i>Internal gain B</i>		<i>LC5</i>
Dr		External forward contract	LC5	
	<i>Cr</i>	Foreign exchange gain		LC5

Both A and B could apply hedge accounting in their individual financial statements provided all conditions in IPSAS 29 are met. However, in this case, no hedge accounting is required because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognized immediately in surplus or deficit of A and B without hedge accounting.

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, the payable in B hedges FC50 of the receivables in A. The external forward contract in TC hedges the remaining FC50 of the receivable in A. Hedge accounting is not necessary in the consolidated financial statements because monetary items are measured at spot foreign exchange rates under IPSAS 4 irrespective of whether hedge accounting is applied.

The net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IPSAS 29.

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
External forward contract	LC5	–
Gains and losses	–	–
Internal contracts	–	–

Case 2: Offset of Cash Flow Hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future expenses of FC500 (rental for offices), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a “loss” of LC20 on its anticipated revenues because the LC value of these revenues decreases. This is offset by a “gain” of LC20 on its forward contract with TC.

B incurs a “gain” of LC50 on its anticipated advertising cost because the LC value of the expense decreases. This is offset by a “loss” of LC50 on its transaction with TC.

TC incurs a “gain” of LC50 on its internal transaction with B, a “loss” of LC20 on its internal transaction with A and a loss of LC30 on its external forward contract.

A and B complete the necessary documentation, the hedges are effective, and both A and B qualify for hedge accounting in their individual financial statements.

A recognizes the gain of LC20 on its internal derivative transaction in net assets/equity and B recognizes the loss of LC50 in net assets/equity. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in *italics*.

A's entries

<i>Dr</i>	<i>Internal contract TC</i>	<i>LC20</i>	
	<i>Cr</i>	<i>Net assets/equity</i>	<i>LC20</i>

B's entries

<i>Dr</i>	<i>Net assets/equity</i>	<i>LC50</i>	
	<i>Cr</i>	<i>Internal contract TC</i>	<i>LC50</i>

TC's entries

<i>Dr</i>	<i>Internal loss A</i>	<i>LC20</i>	
	<i>Cr</i>	<i>Internal contract Cr A</i>	<i>LC20</i>
<i>Dr</i>	<i>Internal contract B</i>	<i>LC50</i>	
	<i>Cr</i>	<i>Internal gain B</i>	<i>LC50</i>
<i>Dr</i>	Foreign exchange loss	LC30	
	<i>Cr</i>	<i>External forward contract</i>	<i>LC30</i>

For the consolidated financial statements, TC's external forward contract on FC300 is designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. IPSAS 29 requires that in the consolidated financial statements at the end of month 1, the accounting effects of the internal derivative transactions must be eliminated.

However, the net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries in order for the requirements of IPSAS 29 to be met.

	<i>Debit</i>	<i>Credit</i>
External forward contract	—	LC30
Net assets/equity	LC30	—
Gains and losses	—	—
Internal contracts	—	—

Case 3: Offset of Fair Value and Cash Flow Hedges

Assume that the exposures and the internal derivative transactions are the same as in cases 1 and 2. However, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for LC in 90 days.

TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential between FC and LC is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a minimal effect on surplus or deficit in TC.

As in cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A recognizes a gain of LC20 on its internal derivative transaction in net assets/equity and B recognizes a loss of LC50 on its internal derivative transaction in net assets/equity.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries

Dr	Foreign exchange loss	LC10	
	Cr Receivables		LC10
Dr	<i>Internal contract TC</i>	<i>LC10</i>	
	Cr <i>Internal gain TC</i>		<i>LC10</i>
Dr	<i>Internal contract TC</i>	<i>LC20</i>	
	Cr <i>Net assets/equity</i>		<i>LC20</i>

B's entries

Dr	Payables	LC5	
	Cr Foreign exchange gain		LC5
Dr	<i>Internal loss TC</i>	<i>LC5</i>	
	Cr <i>Internal contract TC</i>		<i>LC5</i>
Dr	<i>Net assets/equity</i>	<i>LC50</i>	
	Cr <i>Internal contract TC</i>		<i>LC50</i>

TC's entries

Dr	<i>Internal loss A</i>	<i>LC10</i>	
	Cr <i>Internal contract A</i>		<i>LC10</i>
Dr	<i>Internal loss A</i>	<i>LC20</i>	
	Cr <i>Internal contract A</i>		<i>LC20</i>

<i>Dr</i>	<i>Internal contract B</i>	<i>LC5</i>	
<i>Cr</i>	<i>Internal gain B</i>		<i>LC5</i>
<i>Dr</i>	<i>Internal contract B</i>	<i>LC50</i>	
<i>Cr</i>	<i>Internal gain B</i>		<i>LC50</i>
Dr	Foreign exchange loss	LC25	
Cr	External forward contract		LC25

TOTAL (for the internal derivatives)	A	B	Total
	<i>LC</i>	<i>LC</i>	<i>TC</i>
Surplus or deficit (fair value hedges)	10	(5)	5
Net assets/equity (cash flow hedges)	20	(50)	(30)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e., those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	LC30	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable LC5; Cr Net assets/equity LC5;
- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC10; Cr Receivable LC10; and
- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC25; Cr External forward contract LC25.

In the consolidated financial statements at the end of month 1, IPSAS 29 requires the accounting effects of the internal derivative transactions to be eliminated.

However, the total net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of IPSAS 29.

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 4: Offset of Fair Value and Cash Flow Hedges with Adjustment to Carrying Amount of Inventory

Assume similar transactions as in case 3, except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. Assume also that the entity has a policy of basis-adjusting hedged forecast non-financial items. At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of LC50 on B's internal derivative, recognized in net assets/equity in month 1, is adjusted against the carrying amount of inventory in B. The gain of LC20 on A's internal derivative is recognized in net assets/equity as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and a proportion of the receivable (FC50) offset FC300 of the anticipated inventory purchase. There is a natural hedge between the remaining FC200 of anticipated cash outflow in B and the anticipated cash inflow of FC200 in A. This relationship does not qualify for hedge accounting under IPSAS 29 and this time there is only a partial offset between gains and losses on the internal derivatives that hedge these amounts.

At the end of months 1 and 2, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting transactions or events within the economic entity are shown in italics.

A's entries (all at the end of month 1)

Dr	Foreign exchange loss	LC10	
	Cr Receivables		LC10
Dr	<i>Internal contract TC</i>	<i>LC10</i>	

	Cr	Internal gain TC		LC10
Dr		Internal contract TC	LC20	
	Cr	Net assets/equity		LC20

B's entries

At the end of month 1:

Dr		Payables	LC5	
	Cr	Foreign exchange gain		LC5
Dr		Internal loss TC	LC5	
	Cr	Internal contract TC		LC5
Dr		Net assets/equity	LC50	
	Cr	Internal contract TC		LC50

At the end of month 2:

Dr		Inventory	LC50	
	Cr	Net assets/equity		LC50

TC's entries (all at the end of month 1)

Dr		Internal loss A	LC10	
	Cr	Internal contract A		LC10
Dr		Internal loss A	LC20	
	Cr	Internal contract A		LC20
Dr		Internal contract B	LC5	
	Cr	Internal gain B		LC5
Dr		Internal contract B	LC50	
	Cr	Internal gain B		LC50
Dr		Foreign exchange loss	LC25	
	Cr	Forward		LC25

TOTAL (for the internal derivatives)	<i>A</i>	<i>B</i>	<i>Total</i>
	<i>LC</i>	<i>LC</i>	<i>TC</i>
Surplus or deficit (fair value hedges)	10	(5)	5
Net assets/equity (cash flow hedges)	20	–	20
Basis adjustment (inventory)	–	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e., those not marked in *italics* above) produces the total net balances before elimination of the internal derivatives as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	–	LC20
Basis adjustment (inventory)	LC50	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- The payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Payables LC5; Cr Net assets/equity LC5.
- The receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Net assets/equity LC10; Cr Receivable LC10; and at the end of month 2, Dr Inventory LC10; Cr Net assets/equity LC10.
- The external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Net assets/equity LC25; Cr External forward contract LC25; and at the end of month 2, Dr Inventory LC25; Cr Net assets/equity LC25.

The total net balances after elimination of the accounting entries relating to the internal derivatives are as follows:

	<i>Debit</i>	<i>Credit</i>
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Net assets/equity	–	LC5
Basis adjustment (inventory)	LC35	–
Gains and losses	–	–
Internal contracts	–	–

These total net balances are different from those that would be recognized if the internal derivatives were not eliminated, and it is these net balances that IPSAS 29 requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances before elimination of the internal derivatives are as follows:

- (a) To reclassify LC15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not hedged by an external instrument (neither the external forward contract of FC250 in TC nor the external payable of FC100 in A); and
- (b) To reclassify the gain of LC15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

Dr	Net assets/equity	LC15	
	Cr Inventory		LC15

F.1.8 Combination of Written and Purchased Options

In most cases, IPSAS 29.AG127 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with one counterparty, can an entity split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No. IPSAS 29.83 specifies that a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question F.1.3 addresses the issue of whether and when a combination of options is considered as a written option.

F.1.9 Delta-Neutral Hedging Strategy

Does IPSAS 29 permit an entity to apply hedge accounting for a “delta-neutral” hedging strategy and other dynamic hedging strategies under which the quantity of the hedging instrument is constantly adjusted in order to maintain a desired hedge ratio, for example, to achieve a delta-neutral position insensitive to changes in the fair value of the hedged item?

Yes. IPSAS 29.83 states that “a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.” For example, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in IPSAS 29.98 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

F.1.10 Hedging Instrument: Out of the Money Put Option

Entity A has an investment in one share of Entity B, which it has classified as available for sale. To give itself partial protection against decreases in the share price of Entity B, Entity A acquires a put option on one share of Entity B and designates the change in the intrinsic value of the put as a hedging instrument in a fair value hedge of changes in the fair value of its share in Entity B. The put gives Entity A the right to sell one share of Entity B at a strike price of CU90. At the inception of the hedging relationship, the share has a quoted price of CU100. Since the put option gives Entity A the right to dispose of the share at a price of CU90, the put should normally be fully effective in offsetting price declines below CU90 on an intrinsic value basis. Price changes above CU90 are not hedged. In this case, are changes in the fair value of the share of Entity B for prices above CU90 regarded as hedge ineffectiveness under IPSAS 29.98 and recognized in surplus or deficit under IPSAS 29.99?

No. IPSAS 29.83 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument. The changes in the intrinsic value of the option provide protection against the risk of variability in the fair value of one share of Entity B below or equal to the strike price of the put of CU90. For prices above CU90, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on one share of Entity B for prices above CU90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognizing gains and losses on the hedged item.

Therefore, Entity A recognizes changes in the fair value of the share in net assets/equity if it is associated with variation in its price above CU90 (IPSAS 29.64 and IPSAS 29.101). Changes in the fair value of the share associated with price declines below CU90 form part of the designated fair value hedge and are recognized in surplus or deficit under IPSAS 29.99(b). Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognized in surplus or deficit (IPSAS 29.99(a)). Changes in the time value of the put are excluded from the designated hedging relationship and recognized in surplus or deficit under IPSAS 29.65(a).

F.1.11 Hedging Instrument: Proportion of the Cash Flows of a Cash Instrument

In the case of foreign exchange risk, a non-derivative financial asset or non-derivative financial liability can potentially qualify as a hedging instrument. Can an entity treat the cash flows for specified periods during which a financial

asset or financial liability that is designated as a hedging instrument remains outstanding as a proportion of the hedging instrument under IPSAS 29.84, and exclude the other cash flows from the designated hedging relationship?

No. IPSAS 29.84 indicates that a hedging relationship may not be designated for only a portion of the time period in which the hedging instrument is outstanding. For example, the cash flows during the first three years of a ten-year borrowing denominated in a foreign currency cannot qualify as a hedging instrument in a cash flow hedge of the first three years of revenue in the same foreign currency. On the other hand, a non-derivative financial asset or financial liability denominated in a foreign currency may potentially qualify as a hedging instrument in a hedge of the foreign currency risk associated with a hedged item that has a remaining time period until maturity that is equal to or longer than the remaining maturity of the hedging instrument (see Question F.2.17).

F.1.12 Hedges of More Than One Type of Risk

Issue (a) – Normally a hedging relationship is designated between an entire hedging instrument and a hedged item so that there is a single measure of fair value for the hedging instrument. Does this preclude designating a single financial instrument simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge?

No. For example, entities commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. IPSAS 29.85 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in IPSAS 29.85 are met.

Issue (b) – If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

IPSAS 30.25 requires disclosures separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. The instrument in question would be reported in the IPSAS 30.25 disclosures separately for each type of hedge.

F.1.13 Hedging Instrument: Dual Foreign Currency Forward Exchange Contract

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a ten-year fixed rate pound sterling-denominated note receivable. The principal amounts of the asset and liability when converted into the Japanese yen are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pounds sterling at the end of five years. If Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments, can it qualify for hedge accounting?

Yes. IPSAS 29.85 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows.

- (a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and yen, and yen and pounds, respectively.
- (b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward protects it for only the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question F.2.17.
- (c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

F.1.14 Concurrent Offsetting Swaps and Use of One as a Hedging Instrument

Entity A enters into an interest rate swap and designates it as a hedge of the fair value exposure associated with fixed rate debt. The fair value hedge meets the hedge accounting criteria of IPSAS 29. Entity A simultaneously enters into a second interest rate swap with the same swap counterparty that has terms that fully offset the first interest rate swap. Is Entity A required to view the two swaps as one unit and therefore precluded from applying fair value hedge accounting to the first swap?

It depends. IPSAS 29 is transaction-based. If the second swap was not entered into in contemplation of the first swap or there is a substantive business purpose for structuring the transactions separately, then the swaps are not viewed as one unit.

For example, some entities have a policy that requires a centralized treasury (which is a controlled entity in an economic entity) enter into third-party derivative contracts on behalf of other controlled entities within the organization to hedge the controlled entities' interest rate risk exposures. The treasury also enters into internal derivative transactions with those controlled entities in order to track those hedges operationally within the organization. Because the treasury also enters into derivative contracts as part of its trading operations, or because it may wish to rebalance the risk of its overall portfolio, it may enter into a derivative contract with the same third party during the same business day that has substantially the same terms as a contract entered into as a hedging instrument on behalf of another controlled entity. In this case, there is a valid business purpose for entering into each contract.

Judgment is applied to determine whether there is a substantive business purpose for structuring the transactions separately. For example, if the sole purpose is to obtain fair value accounting treatment for the debt, there is no substantive business purpose.

F.2 *Hedged Items*

F.2.1 **Whether a Derivative can be Designated as a Hedged Item**

Does IPSAS 29 permit designating a derivative instrument (whether a stand-alone or separately recognized embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognized in surplus or deficit unless they are designated and effective hedging instruments (IPSAS 29.10). As an exception, IPSAS 29.AG127 permits the designation of a purchased option as the hedged item in a fair value hedge.

F.2.2 **Cash Flow Hedge: Anticipated Issue of Fixed Rate Debt**

Is hedge accounting allowed for a hedge of an anticipated issue of fixed rate debt?

Yes. This would be a cash flow hedge of a highly probable forecast transaction that will affect surplus or deficit (IPSAS 29.96) provided that the conditions in IPSAS 29.98 are met.

To illustrate: Entity R periodically issues new bonds to refinance maturing bonds, provide working capital and for various other purposes. When Entity R decides it will be issuing bonds, it may hedge the risk of changes in the long-term interest rate from the date it decides to issue the bonds to the date the bonds are issued. If long-term interest rates go up, the bond will be issued either at a higher rate or with a higher discount or smaller premium than was originally expected. The higher rate being paid or decrease in proceeds is normally offset by the gain on the hedge. If long-term interest rates go down, the bond will be issued either at a lower rate or with a higher premium or a smaller discount than was originally expected. The lower rate being paid or increase in proceeds is normally offset by the loss on the hedge.

For example, in August 2000 Entity R decided it would issue CU200 million seven-year bonds in January 2001. Entity R performed historical correlation studies and determined that a seven-year treasury bond adequately correlates to the bonds Entity R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Entity R hedged the anticipated issue of the bonds by selling (shorting) CU186 million worth of futures on seven-year treasury bonds. From August 2000 to January 2001 interest rates increased. The short futures positions were closed in January 2001, the date the bonds were issued, and resulted in a CU1.2 million gain that will offset the increased interest payments on the bonds and, therefore, will affect surplus or deficit over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecast issue of debt.

F.2.3 Hedge Accounting: Core Deposit Intangibles

Is hedge accounting treatment permitted for a hedge of the fair value exposure of core deposit intangibles?

It depends on whether the core deposit intangible is generated internally or acquired (e.g., as part of a public sector combination).

Internally generated core deposit intangibles are not recognized as intangible assets under IPSAS 31, *Intangible Assets*. Because they are not recognized, they cannot be designated as a hedged item.

If a core deposit intangible is acquired together with a related portfolio of deposits, the core deposit intangible is required to be recognized separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in IPSAS 31. A recognized core deposit intangible asset could be designated as a hedged item, but only if it meets the conditions in paragraph 98, including the requirement in paragraph 98 that the effectiveness of the hedge can be measured reliably. Because it is often difficult to measure reliably the fair value of a core deposit intangible asset other than on initial recognition, it is unlikely that the requirement in paragraph 98(d) will be met.

F.2.4 Hedge Accounting: Hedging of Future Foreign Currency Revenue Streams

Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable. Under IPSAS 29.96(b) a hedge of an anticipated sale may qualify as a cash flow hedge. For example, an entity which owns and operates a cross-border toll road may use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are “highly probable,” as required by IPSAS 29.98, it may designate a currency borrowing as a cash flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognized in net assets/equity until the revenues occur.

It is unlikely that an entity can reliably predict 100 percent of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the “highly probable” criterion.

F.2.5 Cash Flow Hedges: “All in One” Hedge

If a derivative instrument is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price, can the derivative instrument be designated as the hedging instrument in a cash flow hedge of that gross settlement assuming the other cash flow hedge accounting criteria are met?

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or

received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative. This applies to all fixed price contracts that are accounted for as derivatives under IPSAS 29.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under IPSAS 29 (e.g., because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin), the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, if an entity enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a derivative because its term exceeds the regular way delivery period in the marketplace, the entity may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired.

F.2.6 Hedge Relationships: Entity-Wide Risk

An entity has a fixed rate asset and a fixed rate liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset and designates the interest rate swap as a fair value hedge of the fixed rate asset. Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Yes. IPSAS 29 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure to interest rate increases that is offset by the interest rate swap.

F.2.7 Cash Flow Hedge: Forecast Transaction Related to an Entity's Net Assets/Equity

Can a forecast transaction in the entity's own equity instruments or forecast dividend or similar payments to owners be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecast transaction must expose the entity to a particular risk that can affect surplus or deficit (IPSAS 29.96). The classification of financial instruments as liabilities or net assets/equity generally provides the basis

for determining whether transactions or other payments relating to such instruments are recognized in surplus or deficit IPSAS 28. For example, distributions to holders of an equity instrument are debited by the issuer directly to net assets/equity (IPSAS 28.40). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend or similar distribution that has not yet been paid and is recognized as a financial liability may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.

F.2.8 Hedge Accounting: Risk of a Transaction Not Occurring

Does IPSAS 29 permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall operational risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognized assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (IPSAS 29.96).

F.2.9 Held-to-Maturity Investments: Hedging Variable Interest Rate Payments

Can an entity designate a pay-variable, receive-fixed interest rate swap as a cash flow hedge of a variable rate, held-to-maturity investment?

No. It is inconsistent with the designation of a debt investment as being held to maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. IPSAS 29.88 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk "because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates."

F.2.10 Hedged Items: Purchase of Held-to-Maturity Investment

An entity forecasts the purchase of a financial asset that it intends to classify as held to maturity when the forecast transaction occurs. It enters into a derivative contract with the intent to lock in the current interest rate and designates the derivative as a hedge of the forecast purchase of the financial asset. Can the hedging relationship qualify for cash flow hedge accounting even though the asset will be classified as a held-to-maturity investment?

Yes. With respect to interest rate risk, IPSAS 29 prohibits hedge accounting for financial assets that are classified as held-to-maturity (IPSAS 29.88). However, even though the entity intends to classify the asset as held to maturity, the instrument is not classified as such until the transaction occurs.

F.2.11 Cash Flow Hedges: Reinvestment of Funds Obtained from Held-to-Maturity Investments

An entity owns a variable rate asset that it has classified as held to maturity. It enters into a derivative contract with the intention to lock in the current interest rate on the reinvestment of variable rate cash flows, and designates the derivative as a cash flow hedge of the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on the held-to-maturity asset. Assuming that the other hedge accounting criteria are met, can the hedging relationship qualify for cash flow hedge accounting even though the interest payments that are being reinvested come from an asset that is classified as held to maturity?

Yes. IPSAS 29.88 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question F.2.8 specifies that this applies not only to fair value hedges, i.e., hedges of the exposure to fair value interest rate risk associated with held-to-maturity investments that pay fixed interest, but also to cash flow hedges, i.e., hedges of the exposure to cash flow interest rate risk associated with held-to-maturity investments that pay variable interest at current market rates. However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecast future interest receipts on debt instruments resulting from the forecast reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecast to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

F.2.12 Hedge Accounting: Prepayable Financial Asset

If the issuer has the right to prepay a financial asset, can the investor designate the cash flows after the prepayment date as part of the hedged item?

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are “highly probable” (IPSAS 29.98). For example, cash flows after the prepayment date may qualify as highly probable if they result from a group or pool of similar assets (e.g., mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

F.2.13 Fair Value Hedge: Risk That Could Affect Surplus or Deficit

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are classified as loans and receivables?

Yes. Under IPSAS 29, loans and receivables are carried at amortized cost. Many entities hold the bulk of their loans and receivables until maturity. Thus, changes in

the fair value of such loans and receivables that are due to changes in market interest rates will not affect surplus or deficit. IPSAS 29.96 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect surplus or deficit. Therefore, IPSAS 29.96 may appear to preclude fair value hedge accounting for loans and receivables. However, it follows from IPSAS 29.88 that loans and receivables can be hedged items with respect to interest rate risk since they are not designated as held-to-maturity investments. The entity could sell them and the change in fair values would affect surplus or deficit. Thus, fair value hedge accounting is permitted for loans and receivables.

F.2.14 Intragroup and Intra-entity Hedging Transactions

An Australian entity, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by a Swiss entity, which prepares consolidated financial statements (which include the Australian subsidiary) in Swiss francs. The Swiss controlling entity enters into a forward contract to hedge the change in yen relative to the Australian dollar. Can that hedge qualify for hedge accounting in the consolidated financial statements, or must the Australian controlled that has the foreign currency exposure be a party to the hedging transaction?

The hedge can qualify for hedge accounting provided the other hedge accounting criteria in IPSAS 29 are met. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's surplus or deficit and, therefore, would also affect consolidated surplus or deficit. IPSAS 29 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

F.2.15 Internal Contracts: Single Offsetting External Derivative

An entity uses what it describes as internal derivative contracts to document the transfer of responsibility for interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For example, if the central treasury function has entered into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division, it would enter into an interest rate swap with an external counterparty that exactly offsets the four internal swaps. Assuming that the hedge accounting criteria are met, in the entity's financial statements would the single offsetting external derivative qualify as a hedging instrument in a hedge of a part of the underlying items on a gross basis?

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. IPSAS 29.94 indicates that a hedge of an

overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis. Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An entity follows the approach outlined in IPSAS 29.94 and IPSAS 29.AG141 to designate part of the underlying cash flows as the hedged position.

F.2.16 Internal Contracts: External Derivative Contracts that are Settled Net

Issue (a) – An entity uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. For each internal derivative contract, the central treasury function enters into a derivative contract with a single external counterparty that offsets the internal derivative contract. For example, if the central treasury function has entered into a receive-5 percent-fixed, pay-LIBOR interest rate swap with another division that has entered into the internal contract with central treasury to hedge the exposure to variability in interest cash flows on a pay-LIBOR borrowing, central treasury would enter into a pay-5 percent-fixed, receive-LIBOR interest rate swap on the same principal terms with the external counterparty. Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled since there is a netting agreement with the external counterparty. Assuming that the other hedge accounting criteria are met, can the individual external derivative contracts, such as the pay-5 percent-fixed, receive-LIBOR interest rate swap above, be designated as hedging instruments of underlying gross exposures, such as the exposure to changes in variable interest payments on the pay-LIBOR borrowing above, even though the external derivatives are settled on a net basis?

Generally, yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty, provided the hedge accounting criteria in IPSAS 29 are met. See also Question F.1.13.

Issue (b) – Treasury observes that by entering into the external offsetting contracts and including them in the centralized portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the entity. Therefore, it enters into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally, yes. The purpose of structuring the external derivative contracts in this manner is consistent with the entity's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid purpose qualify as hedging instruments. Moreover, the answer to Question F.1.13 specifies that hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the same counterparty if there is a substantive purpose for structuring the transactions separately.

F.2.17 Partial Term Hedging

IPSAS 29.84 indicates that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Entity A acquires a 10 percent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as available-for-sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

F.2.18 Hedging Instrument: Cross-Currency Interest Rate Swap

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a 10-year fixed rate pound sterling-denominated note receivable. Entity A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Entity A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Entity A?

Yes. IPSAS 29.90 permits hedge accounting for components of risk, if effectiveness can be measured. Also, IPSAS 29.85 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be identified clearly, effectiveness can be demonstrated, and specific designation of the hedging instrument and different risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to

changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and US dollars. The swap is measured at fair value with changes in fair value recognized in surplus or deficit. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five-year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under IPSAS 4 and the changes to their carrying amounts recognized in surplus or deficit.

F.2.19 Hedged Items: Hedge of Foreign Currency Risk of Publicly Traded Shares

Entity A acquires shares in Entity B on a foreign stock exchange for their fair value of 1,000 in foreign currency (FC). It classifies the shares as available for sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell FC750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to FC750 in foreign currency?

Yes. IPSAS 29 permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (IPSAS 29.90). Therefore, Entity A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of FC750 associated with the shares or as a cash flow hedge of a forecast sale of the shares, provided the timing of the sale is identified. Any variability in the fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below FC750.

F.2.20 Hedge Accounting: Stock Index

An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does IPSAS 29 permit

designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, IPSAS 29.93 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

F.2.21 Hedge Accounting: Netting of Assets and Liabilities

May an entity group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An entity's hedging strategy and risk management practices may assess cash flow risk on a net basis but IPSAS 29.94 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. IPSAS 29.AG141 provides an example of how an entity might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

F.3 *Hedge Accounting*

F.3.1 Cash Flow Hedge: Fixed Interest Rate Cash Flows

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt instrument. Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

No. IPSAS 29.96(b) states that a cash flow hedge is "a hedge of the exposure to variability in cash flows." In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

F.3.2 Cash Flow Hedge: Reinvestment of Fixed Interest Rate Cash Flows

An entity manages interest rate risk on a net basis. On January 1, 2001, it forecasts aggregate cash inflows of CU100 on fixed rate assets and aggregate cash outflows of CU90 on fixed rate liabilities in the first quarter of 2002. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecast net cash inflow of CU10. The entity designates as the hedged item the first CU10 of cash inflows on fixed rate assets in the first quarter of 2002. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 2002 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the entity could also hedge the interest rate exposure associated with the forecast reinvestment of the interest and principal it receives on fixed rate assets (see Question F.6.2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (e.g., if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the reinvestment of interest cash inflows on fixed rate assets). However, potentially it could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

F.3.3 Foreign Currency Hedge

Entity A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

- (a) **A fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognized in surplus or deficit; or**
- (b) **A cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognized net assets/equity?**

IPSAS 29 does not preclude either of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk are recognized immediately in surplus or deficit. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognized in net assets/equity, that amount is recognized in surplus or deficit in the same period or periods during which the hedged item (the liability) affects surplus or deficit, i.e., when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to surplus or deficit in the same periods during which the liability is remeasured, not when the payment occurs. See Question F.3.4.

F.3.4 Foreign Currency Cash Flow Hedge

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to surplus or deficit (IPSAS 4.27 and IPSAS 4.32).

If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognized immediately in surplus or deficit and the gain or loss on remeasuring the receivable is also recognized in surplus or deficit.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognized in net assets/equity, and the ineffective portion in surplus or deficit (IPSAS 29.106). The amount recognized in net assets/equity is recognized in surplus or deficit in the same period or periods during which changes in the measurement of the receivable affect surplus or deficit (IPSAS 29.111).

F.3.5 Fair Value Hedge: Variable Rate Debt Instrument

Does IPSAS 29 permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

F.3.6 Fair Value Hedge: Inventory

IPSAS 29.96(a) states that a fair value hedge is “a hedge of the exposure to changes in fair value of a recognized asset or liability ... that is attributable to a particular risk and could affect surplus or deficit.” Can an entity designate inventories, such as oil inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the oil price, although inventories are measured at the lower of cost and net realizable value or cost and current replacement cost under IPSAS 12, *Inventories*?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect surplus or deficit when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realizable value test under IPSAS 12. The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

F.3.7 Hedge Accounting: Forecast Transaction

For cash flow hedges, a forecast transaction that is subject to a hedge must be “highly probable.” How should the term “highly probable” be interpreted?

The term “highly probable” indicates a much greater likelihood of happening than the term “more likely than not.” An assessment of the likelihood that a forecast transaction will take place is not based solely on management’s intentions because intentions are not verifiable. A transaction’s probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

- (a) The frequency of similar past transactions;
- (b) The financial and operational ability of the entity to carry out the transaction;
- (c) Substantial commitments of resources to a particular activity (e.g., the undertaking of specific infrastructure projects);
- (d) The extent of loss or disruption of operations that could result if the transaction does not occur;
- (e) The likelihood that transactions with substantially different characteristics might be used to achieve the same purpose (e.g., an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of debt instruments); and
- (f) The entity’s operational plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity’s transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

F.3.8 Retrospective Designation of Hedges

Does IPSAS 29 permit an entity to designate hedge relationships retrospectively?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in IPSAS 29.98 are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

F.3.9 Hedge Accounting: Designation at the Inception of the Hedge

Does IPSAS 29 permit an entity to designate and formally document a derivative contract as a hedging instrument after entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, IPSAS 29 requires a hedging instrument to be designated and formally documented as such from the inception of the hedge relationship (IPSAS 29.98); in other words, a hedge relationship cannot be designated retrospectively. Also, it precludes designating a hedging relationship for only a portion of the time period during which the hedging instrument remains outstanding (IPSAS 29.84). However, it does not require the hedging instrument to be acquired at the inception of the hedge relationship.

F.3.10 Hedge Accounting: Identification of Hedged Forecast Transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

F.3.11 Cash Flow Hedge: Documentation of Timing of Forecast Transaction

For a hedge of a forecast transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date on, or time period in which, the forecast transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (IPSAS 29.AG151) and it must be possible to measure its effectiveness reliably (IPSAS 29.98(d)). Also, the hedged forecast transaction must be highly probable (IPSAS 29.98(c)). To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance with IPSAS 29.98(d), it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecast transaction is no longer expected to occur, hedge accounting is discontinued in accordance with IPSAS 29.112(c).

F.4 *Hedge Effectiveness*

F.4.1 **Hedging on an After-Tax Basis**

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

IPSAS 29 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

F.4.2 **Hedge Effectiveness: Assessment on Cumulative Basis**

IPSAS 29.98(b) requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognized in surplus or deficit as it occurs.

To illustrate: an entity designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25–50 basis points, while LIBOR changes daily. Over a period of 1–2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.

F.4.3 **Hedge Effectiveness: Counterparty Credit Risk**

Must an entity consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An entity cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument. When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the entity considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the entity. For a cash flow hedge, if it becomes probable that a counterparty will default, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change, which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

F.4.4 Hedge Effectiveness: Effectiveness Tests

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

IPSAS 29 does not provide specific guidance about how effectiveness tests are performed. IPSAS 29 specifies that a hedge is normally regarded as highly effective only if (a) at inception and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results are within a range of 80–125 percent. IPSAS 29.AG145 also states that the expectation in (a) can be demonstrated in various ways.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An entity is required to document at the inception of the hedge how effectiveness will be assessed and then to apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, i.e., a comparison of hedging gains and losses with the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

F.4.5 Hedge Effectiveness: Less than 100 Percent Offset

If a cash flow hedge is regarded as highly effective because the actual risk offset is within the allowed 80–125 percent range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge recognized in net assets/equity?

No. IPSAS 29.106(a) indicates that only the effective portion is recognized in net assets/equity. IPSAS 29.106(b) requires the ineffective portion to be recognized in surplus or deficit.

F.4.6 Assuming Perfect Hedge Effectiveness

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No. IPSAS 29.98(e) requires an entity to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (IPSAS 29.AG150). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

F.5 *Cash Flow Hedges*

F.5.1 Hedge Accounting: Non-Derivative Monetary Asset or Non-Derivative Monetary Liability Used as a Hedging Instrument

If an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognized in surplus or deficit (IPSAS 4.32) and the exchange differences on the hedging instrument be recognized in net assets/equity until the repayment of the liability (IPSAS 29.106)?

No. Exchange differences on the monetary asset and the monetary liability are both recognized in surplus or deficit in the period in which they arise (IPSAS 4.32). IPSAS 29.AG116 specifies that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are recognized in surplus or deficit.

F.5.2 Cash Flow Hedges: Performance of Hedging Instrument (1)

Entity A has a floating rate liability of CU1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of CU49 in the fair value of the swap. This increase consists of a change of CU50 resulting from an increase in market interest rates and a change of minus CU1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by CU50. Assuming that

Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognized in surplus or deficit?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk (IPSAS 29.AG150). However, because Entity A determines that the hedge relationship is still highly effective, it recognizes the effective portion of the change in fair value of the swap, i.e., the net change in fair value of CU49, in net assets/equity. There is no debit to surplus or deficit for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, i.e., CU50, exceeds the cumulative change in value of the hedging instrument, i.e., CU49.

Dr	Swap	CU49	
	Cr	Net assets/equity	CU49

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with IPSAS 29.112.

Would the answer change if the fair value of the swap instead increases to CU51 of which CU50 results from the increase in market interest rates and CU1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to surplus or deficit of CU1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, i.e., CU51, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, i.e., CU50. The difference of CU1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognized in surplus or deficit.

Dr	Swap	CU51	
	Cr	Net assets/equity	CU50
	Cr	Surplus or deficit	CU1

F.5.3 Cash Flow Hedges: Performance of Hedging Instrument (2)

On September 30, 20X1, Entity A hedges the anticipated sale of 24 barrels of oil on March 1, 20X2 by entering into a short forward contract on 24 barrels of oil. The contract requires net settlement in cash determined as the difference between the future spot price of oil on a specified commodity exchange and CU1,000. Entity A expects to sell the oil in a different, local market. Entity A determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge

accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On December 31, the spot price of oil has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is CU1,100. The fair value of Entity A's forward contract is negative CU80. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognized in surplus or deficit?

No. In a cash flow hedge, ineffectiveness is not recognized in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is CU80, while the fair value of the cumulative change in expected future cash flows on the hedged item is CU100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognized in surplus or deficit (IPSAS 29.106(b)). Because Entity A determines that the hedge relationship is still highly effective, it recognizes the entire change in fair value of the forward contract (CU80) in net assets/equity.

Dr	Net assets/equity	CU80	
	Cr Forward		CU80

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with IPSAS 29.112.

F.5.4 Cash Flow Hedges: Forecast Transaction Occurs Before the Specified Period

An entity designates a derivative as a hedging instrument in a cash flow hedge of a forecast transaction, such as a forecast sale of a commodity. The hedging relationship meets all the hedge accounting conditions, including the requirement to identify and document the period in which the transaction is expected to occur within a reasonably specific and narrow range of time (see Question F.2.17). If, in a subsequent period, the forecast transaction is expected to occur in an earlier period than originally anticipated, can the entity conclude that this transaction is the same as the one that was designated as being hedged?

Yes. The change in timing of the forecast transaction does not affect the validity of the designation. However, it may affect the assessment of the effectiveness of the hedging relationship. Also, the hedging instrument would need to be designated as a hedging instrument for the whole remaining period of its existence in order for it to continue to qualify as a hedging instrument (see IPSAS 29.84 and Question F.2.17).

F.5.5 Cash Flow Hedges: Measuring Effectiveness for a Hedge of a Forecast Transaction in a Debt Instrument

A forecast investment in an interest-earning asset or forecast issue of an interest-bearing liability creates a cash flow exposure to interest rate changes because the related interest payments will be based on the market rate that exists when the forecast transaction occurs. The objective of a cash flow hedge of the exposure to interest rate changes is to offset the effects of future changes in interest rates so as to obtain a single fixed rate, usually the rate that existed at the inception of the hedge that corresponds with the term and timing of the forecast transaction. During the period of the hedge, it is not possible to determine what the market interest rate for the forecast transaction will be at the time the hedge is terminated or when the forecast transaction occurs. In this case, how is the effectiveness of the hedge assessed and measured?

During this period, effectiveness can be measured on the basis of changes in interest rates between the designation date and the interim effectiveness measurement date. The interest rates used to make this measurement are the interest rates that correspond with the term and occurrence of the forecast transaction that existed at the inception of the hedge and that exist at the measurement date as evidenced by the term structure of interest rates.

Generally it will not be sufficient simply to compare cash flows of the hedged item with cash flows generated by the derivative hedging instrument as they are paid or received, since such an approach ignores the entity's expectations of whether the cash flows will offset in subsequent periods and whether there will be any resulting ineffectiveness.

The discussion that follows illustrates the mechanics of establishing a cash flow hedge and measuring its effectiveness. For the purpose of the illustrations, assume that an entity expects to issue a CU100,000 one-year debt instrument in three months. The instrument will pay interest quarterly with principal due at maturity. The entity is exposed to interest rate increases and establishes a hedge of the interest cash flows of the debt by entering into a forward starting interest rate swap. The swap has a term of one year and will start in three months to correspond with the terms of the forecast debt issue. The entity will pay a fixed rate and receive a variable rate, and the entity designates the risk being hedged as the LIBOR-based interest component in the forecast issue of the debt.

Yield Curve

The yield curve provides the foundation for computing future cash flows and the fair value of such cash flows both at the inception of, and during, the hedging relationship. It is based on current market yields on applicable reference bonds that are traded in the marketplace. Market yields are converted to spot interest rates ("spot rates" or "zero coupon rates") by eliminating the effect of coupon payments on the market yield. Spot rates are used to discount future cash flows, such as principal and interest rate payments, to arrive at their fair value. Spot rates also are used to compute forward interest rates that are used to compute variable and estimated future cash flows. The relationship between spot rates and one-period forward rates is shown by the following formula:

Spot-forward relationship

$$F = \frac{(1 + SR_t)^t}{(1 + SR_{t-1})^{t-1}} - 1$$

where

F = forward rate (%)

SR = spot rate (%)

t = period in time (e.g., 1, 2, 3, 4, 5)

Also, for the purpose of this illustration, assume that the following quarterly-period term structure of interest rates using quarterly compounding exists at the inception of the hedge.

Yield curve at inception – (beginning of period 1)					
<i>Forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
Spot rates	3.75%	4.50%	5.50%	6.00%	6.25%
Forward rates	3.75%	5.25%	7.51%	7.50%	7.25%

The one-period forward rates are computed on the basis of spot rates for the applicable maturities. For example, the current forward rate for Period 2 calculated using the formula above is equal to $[1.0450^2/1.0375] - 1 = 5.25$ percent. The current one-period forward rate for Period 2 is different from the current spot rate for Period 2, since the spot rate is an interest rate from the beginning of Period 1 (spot) to the end of Period 2, while the forward rate is an interest rate from the beginning of Period 2 to the end of Period 2.

Hedged Item

In this example, the entity expects to issue a CU100,000 one-year debt instrument in three months with quarterly interest payments. The entity is exposed to interest rate increases and would like to eliminate the effect on cash flows of interest rate changes that may happen before the forecast transaction takes place. If that risk is eliminated, the entity would obtain an interest rate on its debt issue that is equal to the one-year forward coupon rate currently available in the marketplace in three months. That forward coupon rate, which is different from the forward (spot) rate, is 6.86 percent, computed from the term structure of interest rates shown above. It is the market rate of interest that exists at the inception of the hedge, given the terms of the forecast debt instrument. It results in the fair value of the debt being equal to par at its issue.

At the inception of the hedging relationship, the expected cash flows of the debt instrument can be calculated on the basis of the existing term structure of interest rates. For this purpose, it is assumed that interest rates do not change and that the debt would be issued at 6.86 percent at the beginning of Period 2. In this case, the cash flows and fair value of the debt instrument would be as follows at the beginning of Period 2.

Issue of Fixed Rate Debt					
Beginning of period 2 - No rate changes (spot based on forward rates)					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Spot rates		5.25%	6.38%	6.75%	6.88%
Forward rates		5.25%	7.51%	7.50%	7.25%
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Principal					100,000
<i>Fair value:</i>					
Interest	6,592	1,694	1,663	1,632	1,603
Principal	93,408				93,408 ^(a)
Total	100,000				
(a) $CU100,000 / (1 + [0.0688/4])^4$					

Since it is assumed that interest rates do not change, the fair value of the interest and principal amounts equals the par amount of the forecast transaction. The fair value amounts are computed on the basis of the spot rates that exist at the inception of the hedge for the applicable periods in which the cash flows would occur had the debt been issued at the date of the forecast transaction. They reflect the effect of discounting those cash flows on the basis of the periods that will remain after the debt instrument is issued. For example, the spot rate of 6.38 percent is used to discount the interest cash flow that is expected to be paid in Period 3, but it is discounted for only two periods because it will occur two periods after the forecast transaction.

The forward interest rates are the same as shown previously, since it is assumed that interest rates do not change. The spot rates are different but they have not actually changed. They represent the spot rates one period forward and are based on the applicable forward rates.

Hedging Instrument

The objective of the hedge is to obtain an overall interest rate on the forecast transaction and the hedging instrument that is equal to 6.86 percent, which is the market rate at the inception of the hedge for the period from Period 2 to Period 5. This objective is accomplished by entering into a forward starting interest rate swap that has a fixed rate of 6.86 percent. Based on the term structure of interest rates that exist at the inception of the hedge, the interest rate swap will have such a rate. At the inception of the hedge, the fair value of the fixed rate payments on the interest rate swap will equal the fair value of the variable rate payments, resulting in the interest rate swap having a fair

value of zero. The expected cash flows of the interest rate swap and the related fair value amounts are shown as follows.

Interest Rate Swap					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Forecast variable interest		1,313	1,877	1,876	1,813
<i>Forecast based on forward rate</i>		<i>5.25%</i>	<i>7.51%</i>	<i>7.50%</i>	<i>7.25%</i>
Net interest		(403)	161	160	97
<i>Fair value:</i>					
<i>Discount rate (spot)</i>		<i>5.25%</i>	<i>6.38%</i>	<i>6.75%</i>	<i>6.88%</i>
Fixed interest	6,592	1,694	1,663	1,632	1,603
Forecast variable interest	6,592	1,296	1,819	1,784	1,693
Fair value of interest rate swap	0	(398)	156	152	90

At the inception of the hedge, the fixed rate on the forward swap is equal to the fixed rate the entity would receive if it could issue the debt in three months under terms that exist today.

Measuring Hedge Effectiveness

If interest rates change during the period the hedge is outstanding, the effectiveness of the hedge can be measured in various ways.

Assume that interest rates change as follows immediately before the debt is issued at the beginning of Period 2.

Yield Curve - Rates Increase 200 Basis Points					
<i>Forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Spot rates	5.75%	6.50%	7.50%		8.00%
Forward rates	5.75%	7.25%	9.51%		9.50%

Under the new interest rate environment, the fair value of the pay-fixed at 6.86 percent, receive-variable interest rate swap that was designated as the hedging instrument would be as follows.

Fair Value of Interest Rate Swap						
<i>Total</i>						
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>						
Fixed interest @6.86%		1,716	1,716	1,716	1,716	
Forecast variable interest		1,438	1,813	2,377	2,376	
<i>Forecast based on new forward rate</i>		<i>5.25%</i>	<i>7.25%</i>	<i>9.51%</i>	<i>9.50%</i>	
Net interest		(279)	97	661	660	
<i>Fair value:</i>						
<i>New discount rate (spot)</i>		<i>5.75%</i>	<i>6.50%</i>	<i>7.50%</i>	<i>8.00%</i>	
Fixed interest	6,562	1,692	1,662	1,623	1,585	
Forecast variable interest	7,615	1,417	1,755	2,248	2,195	
Fair value of net interest	1,053	(275)	93	625	610	

In order to compute the effectiveness of the hedge, it is necessary to measure the change in the present value of the cash flows or the value of the hedged forecast transaction. There are at least two methods of accomplishing this measurement.

Method A Compute Change in Fair Value of Debt					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
<i>Cash flows:</i>					
Fixed interest @6.86%		1,716	1,716	1,716	1,716
Principal					100,000
<i>Fair value:</i>					
<i>New discount rate (spot)</i>		<i>5.75%</i>	<i>6.50%</i>	<i>7.50%</i>	<i>8.00%</i>
Interest	6,562	1,692	1,662	1,623	1,585
Principal	92,385				92,385 ^(a)
Total	98,947				
Fair value at inception	100,000				
Fair value difference	(1,053)				
(a)	CU100,000/(1 + [0.08/4]) ⁴				

Under Method A, a computation is made of the fair value in the new interest rate environment of debt that carries interest that is equal to the coupon interest rate that existed at the inception of the hedging relationship (6.86 percent). This fair value is compared with the expected fair value as of the beginning of Period 2 that was calculated on the basis of the term structure of interest rates that existed at the inception of the hedging relationship, as illustrated above, to determine the change in the fair value. Note that the difference between the change in the fair value of the swap and the change in the expected fair value of the debt exactly offset in this example, since the terms of the swap and the forecast transaction match each other.

Method B Compute Change in Fair Value of Cash Flows					
<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>		<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Market rate at inception		6.86%	6.86%	6.86%	6.86%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		1.11%	(0.39%)	(2.64%)	(2.64%)
Cash flow difference (principal × rate)		CU279	(CU97)	(CU661)	(CU660)

Method B Compute Change in Fair Value of Cash Flows					
<i>Total</i>					
<i>Discount rate (spot)</i>		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,053)	CU275	(CU93)	(CU625)	(CU610)

Under Method B, the present value of the change in cash flows is computed on the basis of the difference between the forward interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. The market rate that existed at the inception of the hedge is the one-year forward coupon rate in three months. The present value of the change in cash flows is computed on the basis of the current spot rates that exist at the effectiveness measurement date for the applicable periods in which the cash flows are expected to occur. This method also could be referred to as the “theoretical swap” method (or “hypothetical derivative” method) because the comparison is between the hedged fixed rate on the debt and the current variable rate, which is the same as comparing cash flows on the fixed and variable rate legs of an interest rate swap.

As before, the difference between the change in the fair value of the swap and the change in the present value of the cash flows exactly offset in this example, since the terms match.

Other Considerations

There is an additional computation that should be performed to compute ineffectiveness before the expected date of the forecast transaction that has not been considered for the purpose of this illustration. The fair value difference has been determined in each of the illustrations as of the expected date of the forecast transaction immediately before the forecast transaction, i.e., at the beginning of Period 2. If the assessment of hedge effectiveness is done before the forecast transaction occurs, the difference should be discounted to the current date to arrive at the actual amount of ineffectiveness. For example, if the measurement date were one month after the hedging relationship was established and the forecast transaction is now expected to occur in two months, the amount would have to be discounted for the remaining two months before the forecast transaction is expected to occur to arrive at the actual fair value. This step would not be necessary in the examples provided above because there was no ineffectiveness. Therefore, additional discounting of the amounts, which net to zero, would not have changed the result.

Under Method B, ineffectiveness is computed on the basis of the difference between the forward coupon interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. Computing the change in cash flows based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date is inappropriate if the objective of the hedge is to establish a single

fixed rate for a series of forecast interest payments. This objective is met by hedging the exposures with an interest rate swap as illustrated in the above example. The fixed interest rate on the swap is a blended interest rate composed of the forward rates over the life of the swap. Unless the yield curve is flat, the comparison between the forward interest rate exposures over the life of the swap and the fixed rate on the swap will produce different cash flows whose fair values are equal only at the inception of the hedging relationship. This difference is shown in the table below.

<i>Total</i>					
<i>Original forward periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>
<i>Remaining periods</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>4</i>
Forward rate at inception		5.25%	7.51%	7.50%	7.25%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		(0.50%)	0.26%	(2.00%)	(2.25%)
Cash flow difference (principal × rate)		(CU125)	CU64	(CU501)	(CU563)
Discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(CU1,055)	(CU123)	CU62	(CU474)	(CU520)
Fair value of interest rate swap	CU1,053				
Ineffectiveness	(CU2)				

If the objective of the hedge is to obtain the forward rates that existed at the inception of the hedge, the interest rate swap is ineffective because the swap has a single blended fixed coupon rate that does not offset a series of different forward interest rates. However, if the objective of the hedge is to obtain the forward coupon rate that existed at the inception of the hedge, the swap is effective, and the comparison based on differences in forward interest rates suggests ineffectiveness when none may exist. Computing ineffectiveness based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date would be an appropriate measurement of ineffectiveness if the hedging objective is to lock in those forward interest rates. In that case, the appropriate hedging instrument would be a series of forward contracts each of which matures on a repricing date that corresponds with the date of the forecast transactions.

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and IPSAS 29 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (IPSAS 29.83). It is recognized, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at

inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

F.5.6 Cash Flow Hedges: Firm Commitment to Purchase Property, Plant and Equipment in a Foreign Currency

Entity A has the Local Currency (LC) as its functional currency and presentation currency. On June 30, 20X1, it enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver LC109,600 on June 30, 20X2 at an initial cost and fair value of zero. It designates the forward exchange contract as a hedging instrument in a cash flow hedge of a firm commitment to purchase spare parts for its electricity distribution network on March 31, 20X2 and the resulting payable of FC100,000, which is to be paid on June 30, 20X2. All hedge accounting conditions in IPSAS 29 are met.

As indicated in the table below, on June 30, 20X1, the spot exchange rate is LC1.072 to FC1, while the twelve-month forward exchange rate is LC1.096 to FC1. On December 31, 20X1, the spot exchange rate is LC1.080 to FC1, while the six-month forward exchange rate is LC1.092 to FC1. On March 31, 20X2, the spot exchange rate is LC1.074 to FC1, while the three-month forward rate is LC1.076 to FC1. On June 30, 20X2, the spot exchange rate is LC1.072 to FC1. The applicable yield curve in the local currency is flat at 6 percent per year throughout the period. The fair value of the forward exchange contract is negative LC388 on December 31, 20X1 $\{([1.092 \times 100,000] - 109,600)/1.06(6/12)\}$, negative LC1,971 on March 31, 20X2 $\{([1.076 \times 100,000] - 109,600)/1.06((3/12))\}$, and negative LC2,400 on June 30, 20X2 $\{1.072 \times 100,000 - 109,600\}$.

Date	Spot rate	Forward rate to June 30, 20X2	Fair value of forward contract
June 30, 20X1	1.072	1.096	–
December 31, 20X1	1.080	1.092	(388)
March 31, 20X2	1.074	1.076	(1,971)
June 30, 20X2	1.072	–	(2,400)

Issue (a) – What is the accounting for these transactions if the hedging relationship is designated as being for changes in the fair value of the forward exchange contract and the entity’s accounting policy is to apply basis adjustment to non-financial assets that result from hedged forecast transactions?

The accounting entries are as follows.

June 30, 20X1

Dr	Forward	LC0	
	Cr	Cash	LC0

To record the forward exchange contract at its initial amount of zero (IPSAS 29.45). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract and the assessment of hedge effectiveness are based on the forward price (IPSAS 29.AG149).

December 31, 20X1

Dr	Net assets/equity	LC388	
	Cr	Forward liability	LC388

To record the change in the fair value of the forward exchange contract between June 30, 20X1 and December 31, 20X1, i.e., $LC388 - 0 = LC388$, in net assets/equity (IPSAS 29.106). The hedge is fully effective because the loss on the forward exchange contract (LC388) exactly offsets the change in cash flows associated with the purchase contract based on the forward price $[(LC388) = \{([1.092 \times 100,000] - 109,600)/1.06(6/12)\} - \{([1.096 \times 100,000] - 109,600)/1.06\}]$

March 31, 20X2

Dr	Net assets/equity	LC1,583	
	Cr	Forward liability	LC1,583

To record the change in the fair value of the forward exchange contract between January 1, 20X2 and March 31, 20X2 (i.e., $LC1,971 - LC388 = LC1,583$) in net assets/equity (IPSAS 29.106). The hedge is fully effective because the loss on the forward exchange contract (LC1,583) exactly offsets the change in cash flows associated with the purchase contract based on the forward price $[(LC1,583) = \{([1.076 \times 100,000] - 109,600)/1.06(3/12)\} - \{([1.092 \times 100,000] - 109,600)/1.06(6/12)\}]$

Dr	Property, plant and equipment (purchase price)	LC107,400	
Dr	Property, plant and equipment (hedging loss)	LC1,971	
	Cr	Net assets/equity	LC1,971
	Cr	Payable	LC107,400

To recognize the purchase of the spare parts at the spot rate ($1.074 \times FC100,000$) and remove the cumulative loss on the forward exchange contract that has been recognized in net assets/equity (LC1,971) and include it in the initial measurement of the spare parts purchased. Accordingly, the initial measurement of the is LC109,371 consisting of a purchase consideration of LC107,400 and a hedging loss of LC1,971.

June 30, 20X2

Dr	Payable	LC107,400	
	Cr	Cash	LC107,200
	Cr	Surplus or deficit	LC200

To record the settlement of the payable at the spot rate ($FC100,000 \times 1.072 = 107,200$) and the associated exchange gain of LC200 ($LC107,400 - LC107,200$).

Dr	Surplus or deficit	LC429	
	Cr	Forward liability	LC429

To record the loss on the forward exchange contract between April 1, 20X2 and June 30, 20X2 (i.e., $LC2,400 - LC1,971 = LC429$) in surplus or deficit. The hedge is regarded as fully effective because the loss on the forward exchange contract (LC429) exactly offsets the change in the fair value of the payable based on the forward price ($LC429 = ([1.072 \times 100,000] - 109,600 - \{([1.076 \times 100,000] - 109,600)/1.06(3/12)\})$).

Dr	Forward liability	LC2,400	
	Cr	Cash	LC2,400

To record the net settlement of the forward exchange contract.

Issue (b) – What is the accounting for these transactions if the hedging relationship instead is designated as being for changes in the spot element of the forward exchange contract and the interest element is excluded from the designated hedging relationship (IPSAS 29.83)?

The accounting entries are as follows.

June 30, 20X1

Dr	Forward	LC0	
	Cr	Cash	LC0

To record the forward exchange contract at its initial amount of zero (IPSAS 29.45). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the premium or discount on the forward contract is excluded from the assessment of effectiveness (IPSAS 29.AG149).

December 31, 20X1

Dr	Surplus or deficit (interest element)	LC1,165	
	Cr	Net assets/equity (spot element)	LC777
	Cr	Forward liability	LC388

To record the change in the fair value of the forward exchange contract between June 30, 20X1 and December 31, 20X1, i.e., $LC388 - 0 = LC388$. The change in the present value of spot settlement of the forward exchange contract is a gain of LC777 ($\{([1.080 \times 100,000] - 107,200)/1.06(6/12)\} - \{([1.072 \times 100,000] - 107,200)/1.06\}$), which is recognized in net assets/equity (IPSAS 29.106). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,165 ($388 + 777$), which is recognized in surplus or deficit (IPSAS 29.83 and IPSAS 29.64(a)). The hedge is fully effective because the gain in the spot element of the forward contract (LC777) exactly offsets the change in the purchase price at spot rates ($LC777 = \{([1.080 \times 100,000] - 107,200)/1.06(6/12)\} - \{([1.072 \times 100,000] - 107,200)/1.06\}$).

March 31, 20X2

Dr	Net assets/equity (spot element)	LC580	
Dr	Surplus or deficit (interest element)	LC1,003	
	Cr	Forward liability	LC1,583

To record the change in the fair value of the forward exchange contract between January 1, 20X2 and March 31, 20X2, i.e., $LC1,971 - LC388 = LC1,583$. The change in the present value of the spot settlement of the forward exchange contract is a loss of LC580 ($\{([1.074 \times 100,000] - 107,200)/1.06(3/12)\} - \{([1.080 \times 100,000] - 107,200)/1.06(6/12)\}$), which is recognized in net assets/equity (IPSAS 29.106(a)). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,003 ($LC1,583 - LC580$), which is recognized in surplus or deficit (IPSAS 29.83 and IPSAS 29.,64(a)). The hedge is fully effective because the loss in the spot element of the forward contract (LC580) exactly offsets the change in the purchase price at spot rates [$580 = \{([1.074 \times 100,000] - 107,200)/1.06(3/12)\} - \{([1.080 \times 100,000] - 107,200) /1.06(6/12)\}$].

Dr	Property, plant and equipment (purchase price)	LC107,400	
Dr	Net assets/equity	LC197	
	Cr	Property, plant and equipment (hedging gain)	LC197
	Cr	Payable	LC107,400

To recognize the purchase of spare parts at the spot rate ($= 1.074 \times FC100,000$) and remove the cumulative gain on the spot element of the forward exchange contract that has been recognized in net assets/equity ($LC777 - LC580 = LC197$) and include it in the initial measurement of the spare parts. Accordingly, the initial measurement of the spare parts is LC107,203, consisting of a purchase consideration of LC107,400 and a hedging gain of LC197.

June 30, 20X2

Dr	Payable	LC107,400	
	Cr	Cash	LC107,200
	Cr	Surplus or deficit	LC200

To record the settlement of the payable at the spot rate ($FC100,000 \times 1.072 = LC107,200$) and the associated exchange gain of LC200 ($- [1.072 - 1.074] \times FC100,000$).

Dr	Surplus or deficit (spot element)	LC197	
Dr	Surplus or deficit (interest element)	LC232	
	Cr	Forward liability	LC429

To record the change in the fair value of the forward exchange contract between April 1, 20X2 and June 30, 20X2 (i.e., $LC2,400 - LC1,971 = LC429$). The change in the present value of the spot settlement of the forward exchange contract is a loss of LC197 ($[1.072 \times 100,000] - 107,200 - \{([1.074 \times 100,000] - 107,200)/1.06(3/12)\}$), which is recognized in surplus or deficit. The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC232 ($LC429 - LC197$), which is recognized in surplus or deficit. The hedge is fully effective because the loss in the spot element of the forward contract (LC197) exactly offsets the change in the present value of the spot settlement of the payable ($LC197 = \{[1.072 \times 100,000] - 107,200 - \{([1.074 \times 100,000] - 107,200)/1.06(3/12)\}$).

Dr	Forward liability	LC2,400	
	Cr	Cash	LC2,400

To record the net settlement of the forward exchange contract.

The following table provides an overview of the components of the change in fair value of the hedging instrument over the term of the hedging relationship. It illustrates that the way in which a hedging relationship is designated affects the subsequent accounting for that hedging relationship, including the assessment of hedge effectiveness and the recognition of gains and losses.

Period ending	Change in spot settlement	Fair value of change in spot settlement	Change in forward settlement	Fair value of change in forward settlement	Fair value of change in interest element
	LC	LC	LC	LC	LC
June 20X1	—	—	—	—	—
December 20X1	800	777	(400)	(388)	(1,165)
March 20X2	(600)	(580)	(1,600)	(1,583)	(1,003)
June 20X2	(200)	(197)	(400)	(429)	(232)
Total	—	—	(2,400)	(2,400)	(2,400)

F.6 *Hedges: Other Issues*F.6.1 **Hedge Accounting: Management of Interest Rate Risk in Entities Such as Departments of Finance**

Entities, such as departments of finance, often manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have systems to accumulate critical information throughout the entity about their financial assets, financial liabilities and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many entities use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If an entity manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under IPSAS 29?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to the net exposure (IPSAS 29.94, IPSAS 29.AG141 and IPSAS 29.AG154). It is not possible to designate a net position as a hedged item under IPSAS 29 because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognized in surplus or deficit.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting in IPSAS 29.98 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately affects the entity's surplus or deficit (IPSAS 29.AG153) and the entity designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their objective.

The factors an entity must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question F.6.2.

F.6.2 **Hedge Accounting Considerations when Interest Rate Risk is Managed on a Net Basis**

If an entity manages its exposure to interest rate risk on a net basis, what are the issues the entity should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues (a) – (l) below deal with the main issues. First, Issues (a) and (b) discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues (c) – (l) expand on various aspects of the accounting for cash flow hedges. Issues (c) – (f) consider the application of the hedge accounting criteria for cash flow hedges in IPSAS 29, and Issues (g) and (h) discuss the required accounting treatment. Finally, Issues (i) – (l) elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue (a) – Can a derivative that is used to manage interest rate risk on a net basis be designated under IPSAS 29 as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Both types of designation are possible under IPSAS 29. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets, liabilities and firm commitments or as a cash flow hedge of forecast transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

In economic terms, it does not matter whether the derivative instrument is regarded as a fair value hedge or as a cash flow hedge. Under either perspective of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offset the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue (b).

To illustrate: a department of finance has the following assets and liabilities with a maturity of two years.

	Variable interest	Fixed interest
	CU	CU
Assets	60	100
Liabilities	(100)	(60)
Net	<u>(40)</u>	<u>40</u>

The entity takes out a two-year swap with a notional principal of CU40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be regarded and designated either as a fair value hedge of CU40 of the fixed rate assets or as a cash flow hedge of CU40 of the variable rate liabilities.

Issue (b) – What are the critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of a derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses for these categories are different. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of Prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the highly probable test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (IPSAS 29.98(b)). This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. If an entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. However, for that period, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. Furthermore, the fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecast cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (IPSAS 29.98(c) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument (IPSAS 29.98(b)). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecast transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecast transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems Considerations

The accounting for fair value hedges differs from that for cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective interest rate of the hedged item (IPSAS 29.99). As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the assets or liabilities being hedged in order for the entity to be able to recompute their effective interest rate, determine the subsequent amortization of the fair value adjustment to surplus or deficit, and determine the amount that should be recognized in surplus or deficit when assets are sold or liabilities extinguished (IPSAS 29.99 and IPSAS 29.103). To comply with the requirements for fair value hedge accounting, it will generally be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective interest rate of the hedged items, and amortize the changes to surplus or deficit over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecast transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognized in net assets/equity (IPSAS 29.105). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the cumulative gains and losses recognized in net assets/equity from changes in the fair value of a hedging instrument should be recognized in surplus or deficit (IPSAS 29.111 and IPSAS 29.112). For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling the changes in the cash flows of the derivative and the recognition of such changes in surplus or deficit.

The timing of the recognition in surplus or deficit can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecast transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced, each of which creates a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rates are matched with the derivative hedging instrument. IPSAS 29.111 specifies that the amounts recognized in net assets/equity should be recognized in surplus or deficit in the same period or periods during which the hedged item affects surplus or deficit.

Issue (c) – If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by IPSAS 29.98(a)?

The following would be included in the documentation.

The hedging relationship – The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.

The entity's risk management objective and strategy for undertaking the hedge – The entity's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.

The type of hedge – The hedge is documented as a cash flow hedge.

The hedged item – The hedged item is documented as a group of forecast transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for example, scheduled on a monthly basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue (e), the forecast transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The hedged risk – The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based on the same yield curve as the derivative hedging instrument.

The hedging instrument – Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecast transactions occurring in the specified future time periods designated as being hedged.

The method of assessing effectiveness – The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecast transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

Issue (d) – If the hedging relationship is designated as a cash flow hedge, how does an entity satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in IPSAS 29.98(b)?

An entity may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue (e) – If the hedging relationship is designated as a cash flow hedge, how does an entity demonstrate a high probability of the forecast transactions occurring as required by IPSAS 29.98(c)?

An entity may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecast transactions that are designated as being hedged are highly probable to occur. Such a schedule should be supported by management's stated intentions and past practice of reinvesting cash inflows and refinancing cash outflows.

For example, an entity may forecast aggregate gross cash inflows of CU100 and aggregate gross cash outflows of CU90 in a particular time period in the near future. In this case, it may wish to designate the forecast reinvestment of gross cash inflows of CU10 as the hedged item in the future time period. If more than CU10 of the forecast cash inflows are contractually specified and have low credit risk, the entity has strong evidence to support an assertion that gross cash inflows of CU10 are highly probable to occur and to support the designation of the forecast reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecast transactions occurring may also be demonstrated under other circumstances.

Issue (f) – If the hedging relationship is designated as a cash flow hedge, how does an entity assess and measure effectiveness under IPSAS 29.98(d) and IPSAS 29.98(e)?

Effectiveness is required to be measured at a minimum at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more

frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the recognition in surplus or deficit of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecast transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognized initially in net assets/equity are recognized in surplus or deficit.

Issue (g) – If the hedging relationship is designated as a cash flow hedge, how does an entity account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions in IPSAS 29.106–IPSAS 29.111, as follows:

- (a) The portion of gains and losses on hedging derivatives determined to result from effective hedges is recognized in net assets/equity whenever effectiveness is measured; and
- (b) The ineffective portion of gains and losses resulting from hedging derivatives is recognized in surplus or deficit.

IPSAS 29.111 specifies that the amounts recognized in net assets/equity should be recognized in surplus or deficit in the same period or periods during which the hedged item affects surplus or deficit. Accordingly, when the forecast transactions occur, the amounts previously recognized in net assets/equity are recognized in surplus or deficit. For example, if an interest rate swap is designated as a hedging instrument of a series of forecast cash flows, the changes in the cash flows of the swap are removed from net assets/equity and recognized in surplus or deficit in the periods when the forecast cash flows and the cash flows of the swap offset each other.

Issue (h) – If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognized in net assets/equity if the hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecast transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for example, the forecast transactions are no longer highly probable, the net cumulative gain or loss recognized in net assets/equity remains in net assets/equity until the forecast transaction occurs (IPSAS

29.112(a) and IPSAS 29.112(b)). If the hedged forecast transactions are no longer expected to occur, the net cumulative gain or loss is recognized in surplus or deficit (IPSAS 29.112(c)).

Issue (i) – IPSAS 29.84 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, does IPSAS 29.84 preclude redesignating the hedging instrument?

No. IPSAS 29.84 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity. IPSAS 29.84 does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the ineffective portion of the gain or loss on the derivative instrument is recognized immediately in surplus or deficit (IPSAS 29.106) and hedge accounting based on the previous designation of the hedge relationship cannot be continued (IPSAS 29.112). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognized in net assets/equity remaining in net assets/equity?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognized in surplus or deficit in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognized in net assets/equity are recognized in surplus or deficit in the same period or periods during which the hedged forecast transaction affects surplus or deficit (such as in the periods that interest expenses are recognized). However, if an entity expects at any time that all or a portion of a net loss recognized net assets/equity will not be recovered in one or more future periods, it shall reclassify immediately into surplus or deficit the amount that is not expected to be recovered.

Issue (k) – In the answer to Issue (c) above it was indicated that the designated hedged item is a portion of a cash flow exposure. Does IPSAS 29 permit a portion of a cash flow exposure to be designated as a hedged item?

Yes. IPSAS 29 does not specifically address a hedge of a portion of a cash flow exposure for a forecast transaction. However, IPSAS 29.90 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecast reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by IPSAS 29.92, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecast transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue (I) – In the answer to Issue (c) above it was indicated that the hedged item is documented as a group of forecast transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities and option features, how can an entity satisfy the tests in IPSAS 29.87 and IPSAS 29.93 requiring the hedged group to have similar risk characteristics?

IPSAS 29.87 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics. IPSAS 29.93 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated, and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecast transactions. For hedges of cash flow exposures relating to a group of forecast transactions, the overall exposure of the forecast transactions and the assets or liabilities that are repriced may have very different risks. The exposure from forecast transactions may differ depending on the terms that are expected as they relate to credit exposures, maturities, options and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, provided they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free or benchmark interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (i.e.,

the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (IPSAS 29.83). For example, if a portfolio of assets consists of assets rated A, BB and B, and the current market interest rates for these assets are LIBOR+20 basis points, LIBOR+40 basis points and LIBOR+60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments based on LIBOR are made to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

F.6.3 Illustrative Example of Applying the Approach in Question F.6.2

The purpose of this example is to illustrate the process of establishing, monitoring and adjusting hedge positions and of qualifying for cash flow hedge accounting in applying the approach to hedge accounting described in Question F.6.2 when an entity manages its interest rate risk on an entity-wide basis. To this end, this example identifies a methodology that allows for the use of hedge accounting and takes advantage of existing risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

The approach illustrated here reflects only one of a number of risk management processes that could be employed and could qualify for hedge accounting. Its use is not intended to suggest that other alternatives could not or should not be used. The approach being illustrated could also be applied in other circumstances (such as for cash flow hedges), for example, hedging the rollover of commercial paper financing.

Identifying, Assessing and Reducing Cash Flow Exposures

The discussion and illustrations that follow focus on the risk management activities of an entity, such as a department of finance that manages its interest rate risk by analyzing expected cash flows in a particular currency on an entity-wide basis. The cash flow analysis forms the basis for identifying the interest rate risk of the entity, entering into hedging transactions to manage the risk, assessing the effectiveness of risk management activities, and qualifying for and applying cash flow hedge accounting.

The illustrations that follow assume that an entity had the following expected future net cash flows and hedging positions outstanding in a specific currency, consisting of interest rate swaps, at the beginning of Period X0. The cash flows shown are expected

to occur at the end of the period and, therefore, create a cash flow interest exposure in the following period as a result of the reinvestment or repricing of the cash inflows or the refinancing or repricing of the cash outflows.

The illustrations assume that the entity has an ongoing interest rate risk management program. Schedule I shows the expected cash flows and hedging positions that existed at the beginning of Period X0. It is included here to provide a starting point in the analysis. It provides a basis for considering existing hedges in connection with the evaluation that occurs at the beginning of Period X1.

Schedule I End of Period: Expected Cash Flows and Hedging Positions							
<i>Quarterly period</i>	<i>X0</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Expected net cash flows		1,100	1,500	1,200	1,400	1,500	x,xxx
<i>Outstanding interest rate swaps:</i>							
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after outstanding swaps		100	500	500	700	800	x,xxx

The schedule depicts five quarterly periods. The actual analysis would extend over a period of many years, represented by the notation "...n." An entity that manages its interest rate risk on an entity-wide basis re-evaluates its cash flow exposures periodically. The frequency of the evaluation depends on the entity's risk management policy.

For the purposes of this illustration, the entity is re-evaluating its cash flow exposures at the end of Period X0. The first step in the process is the generation of forecast net cash flow exposures from existing interest-earning assets and interest-bearing liabilities, including the rollover of short-term assets and short-term liabilities. Schedule II below illustrates the forecast of net cash flow exposures. A common technique for assessing exposure to interest rates for risk management purposes is an interest rate sensitivity gap analysis showing the gap between interest rate-sensitive assets and interest rate-sensitive liabilities over different time intervals. Such an analysis could be used as a starting point for identifying cash flow exposures to interest rate risk for hedge accounting purposes.

Schedule II Forecast Net Cash Flow and Repricing Exposures							
<i>Quarterly period</i>	<i>Notes</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>n</i>
<i>(units)</i>		<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
CASH INFLOW AND REPRICING EXPOSURES – from assets							
<i>Principal and interest payments:</i>							
Long-term fixed rate	(1)	2,400	3,000	3,000	1,000	1,200	x,xxx
Short-term (roll over)	(1)(2)	1,575	1,579	1,582	1,586	1,591	x,xxx
Variable rate – principal payments	(1)	2,000	1,000	–	500	500	x,xxx
Variable rate – estimated interest	(2)	125	110	105	114	118	x,xxx
<i>Total expected cash inflows</i>		<i>6,100</i>	<i>5,689</i>	<i>4,687</i>	<i>3,200</i>	<i>3,409</i>	<i>x,xxx</i>
Variable rate asset balances	(3)	8,000	7,000	7,000	6,500	6,000	x,xxx
<i>Cash inflows and repricings</i>	(4)	<i>14,100</i>	<i>12,689</i>	<i>11,687</i>	<i>9,700</i>	<i>9,409</i>	<i>x,xxx</i>
CASH OUTFLOW AND REPRICING EXPOSURES - from liabilities							
<i>Principal and interest payments:</i>							
Long-term fixed rate	(1)	2,100	400	500	500	301	x,xxx
Short-term (roll over)	(1)(2)	735	737	738	740	742	x,xxx
Variable rate – principal payments	(1)	–	–	2,000	–	1,000	x,xxx
Variable rate – estimated interest	(2)	100	110	120	98	109	x,xxx
<i>Total expected cash outflows</i>		<i>2,935</i>	<i>1,247</i>	<i>3,358</i>	<i>1,338</i>	<i>2,152</i>	<i>x,xxx</i>
Variable rate liability balances	(3)	8,000	8,000	6,000	6,000	5,000	x,xxx
<i>Cash outflows and repricings</i>	(4)	<i>10,935</i>	<i>9,247</i>	<i>9,358</i>	<i>7,338</i>	<i>7,152</i>	<i>x,xxx</i>
<i>NET EXPOSURES</i>	(5)	<i>3,165</i>	<i>3,442</i>	<i>2,329</i>	<i>2,362</i>	<i>2,257</i>	<i>x,xxx</i>

Schedule II Forecast Net Cash Flow and Repricing Exposures

1. The cash flows are estimated using contractual terms and assumptions based on management's intentions and market factors. It is assumed that short-term assets and liabilities will continue to be rolled over in succeeding periods. Assumptions about prepayments and defaults and the withdrawal of deposits are based on market and historical data. It is assumed that principal and interest inflows and outflows will be reinvested and refinanced, respectively, at the end of each period at the then current market interest rates and share the benchmark interest rate risk to which they are exposed.
2. Forward interest rates obtained from Schedule VI are used to forecast interest payments on variable rate financial instruments and expected rollovers of short-term assets and liabilities. All forecast cash flows are associated with the specific time periods (3 months, 6 months, 9 months, and 12 months) in which they are expected to occur. For completeness, the interest cash flows resulting from reinvestments, refinancings and repricings are included in the schedule and shown gross even though only the net margin may actually be reinvested. Some entities may choose to disregard the forecast interest cash flows for risk management purposes because they may be used to absorb operating costs and any remaining amounts would not be significant enough to affect risk management decisions.
3. The cash flow forecast is adjusted to include the variable rate asset and liability balances in each period in which such variable rate asset and liability balances are repriced. The principal amounts of these assets and liabilities are not actually being paid and, therefore, do not generate a cash flow. However, since interest is computed on the principal amounts for each period based on the then current market interest rate, such principal amounts expose the entity to the same interest rate risk as if they were cash flows being reinvested or refinanced.
4. The forecast cash flow and repricing exposures that are identified in each period represent the principal amounts of cash inflows that will be reinvested or repriced and cash outflows that will be refinanced or repriced at the market interest rates that are in effect when those forecast transactions occur.
5. The net cash flow and repricing exposure is the difference between the cash inflow and repricing exposures from assets and the cash outflow and repricing exposures from liabilities. In the illustration, the entity is exposed to interest rate declines because the exposure from assets exceeds the exposure from liabilities and the excess (i.e., the net amount) will be reinvested or repriced at the current market rate and there is no offsetting refinancing or repricing of outflows.

Note that some entities may regard some portion of their non-interest bearing demand deposits as economically equivalent to long-term debt. However, these deposits do not create a cash flow exposure to interest rates and would therefore be excluded from this analysis for accounting purposes.

Schedule II Forecast net cash flow and repricing exposures provides no more than a starting point for assessing cash flow exposure to interest rates and for adjusting hedging positions. The complete analysis includes outstanding hedging positions and is shown in Schedule III Analysis of expected net exposures and hedging positions. It

compares the forecast net cash flow exposures for each period (developed in Schedule II) with existing hedging positions (obtained from Schedule I), and provides a basis for considering whether adjustment of the hedging relationship should be made.

Schedule III Analysis of Expected Net Exposures and Hedging Positions						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Net cash flow and repricing exposures (Schedule II)	3,165	3,442	2,329	2,362	2,257	x,xxx
<i>Pre-existing swaps outstanding:</i>						
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
<i>Net exposure after pre-existing swaps</i>	<i>2,165</i>	<i>2,442</i>	<i>1,629</i>	<i>1,662</i>	<i>1,557</i>	<i>x,xxx</i>
<i>Transactions to adjust outstanding hedging positions:</i>						
Receive-fixed, pay variable swap 1 (notional amount, 10-years)	2,000	2,000	2,000	2,000	2,000	x,xxx
Pay-fixed, receive-variable swap 2 (notional amount, 3-years)			(1,000)	(1,000)	(1,000)	x,xxx
Swaps ...X						x,xxx
<i>Unhedged cash flow and repricing exposure</i>	<i>165</i>	<i>442</i>	<i>629</i>	<i>662</i>	<i>557</i>	<i>x,xxx</i>

The notional amounts of the interest rate swaps that are outstanding at the analysis date are included in each of the periods in which the interest rate swaps are outstanding to illustrate the impact of the outstanding interest rate swaps on the identified cash flow exposures. The notional amounts of the outstanding interest rate swaps are included in each period because interest is computed on the notional amounts each period, and the variable rate components of the outstanding swaps are repriced to the current market rate quarterly. The notional amounts create an exposure to interest rates that in part is similar to the principal balances of variable rate assets and variable rate liabilities.

The exposure that remains after considering the existing positions is then evaluated to determine the extent to which adjustments of existing hedging positions are necessary. The bottom portion of Schedule III shows the beginning of Period X1 using interest rate swap transactions to reduce the net exposures further to within the tolerance levels established under the entity's risk management policy.

Note that in the illustration, the cash flow exposure is not entirely eliminated. Many entities do not fully eliminate risk but rather reduce it to within some tolerable limit.

Various types of derivative instruments could be used to manage the cash flow exposure to interest rate risk identified in the schedule of forecast net cash flows (Schedule II). However, for the purpose of the illustration, it is assumed that interest rate swaps are

used for all hedging activities. It is also assumed that in periods in which interest rate swaps should be reduced, rather than terminating some of the outstanding interest rate swap positions, a new swap with the opposite return characteristics is added to the portfolio.

In the illustration in Schedule III above, swap 1, a receive-fixed, pay-variable swap, is used to reduce the net exposure in Periods X1 and X2. Since it is a 10-year swap, it also reduces exposures identified in other future periods not shown. However, it has the effect of creating an over-hedged position in Periods X3–X5. Swap 2, a forward starting pay-fixed, receive-variable interest rate swap, is used to reduce the notional amount of the outstanding receive-fixed, pay-variable interest rate swaps in Periods X3–X5 and thereby reduce the over-hedged positions.

It also is noted that in many situations, no adjustment or only a single adjustment of the outstanding hedging position is necessary to bring the exposure to within an acceptable limit. However, when the entity's risk management policy specifies a very low tolerance of risk a greater number of adjustments to the hedging positions over the forecast period would be needed to further reduce any remaining risk.

To the extent that some of the interest rate swaps fully offset other interest rate swaps that have been entered into for hedging purposes, it is not necessary to include them in a designated hedging relationship for hedge accounting purposes. These offsetting positions can be combined, de-designated as hedging instruments, if necessary, and reclassified for accounting purposes from the hedging portfolio to the trading portfolio. This procedure limits the extent to which the gross swaps must continue to be designated and tracked in a hedging relationship for accounting purposes. For the purposes of this illustration it is assumed that CU500 of the pay-fixed, receive-variable interest rate swaps fully offset CU500 of the receive-fixed, pay-variable interest rate swaps at the beginning of Period X1 and for Periods X1–X5, and are de-designated as hedging instruments and reclassified to the trading account.

After reflecting these offsetting positions, the remaining gross interest rate swap positions from Schedule III are shown in Schedule IV as follows.

Schedule IV Interest Rate Swaps Designated as Hedges						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Receive-fixed, pay-variable (notional amounts)	3,500	3,500	2,700	2,700	2,700	x,xxx
Pay-fixed, receive-variable (notional amounts)	(500)	(500)	(1,000)	(1,000)	(1,000)	x,xxx
<i>Net outstanding swaps positions</i>	<i>3,000</i>	<i>3,000</i>	<i>1,700</i>	<i>1,700</i>	<i>1,700</i>	<i>x,xxx</i>

For the purposes of the illustrations, it is assumed that swap 2, entered into at the beginning of Period X1, only partially offsets another swap being accounted for as a hedge and therefore continues to be designated as a hedging instrument.

*Hedge Accounting Considerations*Illustrating the Designation of the Hedging Relationship

The discussion and illustrations thus far have focused primarily on economic and risk management considerations relating to the identification of risk in future periods and the adjustment of that risk using interest rate swaps. These activities form the basis for designating a hedging relationship for accounting purposes.

The examples in IPSAS 29 focus primarily on hedging relationships involving a single hedged item and a single hedging instrument, but there is little discussion and guidance on portfolio hedging relationships for cash flow hedges when risk is being managed centrally. In this illustration, the general principles are applied to hedging relationships involving a component of risk in a portfolio having multiple risks from multiple transactions or positions.

Although designation is necessary to achieve hedge accounting, the way in which the designation is described also affects the extent to which the hedging relationship is judged to be effective for accounting purposes and the extent to which the entity's existing system for managing risk will be required to be modified to track hedging activities for accounting purposes. Accordingly, an entity may wish to designate the hedging relationship in a manner that avoids unnecessary systems changes by taking advantage of the information already generated by the risk management system and avoids unnecessary bookkeeping and tracking. In designating hedging relationships, the entity may also consider the extent to which ineffectiveness is expected to be recognized for accounting purposes under alternative designations.

The designation of the hedging relationship needs to specify various matters. These are illustrated and discussed here from the perspective of the hedge of the interest rate risk associated with the cash inflows, but the guidance can also be applied to the hedge of the risk associated with the cash outflows. It is fairly obvious that only a portion of the gross exposures relating to the cash inflows is being hedged by the interest rate swaps. Schedule V The general hedging relationship illustrates the designation of the portion of the gross reinvestment risk exposures identified in Schedule II as being hedged by the interest rate swaps.

Schedule V The General Hedging Relationship						
<i>Quarterly period</i>	<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
<i>(units)</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>	<i>CU</i>
Cash inflow repricing exposure (Schedule II)	14,100	12,689	11,687	9,700	9,409	x,xxx
Receive-fixed, pay-variable swaps (Schedule IV)	3,500	3,500	2,700	2,700	2,700	x,xxx
<i>Hedged exposure percentage</i>	<i>24.8%</i>	<i>27.6%</i>	<i>23.1%</i>	<i>27.8%</i>	<i>28.7%</i>	<i>xx.x%</i>

The hedged exposure percentage is computed as the ratio of the notional amount of the receive-fixed, pay-variable swaps that are outstanding divided by the gross exposure. Note that in Schedule V there are sufficient levels of forecast reinvestments in each

period to offset more than the notional amount of the receive-fixed, pay-variable swaps and satisfy the accounting requirement that the forecast transaction is highly probable.

It is not as obvious, however, how the interest rate swaps are specifically related to the cash flow interest risks designated as being hedged and how the interest rate swaps are effective in reducing that risk. The more specific designation is illustrated in Schedule VI The specific hedging relationship below. It provides a meaningful way of depicting the more complicated narrative designation of the hedge by focusing on the hedging objective to eliminate the cash flow variability associated with future changes in interest rates and to obtain an interest rate equal to the fixed rate inherent in the term structure of interest rates that exists at the commencement of the hedge.

The expected interest from the reinvestment of the cash inflows and repricings of the assets is computed by multiplying the gross amounts exposed by the forward rate for the period. For example, the gross exposure for Period X2 of CU14,100 is multiplied by the forward rate for Periods X2–X5 of 5.50 percent, 6.00 percent, 6.50 percent and 7.25 percent, respectively, to compute the expected interest for those quarterly periods based on the current term structure of interest rates. The hedged expected interest is computed by multiplying the expected interest for the applicable three-month period by the hedged exposure percentage.

Schedule VI The Specific Hedging Relationship								
<i>Term structure of interest rates</i>								
<i>Quarterly period</i>			<i>X1</i>	<i>X2</i>	<i>X3</i>	<i>X4</i>	<i>X5</i>	<i>...n</i>
Spot rates			5.00%	5.25%	5.50%	5.75%	6.05%	x.xx%
Forward rates ^(a)			5.00%	5.50%	6.00%	6.50%	7.25%	x.xx%
<i>Cash flow exposures and expected interest amounts</i>								
Repricing period	Time to forecast transaction	Gross amounts exposed	CU	CU	CU	CU	CU	CU
2	3 months	14,100	→	194	212	229	256	
3	6 months	12,689			190	206	230	xxx
4	9 months	11,687				190	212	xxx
5	12 months	9,700					176	xxx
6	15 months	9,409						xxx
Hedged percentage (Schedule V) in the previous period				24.8%	27.6%	23.1%	27.8%	xx.x%
Hedged expected interest				48	52	44	49	xx
(a) The forward interest rates are computed from the spot interest rates and rounded for the purposes of the presentation. Computations that are based on the forward interest rates are made based on the actual computed forward rate and then rounded for the purposes of the presentation.								

It does not matter whether the gross amount exposed is reinvested in long-term fixed rate debt or variable rate debt, or in short-term debt that is rolled over in each subsequent period. The exposure to changes in the forward interest rate is the same. For example, if the CU14,100 is reinvested at a fixed rate at the beginning of Period X2 for six months, it will be reinvested at 5.75 percent. The expected interest is based on the forward interest rates for Period X2 of 5.50 percent and for Period X3 of 6.00 percent, equal to a blended rate of 5.75 percent $(1.055 \times 1.060)^{0.5}$, which is the Period X2 spot rate for the next six months.

However, only the expected interest from the reinvestment of the cash inflows or repricing of the gross amount for the first three-month period after the forecast transaction occurs is designated as being hedged. The expected interest being hedged is represented by the shaded cells. The exposure for the subsequent periods is not hedged. In the example, the portion of the interest rate exposure being hedged is the forward rate of 5.50 percent for Period X2. In order to assess hedge effectiveness and compute actual hedge ineffectiveness on an ongoing basis, the entity may use the information on hedged interest cash inflows in Schedule VI and compare it with updated estimates of expected interest cash inflows (e.g., in a table that looks like Schedule II). As long as expected interest cash inflows exceed hedged interest cash inflows, the entity may compare the cumulative change in the fair value of the hedged cash inflows with the cumulative change in the fair value of the hedging instrument to compute actual hedge effectiveness. If there are insufficient expected interest cash inflows, there will be ineffectiveness. It is measured by comparing the cumulative change in the fair value of the expected interest cash flows to the extent they are less than the hedged cash flows with the cumulative change in the fair value of the hedging instrument.

Describing the Designation of the Hedging Relationship

As mentioned previously, there are various matters that should be specified in the designation of the hedging relationship that complicate the description of the designation but are necessary to limit ineffectiveness to be recognized for accounting purposes and to avoid unnecessary systems changes and bookkeeping. The example that follows describes the designation more fully and identifies additional aspects of the designation not apparent from the previous illustrations.

Example Designation*Hedging Objective*

The hedging objective is to eliminate the risk of interest rate fluctuations over the hedging period, which is the life of the interest rate swap, and in effect obtain a fixed interest rate during this period that is equal to the fixed interest rate on the interest rate swap.

Type of Hedge

Cash flow hedge.

Hedging Instrument

The receive-fixed, pay-variable swaps are designated as the hedging instrument. They hedge the cash flow exposure to interest rate risk.

Each repricing of the swap hedges a three-month portion of the interest cash inflows that results from:

- The forecast reinvestment or repricing of the principal amounts shown in Schedule V.
- Unrelated investments or repricings that occur after the repricing dates on the swap over its life and involve different borrowers or lenders.

The Hedged Item—General

The hedged item is a portion of the gross interest cash inflows that will result from the reinvestment or repricing of the cash flows identified in Schedule V and are expected to occur within the periods shown on such schedule. The portion of the interest cash inflow that is being hedged has three components:

- The principal component giving rise to the interest cash inflow and the period in which it occurs;
- The interest rate component; and
- The time component or period covered by the hedge.

The Hedged Item—The Principal Component

The portion of the interest cash inflows being hedged is the amount that results from the first portion of the principal amounts being invested or repriced in each period:

- That is equal to the sum of the notional amounts of the received-fixed, pay-variable interest rate swaps that are designated as hedging instruments and outstanding in the period of the reinvestment or repricing, and
- That corresponds to the first principal amounts of cash flow exposures that are invested or repriced at or after the repricing dates of the interest rate swaps.

The Hedged Item—The Interest Rate Component

The portion of the interest rate change that is being hedged is the change in both of the following:

- The credit component of the interest rate being paid on the principal amount invested or repriced that is equal to the credit risk inherent in the interest rate swap. It is that portion of the interest rate on the investment that is equal to the interest index of the interest rate swap, such as LIBOR; and
- The yield curve component of the interest rate that is equal to the repricing period on the interest rate swap designated as the hedging instrument.

Example Designation*The Hedged Item—The Hedged Period*

The period of the exposure to interest rate changes on the portion of the cash flow exposures being hedged is:

- The period from the designation date to the repricing date of the interest rate swap that occurs within the quarterly period in which, but not before, the forecast transactions occur; and
- Its effects for the period after the forecast transactions occur equal to the repricing interval of the interest rate swap.

It is important to recognize that the swaps are not hedging the cash flow risk for a single investment over its entire life. The swaps are designated as hedging the cash flow risk from different principal investments and repricings that are made in each repricing period of the swaps over their entire term. The swaps hedge only the interest accruals that occur in the first period following the reinvestment. They are hedging the cash flow impact resulting from a change in interest rates that occurs up to the repricing of the swap. The exposure to changes in rates for the period from the repricing of the swap to the date of the hedged reinvestment of cash inflows or repricing of variable rate assets is not hedged. When the swap is repriced, the interest rate on the swap is fixed until the next repricing date and the accrual of the net swap settlements is determined. Any changes in interest rates after that date that affect the amount of the interest cash inflow are no longer hedged for accounting purposes.

*Designation Objectives*Systems Considerations

Many of the tracking and bookkeeping requirements are eliminated by designating each repricing of an interest rate swap as hedging the cash flow risk from forecast reinvestments of cash inflows and repricings of variable rate assets for only a portion of the lives of the related assets. Much tracking and bookkeeping would be necessary if the swaps were instead designated as hedging the cash flow risk from forecast principal investments and repricings of variable rate assets over the entire lives of these assets.

This type of designation avoids keeping track of gains and losses recognized in net assets/equity after the forecast transactions occur (IPSAS 29.108 and IPSAS 29.109) because the portion of the cash flow risk being hedged is that portion that will be recognized in surplus or deficit in the period immediately following the forecast transactions that corresponds with the periodic net cash settlements on the swap. If the hedge were to cover the entire life of the assets being acquired, it would be necessary to associate a specific interest rate swap with the asset being acquired. If a forecast transaction is the acquisition of a fixed rate instrument, the fair value of the swap that hedged that transaction would be recognized in surplus or deficit to adjust the interest revenue on the asset when the interest revenue is recognized. The swap would then have to be terminated or redesignated in another hedging relationship. If a forecast transaction is the acquisition of a variable rate asset, the swap would continue in the

hedging relationship but it would have to be tracked back to the asset acquired so that any fair value amounts on the swap recognized in net assets/equity could be recognized in surplus or deficit upon the subsequent sale of the asset.

It also avoids the necessity of associating with variable rate assets any portion of the fair value of the swaps that is recognized in net assets/equity. Accordingly, there is no portion of the fair value of the swap that is recognized in net assets/equity that should be recognized in surplus or deficit when a forecast transaction occurs or upon the sale of a variable rate asset.

This type of designation also permits flexibility in deciding how to reinvest cash flows when they occur. Since the hedged risk relates only to a single period that corresponds with the repricing period of the interest rate swap designated as the hedging instrument, it is not necessary to determine at the designation date whether the cash flows will be reinvested in fixed rate or variable rate assets or to specify at the date of designation the life of the asset to be acquired.

Effectiveness Considerations

Ineffectiveness is greatly reduced by designating a specific portion of the cash flow exposure as being hedged.

- Ineffectiveness due to credit differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the cash flow risk being hedged as the risk attributable to changes in the interest rates that correspond with the rates inherent in the swap, such as the AA rate curve. This type of designation prevents changes resulting from changes in credit spreads from being considered as ineffectiveness.
- Ineffectiveness due to duration differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the interest rate risk being hedged as the risk relating to changes in the portion of the yield curve that corresponds with the period in which the variable rate leg of the interest rate swap is repriced.
- Ineffectiveness due to interest rate changes that occur between the repricing date of the interest rate swap and the date of the forecast transactions is eliminated by simply not hedging that period of time. The period from the repricing of the swap and the occurrence of the forecast transactions in the period immediately following the repricing of the swap is left unhedged. Therefore, the difference in dates does not result in ineffectiveness.

Accounting Considerations

The ability to qualify for hedge accounting using the methodology described here is founded on provisions in IPSAS 29 and on interpretations of its requirements. Some of those are described in the answer to Question F.6.2 Hedge Accounting Considerations when Interest Rate Risk is Managed on a Net Basis. Some additional and supporting provisions and interpretations are identified below.

Hedging a Portion of the Risk Exposure

The ability to identify and hedge only a portion of the cash flow risk exposure resulting from the reinvestment of cash flows or repricing of variable rate instruments is found in IPSAS 29.90 as interpreted in the answers to Questions F.6.2 Issue (k) and F.2.17 Partial Term Hedging.

Hedging Multiple Risks with a Single Instrument

The ability to designate a single interest rate swap as a hedge of the cash flow exposure to interest rates resulting from various reinvestments of cash inflows or repricings of variable rate assets that occur over the life of the swap is founded on IPSAS 29.85 as interpreted in the answer to Question F.1.12 Hedges of More Than One Type of Risk.

Hedging Similar Risks in a Portfolio

The ability to specify the forecast transaction being hedged as a portion of the cash flow exposure to interest rates for a portion of the duration of the investment that gives rise to the interest payment without specifying at the designation date the expected life of the instrument and whether it pays a fixed or variable rate is founded on the answer to Question F.6.2 Issue (l), which specifies that the items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged.

Hedge Terminations

The ability to de-designate the forecast transaction (the cash flow exposure on an investment or repricing that will occur after the repricing date of the swap) as being hedged is provided for in IPSAS 29.112 dealing with hedge terminations. While a portion of the forecast transaction is no longer being hedged, the interest rate swap is not de-designated, and it continues to be a hedging instrument for the remaining transactions in the series that have not occurred. For example, assume that an interest rate swap having a remaining life of one year has been designated as hedging a series of three quarterly reinvestments of cash flows. The next forecast cash flow reinvestment occurs in three months. When the interest rate swap is repriced in three months at the then current variable rate, the fixed rate and the variable rate on the interest rate swap become known and no longer provide hedge protection for the next three months. If the next forecast transaction does not occur until three months and ten days, the ten-day period that remains after the repricing of the interest rate swap is not hedged.

F.6.4 **Hedge Accounting: Premium or Discount on Forward Exchange Contract**

A forward exchange contract is designated as a hedging instrument, for example, in a hedge of a net investment in a foreign operation. Is it permitted to amortize the discount or premium on the forward exchange contract to surplus or deficit over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortized to surplus or deficit under IPSAS 29. Derivatives are always measured at fair value in

the statement of financial position. The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognized in surplus or deficit unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a foreign operation, in which case the effective portion of the gain or loss is recognized in net assets/equity. In that case, the amounts recognized in net assets/equity are recognized in surplus or deficit when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under IPSAS 29.84(b), the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are recognized in surplus or deficit.

F.6.5 **IPSAS 29 and IPSAS 4 Fair Value Hedge of Asset Measured at Cost**

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does IPSAS 29 require the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions in IPSAS 29.98 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

Section G: Other

G.1 *Disclosure of Changes in Fair Value*

IPSAS 29 requires financial assets classified as available-for-sale (AFS) and financial assets and financial liabilities at fair value through surplus or deficit to be remeasured to fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through surplus or deficit are recognized in surplus or deficit, and fair value changes for AFS assets are recognized in net assets/equity. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

IPSAS 30.23 requires items of revenue, expense and gains and losses to be disclosed. This disclosure requirement encompasses items of revenue, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of fair value changes, distinguishing between changes that are recognized in surplus or deficit and changes that are recognized in net assets/equity. Further breakdown is provided of changes that relate to:

- (a) AFS assets, showing separately the amount of gain or loss recognized in net assets/equity during the period and the amount that was recognized in surplus for deficit for the period;
- (b) Financial assets or financial liabilities at fair value through surplus or deficit, showing separately those fair value changes on financial assets or financial liabilities (i) designated as such upon initial recognition and (ii) classified as held for trading in accordance with IPSAS 29; and
- (c) Hedging instruments.

IPSAS 30 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that in accordance with IPSAS 29 it categorizes as held for trading, but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, IPSAS 30.10 requires disclosure of the carrying amounts of financial assets or financial liabilities at fair value through surplus or deficit, showing separately: (i) those designated as such upon initial recognition and (ii) those held for trading in accordance with IPSAS 29.

G.2 *IPSAS 29 and IPSAS 2 Hedge Accounting: Statements of Cash Flows*

How should cash flows arising from hedging instruments be classified in statements of cash flows?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in IPSAS 2 has not been updated to reflect IPSAS 29, the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments under IPSAS 29.

Illustrative Examples

These examples accompany, but are not part of, IPSAS 29.

Hedging Interest Rate Risk for a Portfolio of Assets and Liabilities

- IE1. On January 1, 20X1 Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.
- IE2. For risk management purposes, Entity A analyzes the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (i.e., it has 60 separate monthly time periods).⁵ The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.
- IE3. This example deals only with the repricing time period expiring in three months' time, i.e., the time period maturing on March 31, 20X1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of CU100 million and liabilities of CU80 million into this time period. All of the liabilities are repayable on demand.
- IE4. Entity A decides, for risk management purposes, to hedge the net position of CU20 million and accordingly enters into an interest rate swap⁶ on January 1, 20X1, to pay a fixed rate and receive London Interbank Offered Rate (LIBOR), with a notional principal amount of CU20 million and a fixed life of three months.
- IE5. This example makes the following simplifying assumptions:
- (a) The coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;
 - (b) The coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and

⁵ In this example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

⁶ This example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

- (c) The interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap).

- IE6. It is also assumed that Entity A tests effectiveness on a monthly basis.
- IE7. The fair value of an equivalent non-prepayable asset of CU20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows:

	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
Fair value (asset) (CU)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

- IE8. The fair value of the swap at various times during the period of the hedge is as follows:

	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb-28, 20X1	Mar 31, 20X1
Fair value (liability) (CU)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting Treatment

- IE9. On January 1, 20X1, Entity A designates as the hedged item an amount of CU20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (i.e., the CU20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 98(d) and AG162 of the Standard.
- IE10. Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

End of Month 1 (January 31, 20X1)

- IE11. On January 31, 20X1 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as CU96 million.

IE12. The fair value of the designated interest rate swap with a notional principal of CU20 million is (CU47,408)⁷ (the swap is a liability).

IE13. Entity A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows.

- (a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 percent (CU20 million ÷ CU100 million).
- (b) Second, it applies this percentage (20 percent) to its revised estimate of the amount in that time period (CU96 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU19.2 million.
- (c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU19.2 million) that is attributable to changes in LIBOR. This is CU45,511 (CU47,408⁸ × (CU19.2 million ÷ CU20 million)).

IE14. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU172,097	
	Cr	Surplus or deficit (interest revenue) ⁹	CU172,097

To recognize the interest received on the hedged amount (CU19.2 million).

Dr	Surplus or deficit (interest expense)	CU179,268	
	Cr	Surplus or deficit (interest revenue)	CU179,268
	Cr	Cash	Nil

To recognize the interest received and paid on the swap designated as the hedging instrument.

Dr	Surplus or deficit (loss)	CU47,408	
	Cr	Derivative liability	CU47,408

To recognize the change in the fair value of the swap.

Dr	Separate line item in the statement of financial position	CU45,511	
	Cr	Surplus or deficit (gain)	CU45,511

To recognize the change in the fair value of the hedged amount.

⁷ See paragraph IE8.

⁸ i.e., CU20,047,408 – CU 20,000,000, see paragraph IE7.

⁹ This example does not show how amounts of interest revenue and interest expense are calculated.

- IE15. The net result on surplus or deficit (excluding interest revenue and interest expense) is to recognize a loss of (CU1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

Beginning of Month 2

- IE16. On February 1, 20X1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold 81/3 percent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.
- IE17. On this basis, Entity A computes that it has sold 81/3 percent of the assets allocated to the three-month time period, i.e., CU8 million (81/3 percent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.¹⁰ On derecognition of the assets, Entity A also removes from the separate line item in the statement of financial position an amount that represents the change in the fair value of the hedged assets that it has now sold. This is 81/3 percent of the total line item balance of CU45,511, i.e., CU3,793.
- IE18. Entity A makes the following accounting entries to recognize the sale of the asset and the removal of part of the balance in the separate line item in the statement of financial position:

Dr	Cash	CU8,018,400	
	Cr	Asset	CU8,000,000
	Cr	Separate line item in the statement of financial position	CU3,793
	Cr	Surplus or deficit (gain)	CU14,607

To recognize the sale of the asset at fair value and to recognize a gain on sale

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate, no ineffectiveness arises.

- IE19. Entity A now has CU88 million of assets and CU80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now CU8 million and, accordingly, it designates CU8 million as the hedged amount.

¹⁰ The amount realized on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in IE7.

- IE20. Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument CU8 million or 40 percent of the notional amount of the original swap with a remaining life of two months and a fair value of CU18,963.¹¹ It also complies with the other designation requirements in paragraphs 98(a) and AG162 of the Standard. The CU12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognized in surplus or deficit, or is designated as the hedging instrument in a different hedge.¹²
- IE21. As at February 1, 20X1 and after accounting for the sale of assets, the separate line item in the statement of financial position is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6¹³ million of assets. However, as at February 1, 20X1, Entity A is hedging only CU8 million of assets that have a cumulative change in fair value of CU18,963.¹⁴ The remaining separate line item in the statement of financial position of CU22,755¹⁵ relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortizes this amount over the remaining life of the time period, i.e., it amortizes CU22,755 over two months.
- IE22. Entity A determines that it is not practicable to use a method of amortization based on a recalculated effective yield and hence uses a straight-line method.

End of Month 2 (February 28, 20X1)

- IE23. On February 28, 20X1 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of CU8 million is (CU9,518)¹⁶ (the swap is a liability). Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at February 28, 20X1 as CU8,009,518.¹⁷
- IE24. Entity A makes the following accounting entries relating to the hedge in this time period:

¹¹ CU47,408 × 40 percent.

¹² The entity could instead enter into an offsetting swap with a notional principle of CU12 million to adjust its position and designate as the hedging instrument all CU20 million of the existing swap and all CU12 million of the new offsetting swap.

¹³ CU19.2 million – (8⅓ × CU19.2 million).

¹⁴ CU41,718 × (CU8 million/CU17.6 million).

¹⁵ CU41,718 – CU18,963.

¹⁶ CU23,795 [see paragraph IE8] × (CU8 million/CU20 million).

¹⁷ CU20,023,795 [see paragraph IE7] × (CU8 million/CU20 million).

Dr	Cash	CU71,707	
	Cr	Surplus or deficit (interest revenue)	CU71,707

To recognize the interest received on the hedged amount (CU8 million).

Dr	Surplus or deficit (interest expense)	CU71,707	
	Cr	Surplus or deficit(interest revenue)	CU62,115
	Cr	Cash	CU9,592

To recognize the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,445	
	Cr	Surplus or deficit (gain)	CU9,445

To recognize the change in the fair value of the portion of the swap designated as the hedging instrument (CU8 million) (CU9,518 – CU18,963).

Dr	Surplus or deficit (loss)	CU9,445	
	Cr	Separate line item in the statement of financial position	CU9,445

To recognize the change in the fair value of the hedged amount (CU8,009,518 – CU8,018,963).

IE25. The net effect on surplus or deficit (excluding interest revenue and interest expense) is nil reflecting that the hedge is fully effective.

IE26. Entity A makes the following accounting entry to amortize the line item balance for this time period:

Dr	Surplus or deficit (loss)	CU11,378	
	Cr	Separate line item in the statement of financial position	CU11,378 (a)

To recognize the amortization charge for the period.

(a) $CU22,755 \div 2$

End of Month 3

IE27. During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On March 31, 20X1 the assets and the swap mature and all balances are recognized in surplus or deficit.

IE28. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU8,071,707	
	Cr	Asset (statement of financial position)	CU8,000,000
	Cr	Surplus or deficit (interest revenue)	CU71,707

To recognize the interest and cash received on maturity of the hedged amount (CU8 million).

Dr	Surplus or deficit (interest expense)	CU71,707	
	Cr	Surplus or deficit (interest-revenue)	CU62,115
	Cr	Cash	CU9,592

To recognize the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,518	
	Cr	Surplus or deficit (gain)	CU9,518

To recognize the expiry of the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Surplus or deficit (loss)	CU9,518	
	Cr	Separate line item in the statement of financial position	CU9,518

To remove the remaining line item balance on expiry of the time period.

IE29. The net effect on surplus or deficit (excluding interest revenue and interest expense) is nil reflecting that the hedge is fully effective.

IE30. Entity A makes the following accounting entry to amortize the line item balance for this time period:

Dr	Surplus or deficit (loss)	CU11,377	
	Cr	Separate line item in the statement of financial position	CU11,377 ^(a)

To recognize the amortization charge for the period.

(a) $CU22,755 \div 2$

Summary

IE31. The tables below summarize:

- (a) Changes in the separate line item in the statement of financial position;
- (b) The fair value of the derivative;
- (c) The surplus or deficit effect of the hedge for the entire three-month period of the hedge; and
- (d) Interest revenue and interest expense relating to the amount designated as hedged.

Description	Jan 1, 20X1	Jan 31, 20X1	Feb 1, 20X1	Feb 28, 20X1	Mar 31, 20X1
	CU	CU	CU	CU	CU
Amount of asset hedged	20,000,000	19,200,000	8,000,000	8,000,000	8,000,000

(a) Changes in the separate line item in the statement of financial position

Brought forward:

Balance to be amortized	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortization	Nil	Nil	Nil	(11,378)	(11,377)

Carried forward:

Balance to be amortized	Nil	Nil	22,755	11,377	Nil
Remaining balance	Nil	45,511	18,963	9,518	Nil

(b) The fair value of the derivative

CU20,000,000	Nil	47,408	—	—	—
CU12,000,000	Nil	—	28,445	No longer designated as the hedging instrument.	
CU8,000,000	Nil	—	18,963	9,518	Nil
Total	Nil	47,408	47,408	9,518	Nil

(c) Effect of the hedge on surplus or deficit

Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	Nil	(1,897)	N/A	Nil	Nil
Amortization	Nil	Nil	N/A	(11,378)	(11,377)

In addition, there is a gain on sale of assets of CU14,607 at February 1, 20X1.

(d) Interest revenue and interest expense relating to the amount designated as hedged**Interest revenue**

— on the asset	Nil	172,097	N/A	71,707	71,707
— on the swap	Nil	179,268	N/A	62,115	62,115

Interest expense

— on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)
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Disposal of a Foreign Operation

- IE32. This example illustrates the application of paragraphs C12 and C13 of Appendix C in connection with the amount recognized in surplus or deficit on the disposal of a foreign operation.

Background

- IE33. This example assumes the economic entity structure set out in the application guidance and that Entity D used a USD borrowing in Entity A to hedge the EUR/USD risk of the net investment in Entity C in Entity D's consolidated financial statements. Entity D uses the step-by-step method of consolidation. Assume the hedge was fully effective and the full USD/EUR accumulated change in the value of the hedging instrument before disposal of Entity C is €24 million (gain). This is matched exactly by the fall in value of the net investment in Entity C, when measured against the functional currency of Entity D (euro).
- IE34. If the direct method of consolidation is used, the fall in the value of Entity D's net investment in Entity C of €24 million would be reflected totally in the foreign currency translation reserve relating to Entity C in Entity D's consolidated financial statements. However, because Entity D uses the step-by-step method, this fall in the net investment value in Entity C of €24 million would be reflected both in Entity B's foreign currency translation reserve relating to Entity C and in Entity D's foreign currency translation reserve relating to Entity B.
- IE35. The aggregate amount recognized in the foreign currency translation reserve in respect of Entities B and C is not affected by the consolidation method. Assume that using the direct method of consolidation, the foreign currency translation reserves for Entities B and C in Entity D's consolidated financial statements are €62 million gain and €24 million loss respectively; using the step-by-step method of consolidation those amounts are €49 million gain and €11 million loss respectively.

Reclassification

- IE36. When the investment in Entity C is disposed of, IPSAS 29 requires the full €24 million gain on the hedging instrument to be recognized in surplus or deficit. Using the step-by-step method, the amount to be recognized in surplus or deficit in respect of the net investment in Entity C would be only €11 million loss. Entity D could adjust the foreign currency translation reserves of both Entities B and C by €13 million in order to match the amounts reclassified in respect of the hedging instrument and the net investment as would have been the case if the direct method of consolidation had been used, if that was its accounting policy. An entity that had not hedged its net investment could make the same reclassification.

Receipt of a Concessionary Loan

IE37. A local authority receives loan funding to the value of CU5 million from an international development agency to build primary healthcare clinics over a period of 5 years. The agreement stipulates that loan should be repaid over the 5 year period as follows:

Year 1: no capital repayments

Year 2: 10% of the capital

Year 3: 20% of the capital

Year 4: 30% of the capital

Year 5: 40% of the capital

Interest is paid annually in arrears, at a rate of 5% per annum on the outstanding balance of the loan. A market related rate of interest for a similar transaction is 10%.

IE38. The entity has received a concessionary loan of CU5 million, which will be repaid at 5% below the current market interest rate. The difference between the proceeds of the loan and the present value of the contractual payments in terms of the loan agreement, discounted using the market related rate of interest, is recognized as non-exchange revenue.

IE39. The journal entries to account for the concessionary loan are as follows:

- On initial recognition, the entity recognizes the following (assuming that the entity subsequently measures concessionary loan at amortized cost):

Dr	Bank	5,000,000	
	Cr	Loan (refer to Table 2 below)	4,215,450
	Cr	Liability or non-exchange revenue	784,550

Recognition of the receipt of the loan at fair value

IPSAS 23 is considered in recognizing either a liability or revenue for the off-market portion of the loan. Paragraph 1G54 of that Standard provides journal entries for the recognition and measurement of the off-market portion of the loan deemed to be non-exchange revenue.

- Year 1: The entity recognizes the following:

Dr	Interest (refer to Table 3 below)	421,545	
	Cr	Loan	421,545

Recognition of interest using the effective interest method (CU4,215,450 × 10%)

Dr	Loan (refer to Table 1 below)	250,000	
	Cr	Bank	250,000

Recognition of interest paid on outstanding balance (CU5m × 5%)

3. Year 2: The entity recognizes the following:

Dr	Interest	438,700	
	Cr Loan		438,700

Recognition of interest using the effective interest method (CU4,386,995 × 10%)

Dr	Loan	750,000	
	Cr Bank		750,000

Recognition of interest paid on outstanding balance (CU5m × 5% + CU500,000 capital repaid)

4. Year 3: The entity recognizes the following:

Dr	Interest	407,569	
	Cr Loan		407,569

Recognition of interest using the effective interest method (CU4,075,695 × 10%)

Dr	Loan	1,225,000	
	Cr Bank		1,225,000

Recognition of interest paid on outstanding balance (CU4.5m × 5% + CU1m capital repaid)

5. Year 4: The entity recognizes the following:

Dr	Interest	325,826	
	Cr Loan		325,826

Recognition of interest using the effective interest method (CU 3,258,264 × 10%)

Dr	Loan	1,675,000	
	Cr Bank		1,675,000

Recognition of interest paid on outstanding balance (CU3.5m × 5% + CU1.5m capital repaid)

6. Year 5: The entity recognizes the following:

Dr	Interest	190,909	
	Cr Loan		190,909

Recognition of interest using the effective interest method (CU1,909,091 × 10%)

Dr	Loan	2,100,000	
	Cr Bank		2,100,000

Recognition of interest paid on outstanding balance (CU2m × 5% + CU2m capital repaid)

*Calculations:***Table 1: Amortization Schedule (Using Contractual Repayments at 5% Interest)**

	Year 0 CU	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital	5,000,000	5,000,000	5,000,000	4,500,000	3,500,000	2,000,000
Interest	–	250,000	250,000	225,000	175,000	100,000
Payments	–	(250,000)	(750,000)	(1,225,000)	(1,675,000)	(2,100,000)
Balance	5,000,000	5,000,000	4,500,000	3,500,000	2,000,000	–

Table 2: Discounting Contractual Cash Flows (Based on a Market Rate of 10%)

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital balance	5,000,000	4,500,000	3,500,000	2,000,000	–
Interest payable	250,000	250,000	225,000	175,000	100,000
Total payments (capital and interest)	250,000	750,000	1,225,000	1,675,000	2,100,000
Present value of payments	227,272	619,835	920,360	1,144,048	1,303,935
Total present value of payments					4,215,450
Proceeds received					5,000,000
Less: Present value of outflows (fair value of loan on initial recognition)					4,215,450
Off-market portion of loan to be recognized as non-exchange revenue					784,550

Table 3: Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU
Capital	4,215,450	4,386,995	4,075,695	3,258,264	1,909,091
Interest accrual	421,545	438,700	407,569	325,827	190,909
Interest and capital payments	250,000	750,000	1,225,000	1,675,000	2,100,000
Balance	4,386,995	4,075,695	3,258,264	1,909,091	–

Payment of a Concessionary Loan

IE40. The department of education makes low interest loans available to qualifying students on flexible repayment terms as a means of promoting university education.

IE41. The department advanced CU250 million to various students at the beginning of the financial year, with the following terms and conditions:

- Capital is repaid as follows:
 - Year 1 to 3: no capital repayments
 - Year 4: 30% capital to be repaid
 - Year 5: 30% capital to be repaid
 - Year 6: 40% capital to be repaid
- Interest is calculated at 6% interest on the outstanding loan balance, and is paid annually in arrears. Assume the market rate of interest for a similar loan is 11.5%.

IE42. The journal entries to account for the concessionary loan are as follows (assuming the entity subsequently measures the concessionary loan at amortized cost):

1. On initial recognition, the entity recognizes the following:

Dr	Loan	199,345,480	
Dr	Expense	50,654,520	
	Cr Bank		250,000,000

2. Year 1: The entity recognizes the following

Dr	Loan	22,924,730	
	Cr Interest revenue		22,924,730

Interest accrual using the effective interest method $CU199,345,480 \times 11.5\%$

Dr	Bank	15,000,000	
	Cr Loan		15,000,000

Interest payment of $CU250m \times 6\%$

3. Year 2: The entity recognizes the following:

Dr	Loan	23,836,074	
	Cr Interest revenue		23,836,074

Interest accrual using the effective interest method $CU207,270,210 \times 11.5\%$

Dr	Bank	15,000,000	
	Cr Loan		15,000,000

Interest payment of $CU250m \times 6\%$

4.	Year 3: The entity recognizes the following:			
Dr	Loan	24,852,223		
	Cr Interest revenue		24,852,223	
	<i>Interest accrual using the effective interest method $CU216,106,284 \times 11.5\%$</i>			
Dr	Bank	15,000,000		
	Cr Loan		15,000,000	
5.	Year 4: The entity recognizes the following:			
Dr	Loan	25,985,228		
	Cr Interest revenue		25,985,228	
	<i>Interest accrual using the effective interest method $CU225,958,228 \times 11.5\%$</i>			
Dr	Bank	90,000,000		
	Cr Loan		90,000,000	
	<i>Interest payment of $CU250m \times 6\% + CU75m$ capital repaid</i>			
6.	Year 5: The entity recognizes the following:			
Dr	Loan	18,623,530		
	Cr Interest revenue		18,623,530	
	<i>Interest accrual using the effective interest method $CU161,943,735 \times 11.5\%$</i>			
Dr	Bank	85,500,000		
	Cr Loan		85,500,000	
	<i>Interest payment of $CU175m \times 6\% + CU75m$ capital repaid</i>			
7.	Year 6: The entity recognizes the following:			
Dr	Loan	10,932,735		
	Cr Interest revenue		10,932,735	
	<i>Interest accrual using the effective interest method $CU95,067,265 \times 11.5\%$</i>			
Dr	Bank	106,000,000		
	Cr Loan		106,000,000	
	<i>Recognition of capital repaid</i>			

*Calculations***Table 1: Amortization Schedule (Using Contractual Repayments at 6% Interest)**

	Year 0 CU'000	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000	Year 6 CU'000
Capital	250,000	250,000	250,000	250,000	250,000	250,000	250,000
Interest	–	15,000	15,000	15,000	15,000	10,500	6,000
Payments	–	15,000	15,000	15,000	90,000	85,500	106,000
Balance	250,000	250,000	250,000	250,000	175,000	100,000	–

Table 2: Discounting Contractual Cash Flows (Based on a Market Rate of 11.5%)

	Year 1 CU'000	Year 2 CU'000	Year 3 CU'000	Year 4 CU'000	Year 5 CU'000	Year 6 CU'000
Capital balance	250,000	250,000	250,000	175,000	100,000	–
Interest payable	15,000	15,000	15,000	15,000	10,500	6,000
Total payments (capital and interest)	15,000	15,000	15,000	90,000	85,500	106,000
Present value of payments	13,452,915	12,065,394	10,820,981	58,229,497	49,612,576	55,164,117
Total present value of payments						199,345,480
Proceeds paid						250,000,000
Less: Present value of outflows (fair value of loan on initial recognition)						199,345,480
Off-market portion of loan to be recognized as expense						50,654,520

Table 3: Calculation of Loan Balance and Interest Using the Effective Interest Method

	Year 1 CU	Year 2 CU	Year 3 CU	Year 4 CU	Year 5 CU	Year 6 CU
Capital	199,345,480	207,270,210	216,106,284	225,958,228	161,943,735	95,067,265
Interest accrual	22,924,730	23,836,074	24,852,223	25,985,228	18,623,530	10,932,735
Interest and capital payments	15,000,000	15,000,000	15,000,000	90,000,000	85,500,000	106,000,000
Balance	207,270,210	216,106,284	225,958,228	161,943,735	95,067,265	–

Financial Guarantee Contract Provided at Nominal Consideration

- IE43. Entity C is a major motor vehicle manufacturer in Jurisdiction A. On January 1, 201V Government A (the issuer) enters into a financial guarantee contract with Entity B (the holder) to reimburse Entity B against the financial effects of default by Entity C (the debtor) for a 30 year loan of 50 million Currency Units (CUs) repayable in two equal instalments of 25 million CUs in 201X and 204Z. Entity C provides nominal consideration of 30,000 CUs to Government A. Prior to entering into negotiation with Government A, Entity C had approached a number of other entities to issue a guarantee, but none of these entities was prepared to issue such a guarantee. There are no recent examples of financial guarantee contracts in the motor manufacturing sector of the economy in Jurisdiction A or in neighbouring Jurisdictions D & E. Government A concludes that it cannot use a valuation technique as the use of a valuation technique does not provide a reliable measure of fair value. Government A therefore determines to measure the financial guarantee contract in accordance with IPSAS 19.
- IE44. On December, 31 201V, having reviewed the financial position and performance of Entity C, Government A determines that there is no present obligation to Entity B in respect of the financial guarantee contract. Government A does not recognize a liability in its statement of financial position. Government A makes the disclosures relating to fair value and credit risk in IPSAS 30, *Financial Instruments: Disclosures* in respect of the financial guarantee contract. It also discloses a contingent liability of 50 million CUs in accordance with IPSAS 19. In its statement of financial performance Government A recognizes revenue of 1,000 CUs in respect of the nominal consideration payable by Entity C.
- IE45. In 201Z there has been a further downturn in the motor manufacturing sector affecting Entity C. Entity C is seeking bankruptcy protection and has defaulted on the first repayment of principal, although it has met its obligations for interest payments. Government A determines that Entity C is unlikely to recover, but negotiations are advanced with a potential acquirer (Entity D), which will restructure Entity C. Entity D has indicated that it will assume responsibility for the final instalment of the loan with Entity B, but not the initial instalment. Government A recognizes an expense and liability for 25 million CUs and discloses a contingent liability of 25 million CUs.

Interaction Between Measurement Requirements of IPSAS 23 and IPSAS 29*Background*

- IE46. An individual donates shares in listed entity X to public sector entity A on January 1, 20X8. At that date, the shares in entity X have a fair value of CU1,000,000. At December 31, 20X8, the fair value of the shares is CU900,000. As part of the arrangement, entity A incurs the transfer duty to have the shares transferred into its name. These costs amount to CU10,000.

- IE47. Listed entity X provides telecommunications infrastructure and related services to the public. During 20X9, new technology was introduced into the telecommunications industry, making the infrastructure and equipment used by entity X almost obsolete. This resulted in a permanent decline in the value of listed entity X. The value of the impairment loss as at December 31, 20X9 is CU700,000. Entity A has a policy of accounting for investments in shares as an available-for-sale financial asset. Assume that the arrangement is a contractual arrangement, no present obligations arise from the donation and that the entity's reporting period ends on December 31, 20X8.

Analysis

- IE48. As entity A received the shares as a donation, it uses IPSAS 23 to initially recognize the shares acquired and the related non-exchange revenue. However, because entity A has acquired a financial asset, it considers the initial measurement requirements of IPSAS 23 and IPSAS 29.
- IE49. IPSAS 23 prescribes that assets acquired as part of a non-exchange revenue transaction are initially measured at fair value, while IPSAS 29 prescribes that financial assets are initially measured at fair value and, depending on their classification, transaction costs may or may not be included. As the entity has a policy of accounting for investments in shares as available-for-sale financial assets, the transaction costs of CU10,000 are added to the value of the shares of CU1,000,000 on initial measurement.
- IE50. The subsequent measurement and derecognition of the shares is addressed in IPSAS 29. The entity classifies investments in shares as available-for-sale financial assets which means that the shares are measured at a fair value with any subsequent changes in fair value recognized in net assets/equity. Impairment losses are however recognized in surplus or deficit in the period in which they occur.

The journal entries at initial acquisition and at the reporting dates are as follows:

1. Acquisition of shares through donation			
Dr	Available-for-sale financial asset (investment in entity X)	1,010,000	
	Cr Non-exchange revenue		1,000,000
	Cr Bank (Transfer costs paid)		10,000

FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

2.	Subsequent measurement at December 31, 20X8		
Dr	Net assets/equity (fair value adjustment of investment)	110,000	
	Cr Available-for-sale financial asset (investment in entity X)		110,000
3.	Subsequent measurement at December 31, 20X9		
Dr	Impairment loss (surplus or deficit)	700,000	
	Cr Available-for-sale financial asset		700,000

Comparison with IAS 39

IPSAS 29, *Financial Instruments: Recognition and Measurement* is drawn primarily from IAS 39, *Financial Instruments: Recognition and Measurement* (including amendments up to December 31, 2008 as well as amendments made by the IASB to IAS 39 as part of its *Improvements to IFRSs* in April 2009). The main differences between IPSAS 29 and IAS 39 are as follows:

- IPSAS 29 contains additional application guidance to deal with concessionary loans and financial guarantee contracts entered into at nil or nominal consideration. IAS 39 does not deal with these areas.
- In certain instances, IPSAS 29 uses different terminology from IAS 39. The most significant examples are the use of the terms “statement of financial performance” and “net assets/equity.” The equivalent terms in IAS 39 are “statement of comprehensive income or separate income statement (if presented)” and “equity.”
- IPSAS 29 does not distinguish between “revenue” and “income.” IAS 39 distinguishes between “revenue and “income,” with “income” having a broader meaning than the term “revenue.”
- Principles from IFRIC 9, *Reassessment of Embedded Derivatives* and IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* have been included as authoritative appendices to IPSAS 29. The IASB issues IFRICs as separate documents.

IPSAS 30—FINANCIAL INSTRUMENTS: DISCLOSURES

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Financial Reporting Standard (IFRS) 7, *Financial Instruments: Disclosures* published by the International Accounting Standards Board (IASB). Extracts from IFRS 7 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 30—FINANCIAL INSTRUMENTS: DISCLOSURES

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 30, *Financial Instruments: Disclosures* was issued in January 2010.

Since then, IPSAS 30 has been amended by the following IPSASs:

- IPSAS 39, *Employee Benefits* (issued July 2016)
- *The Applicability of IPSASs* (issued April 2016)
- *Improvements to IPSASs 2015* (issued April 2016)
- IPSAS 38, *Disclosure of Interests in Other Entities* (issued January 2015)
- IPSAS 37, *Joint Arrangements* (issued January 2015)
- IPSAS 35, *Consolidated Financial Statements* (issued January 2015)
- IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* (issued January 2015)
- *Improvements to IPSASs 2011* (issued October 2011)

Table of Amended Paragraphs in IPSAS 30

Paragraph Affected	How Affected	Affected By
Introduction section	Deleted	Improvements to IPSASs October 2011
3	Amended	IPSAS 35 January 2015 IPSAS 37 January 2015 IPSAS 39 July 2016
6	Deleted	The Applicability of IPSASs April 2016
7	Deleted	The Applicability of IPSASs April 2016
52A	New	IPSAS 33 January 2015
52B	New	IPSAS 38 January 2015 IPSAS 37 January 2015 IPSAS 35 January 2015

Paragraph Affected	How Affected	Affected By
52C	New	Improvements to IPSASs April 2016
52D	New	The Applicability of IPSASs April 2016
52E	New	IPSAS 39 July 2016
53	Amended	IPSAS 33 January 2015
AG6	Amended	IPSAS 38 January 2015

IPSAS 30—FINANCIAL INSTRUMENTS: DISCLOSURES**CONTENTS**

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International Public Sector Accounting Standard 30, *Financial Instruments: Disclosures*, is set out in paragraphs 1–54. All the paragraphs have equal authority. IPSAS 30 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:
 - (a) The significance of financial instruments for the entity's financial position and performance; and
 - (b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.
2. The principles in this Standard complement the principles for recognizing, measuring, and presenting financial assets and financial liabilities in IPSAS 28, *Financial Instruments: Presentation* and IPSAS 29, *Financial Instruments: Recognition and Measurement*.

Scope

3. **This Standard shall be applied by all entities to all types of financial instruments, except:**
 - (a) **Those interests in controlled entities, associates, or joint ventures that are accounted for in accordance with IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements* or IPSAS 36, *Investments in Associates and Joint Ventures*. However, in some cases, IPSAS 34, IPSAS 35, or IPSAS 37 require or permit an entity to account for an interest in a controlled entity, associate, or joint venture using IPSAS 29; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in controlled entities, associates, or joint ventures unless the derivative meets the definition of an equity instrument in IPSAS 28.**
 - (b) **Employers' rights and obligations arising from employee benefit plans, to which IPSAS 39, *Employee Benefits* applies.**
 - (c) **Rights and obligations arising under insurance contracts. However, this Standard applies to:**
 - (i) **Derivatives that are embedded in insurance contracts if IPSAS 29 requires the entity to account for them separately; and**
 - (ii) **An issuer of financial guarantee contracts if the issuer applies IPSAS 29 in recognizing and measuring the contracts, but shall apply the relevant international or national accounting standard dealing with insurance**

contracts if the issuer elects to apply those standards in recognizing and measuring them.

In addition to (i) and (ii) above, an entity may apply this Standard to insurance contracts which involve the transfer of financial risk.

- (d) **Financial instruments, contracts, and obligations under share-based payment transactions to which the relevant international or national accounting standard dealing with share-based payment applies, except for contracts within the scope of paragraphs 4–6 of IPSAS 29, to which that Standard applies.**
 - (e) **Instruments that are required to be classified as equity instruments in accordance with paragraphs 15 and 16 or paragraphs 17 and 18 of IPSAS 28.**
4. This Standard applies to recognized and unrecognized financial instruments. Recognized financial instruments include financial assets and financial liabilities that are within the scope of IPSAS 29. Unrecognized financial instruments include some financial instruments that, although outside the scope of IPSAS 29, are within the scope of this Standard (such as some loan commitments).
 5. This Standard applies to contracts to buy or sell a non-financial item that are within the scope of IPSAS 29 (see paragraphs 4–6 of IPSAS 29).
 6. [Deleted]
 7. [Deleted]

Definitions

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

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk, and other price risk.

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

A financial asset is **past due** when a counterparty has failed to make a payment when contractually due.

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

Classes of Financial Instruments and Level of Disclosure

9. When this Standard requires disclosures by class of financial instrument, an entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Significance of Financial Instruments for Financial Position and Financial Performance

10. An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Statement of Financial Position

Categories of Financial Assets and Financial Liabilities

11. The carrying amounts of each of the following categories, as defined in IPSAS 29, shall be disclosed either in the statement of financial position or in the notes:
 - (a) Financial assets at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition, and (ii) those classified as held-for-trading in accordance with IPSAS 29;
 - (b) Held-to-maturity investments;

- (c) Loans and receivables;
- (d) Available-for-sale financial assets;
- (e) Financial liabilities at fair value through surplus or deficit, showing separately (i) those designated as such upon initial recognition, and (ii) those classified as held-for-trading in accordance with IPSAS 29; and
- (f) Financial liabilities measured at amortized cost.

Financial Assets or Financial Liabilities at Fair Value through Surplus or Deficit

12. If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through surplus or deficit, it shall disclose:
 - (a) The maximum exposure to credit risk (see paragraph 43(a)) of the loan or receivable (or group of loans or receivables) at the end of the reporting period.
 - (b) The amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
 - (c) The amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
 - (i) As the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
 - (ii) Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate, or index of prices or rates.
 - (d) The amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.
13. If the entity has designated a financial liability as at fair value through surplus or deficit in accordance with paragraph 10 of IPSAS 29, it shall disclose:
 - (a) The amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:
 - (i) 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 Appendix A, paragraph AG4); or

- (ii) Using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

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. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

- (b) The difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

14. The entity shall disclose:

- (a) The methods used to comply with the requirements in paragraphs 12(c) and 13(a).
- (b) If the entity believes that the disclosure it has given to comply with the requirements in paragraph 12(c) or 13(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

Reclassification

15. If the entity has reclassified a financial asset (in accordance with paragraphs 60–63 of IPSAS 29) as one measured:

- (a) At cost or amortized cost, rather than at fair value; or
- (b) At fair value, rather than at cost or amortized cost;

it shall disclose the amount reclassified into and out of each category and the reason for that reclassification.

16. If the entity has reclassified a financial asset out of the fair value through surplus or deficit category in accordance with paragraph 55 or 57 of IPSAS 29 or out of the available-for-sale category in accordance with paragraph 58 of IPSAS 29, it shall disclose:

- (a) The amount reclassified into and out of each category;
- (b) For each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods;

- (c) If a financial asset was reclassified in accordance with paragraph 55 of IPSAS 29, the rare situation, and the facts and circumstances indicating that the situation was rare;
- (d) For the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognized in surplus or deficit or in net assets/equity in that reporting period and in the previous reporting period;
- (e) For each reporting period following the reclassification (including the reporting period in which the financial asset was reclassified) until derecognition of the financial asset, the fair value gain or loss that would have been recognized in surplus or deficit or in net assets/equity if the financial asset had not been reclassified, and the gain, loss, revenue, and expense recognized in surplus or deficit; and
- (f) The effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.

Derecognition

17. An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 17–39 of IPSAS 29). The entity shall disclose for each class of such financial assets:
 - (a) The nature of the assets;
 - (b) The nature of the risks and rewards of ownership to which the entity remains exposed;
 - (c) When the entity continues to recognize all of the assets, the carrying amounts of the assets, and of the associated liabilities; and
 - (d) When the entity continues to recognize the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognize, and the carrying amount of the associated liabilities.

Collateral

18. An entity shall disclose:
 - (a) The carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph 39(a) of IPSAS 29; and
 - (b) The terms and conditions relating to its pledge.

19. When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it shall disclose:
- (a) The fair value of the collateral held;
 - (b) The fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and
 - (c) The terms and conditions associated with its use of the collateral.

Allowance Account for Credit Losses

20. When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g., an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.

Compound Financial Instruments with Multiple Embedded Derivatives

21. If an entity has issued an instrument that contains both a liability and an equity component (see paragraph 33 of IPSAS 28) and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

Defaults and Breaches

22. For loans payable recognized at the end of the reporting period, an entity shall disclose:
- (a) Details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
 - (b) The carrying amount of the loans payable in default at the end of the reporting period; and
 - (c) Whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorized for issue.
23. If, during the period, there were breaches of loan agreement terms other than those described in paragraph 22, an entity shall disclose the same information as required by paragraph 22 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the end of the reporting period).

Statement of Financial Performance*Items of Revenue, Expense, Gains, or Losses*

24. An entity shall disclose the following items of revenue, expense, gains, or losses either in the statement of financial performance or in the notes:
- (a) Net gains or net losses on:
 - (i) Financial assets or financial liabilities at fair value through surplus or deficit, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with IPSAS 29;
 - (ii) Available-for-sale financial assets, showing separately the amount of gain or loss recognized in net assets/equity during the period and the amount reclassified from net assets/equity and recognized directly in surplus or deficit for the period;
 - (iii) Held-to-maturity investments;
 - (iv) Loans and receivables; and
 - (v) Financial liabilities measured at amortized cost;
 - (b) Total interest revenue and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through surplus or deficit;
 - (c) Fee revenue and expense (other than amounts included in determining the effective interest rate) arising from:
 - (i) Financial assets or financial liabilities that are not at fair value through surplus or deficit; and
 - (ii) Trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;
 - (d) Interest revenue on impaired financial assets accrued in accordance with paragraph AG126 of IPSAS 29; and
 - (e) The amount of any impairment loss for each class of financial asset.

Other Disclosures*Accounting Policies*

25. In accordance with paragraph 132 of IPSAS 1, an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge Accounting

26. An entity shall disclose the following separately for each type of hedge described in IPSAS 29 (i.e., fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):
- (a) A description of each type of hedge;
 - (b) A description of the financial instruments designated as hedging instruments and their fair values at the end of the reporting period; and
 - (c) The nature of the risks being hedged.
27. For cash flow hedges, an entity shall disclose:
- (a) The periods when the cash flows are expected to occur and when they are expected to affect surplus or deficit;
 - (b) A description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;
 - (c) The amount that was recognized in net assets/equity during the period;
 - (d) The amount that was reclassified from net assets/equity and included in surplus or deficit for the period, showing the amount included in each line item in the statement of financial performance; and
 - (e) The amount that was removed from net assets/equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.
28. An entity shall disclose separately:
- (a) In fair value hedges, gains or losses:
 - (i) On the hedging instrument; and
 - (ii) On the hedged item attributable to the hedged risk.
 - (b) The ineffectiveness recognized in surplus or deficit that arises from cash flow hedges; and
 - (c) The ineffectiveness recognized in surplus or deficit that arises from hedges of net investments in foreign operations.

Fair Value

29. Except as set out in paragraph 35 for each class of financial assets and financial liabilities (see paragraph 9), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

30. In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.
31. An entity shall disclose for each class of financial instruments the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates. If there has been a change in valuation technique, the entity shall disclose that change and the reasons for making it.
32. To make the disclosures required by paragraph 33 an entity shall classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy shall have the following levels:
 - (a) Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);
 - (b) Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as price) or indirectly (i.e., derived from prices) (Level 2); and
 - (c) Inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

The level in the fair value hierarchy within which the fair value measurement is categorized in its entirety shall be determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety. For this purpose, the significance of an input is assessed against the fair value measurement in its entirety. If a fair value measurement uses observable inputs that require significant adjustment based on unobservable inputs, that measurement is a Level 3 measurement. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

33. For fair value measurements recognized in the statement of financial position an entity shall disclose for each class of financial instruments:
 - (a) The level in the fair value hierarchy into which the fair value measurements are categorized in their entirety, segregating fair value measurements in accordance with the levels defined in paragraph 32.
 - (b) Any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers. Transfers into each level shall be disclosed and discussed separately from transfers out of each level. For this purpose, significance shall be judged with respect to surplus or deficit, and total assets or total liabilities.

- (c) For fair value measurements in Level 3, a reconciliation from the beginning balances to the ending balances, disclosing separately changes during the period attributable to the following:
 - (i) Total gains or losses for the period recognized in surplus or deficit, and a description of where they are presented in the statement of financial performance;
 - (ii) Total gains or losses recognized in net assets/equity;
 - (iii) Purchases, sales, issues, and settlements (each type of movement disclosed separately); and
 - (iv) Transfers into or out of Level 3 (e.g., transfers attributable to changes in the observability of market data) and the reasons for those transfers. For significant transfers, transfers into Level 3 shall be disclosed and discussed separately from transfers out of Level 3.
- (d) The amount of total gains or losses for the period in (c)(i) above included in surplus or deficit that are attributable to gains or losses relating to those assets and liabilities held at the end of the reporting period and a description of where those gains or losses are presented in the statement of financial performance.
- (e) For fair value measurements in Level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, the entity shall state that fact and disclose the effect of those changes. The entity shall disclose how the effect of a change to a reasonably possible alternative assumption was calculated. For this purpose, significance shall be judged with respect to surplus or deficit, and total assets or total liabilities, or, when changes in fair value are recognized in net assets/equity, total equity.

An entity shall present the quantitative disclosures required by this paragraph in tabular format unless another format is more appropriate.

34. If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs AG106–AG112 of IPSAS 29). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e., the fair value of the consideration given or received), unless conditions described in paragraph AG108 of IPSAS 29 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:

- (a) Its accounting policy for recognizing that difference in surplus or deficit to reflect a change in factors (including time) that market

participants would consider in setting a price (see paragraph AG109 of IPSAS 29); and

- (b) The aggregate difference yet to be recognized in surplus or deficit at the beginning and end of the period and a reconciliation of changes in the balance of this difference.
35. Disclosures of fair value are not required:
- (a) When the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;
 - (b) For an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost in accordance with IPSAS 29 because its fair value cannot be measured reliably¹; and
 - (c) For a contract containing a discretionary participation feature if the fair value of that feature cannot be measured reliably.
36. In the cases described in paragraph 35(b) and (c), an entity shall disclose information to help users of the financial statements make their own judgments about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:
- (a) The fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
 - (b) A description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
 - (c) Information about the market for the instruments;
 - (d) Information about whether and how the entity intends to dispose of the financial instruments; and
 - (e) If financial instruments whose fair value previously could not be reliably measured are derecognized, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognized.

Concessionary Loans

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

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

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

Nature and Extent of Risks Arising from Financial Instruments

- 38. **An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.**
- 39. The disclosures required by paragraphs 40–49 focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, liquidity risk, and market risk.

Qualitative Disclosures

- 40. For each type of risk arising from financial instruments, an entity shall disclose:
 - (a) The exposures to risk and how they arise;
 - (b) Its objectives, policies, and processes for managing the risk and the methods used to measure the risk; and
 - (c) Any changes in (a) or (b) from the previous period.

Quantitative Disclosures

- 41. For each type of risk arising from financial instruments, an entity shall disclose:
 - (a) Summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity

(as defined in IPSAS 20, *Related Party Disclosures*), for example, the entity's governing body or chief executive officer.

- (b) The disclosures required by paragraphs 43–49, to the extent not provided in (a), unless the risk is not material (see paragraphs 45–47 of IPSAS 1 for a discussion of materiality).
 - (c) Concentrations of risk if not apparent from (a) and (b).
42. If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity shall provide further information that is representative.

Credit Risk

43. An entity shall disclose by class of financial instrument:
- (a) The amount that best represents its maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g., netting agreements that do not qualify for offset in accordance with IPSAS 28);
 - (b) In respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancements;
 - (c) Information about the credit quality of financial assets that are neither past due nor impaired; and
 - (d) The carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Financial Assets that are Either Past Due or Impaired

44. An entity shall disclose by class of financial asset:
- (a) An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired;
 - (b) An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired; and
 - (c) For the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

Collateral and Other Credit Enhancements Obtained

45. When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g., guarantees), and such assets meet the recognition criteria in other Standards, an entity shall disclose:

- (a) The nature and carrying amount of the assets obtained; and
- (b) When the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Liquidity Risk

46. An entity shall disclose:
- (a) A maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.
 - (b) A maturity analysis for derivative financial liabilities. The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows (see paragraph AG14).
 - (c) A description of how it manages the liquidity risk inherent in (a) and (b).

Market Risk

Sensitivity Analysis

47. Unless an entity complies with paragraph 48, it shall disclose:
- (a) A sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how surplus or deficit and net assets/equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
 - (b) The methods and assumptions used in preparing the sensitivity analysis; and
 - (c) Changes from the previous period in the methods and assumptions used, and the reasons for such changes.
48. If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g., interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 47. The entity shall also disclose:
- (a) An explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and
 - (b) An explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Other Market Risk Disclosures

49. When the sensitivity analyses disclosed in accordance with paragraph 47 or 48 are unrepresentative of a risk inherent in a financial instrument (e.g., because the year-end exposure does not reflect the exposure during the year), the entity shall disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

Effective Date and Transition

50. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2013. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2013, it shall disclose that fact.**
51. **An entity shall not apply this Standard before January 1, 2013, unless it also applies IPSAS 28 and IPSAS 29.**
52. If an entity applies this Standard for annual periods beginning before January 1, 2013, it need not present comparative information for the disclosures required by paragraphs 38–49 about the nature and extent of risks arising from financial instruments.
- 52A. **Paragraph 53 was amended by IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* issued in January 2015. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is permitted. If an entity applies IPSAS 33 for a period beginning before January 1, 2017, the amendment shall also be applied for that earlier period.**
- 52B. **IPSAS 35, *Consolidated Financial Statements*, IPSAS 37, *Joint Arrangements*, and IPSAS 38, *Disclosures of Interests in Other Entities*, issued in January 2015, amended paragraphs 3(a) and AG6. An entity shall apply that amendment when it applies IPSAS 35, IPSAS 37 and IPSAS 38.**
- 52C. **Paragraph AG7 was amended by *Improvements to IPSASs 2015* issued in April 2016. An entity shall apply this amendment for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2017 it shall disclose that fact.**
- 52D. **Paragraphs 6 and 7 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.**

- 52E. **Paragraph 3 was amended by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.**
53. When an entity adopts the accrual basis IPSASs of accounting as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.

Withdrawal and Replacement of IPSAS 15 (2001)

54. This Standard and IPSAS 28 supersede IPSAS 15, *Financial Instruments: Disclosure and Presentation* issued in 2001. IPSAS 15 remains applicable until IPSAS 28 and IPSAS 30 are applied or become effective, whichever is earlier.

Appendix A

Application Guidance

This appendix is an integral part of IPSAS 30.

Classes of Financial Instruments and Level of Disclosure (paragraph 9)

- AG1. Paragraph 9 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 9 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in IPSAS 29 (which determine how financial instruments are measured and where changes in fair value are recognized).
- AG2. In determining classes of financial instrument, an entity shall, at a minimum:
- (a) Distinguish instruments measured at amortized cost from those measured at fair value.
 - (b) Treat as a separate class or classes those financial instruments outside the scope of this Standard.
- AG3. An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this Standard, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Significance of Financial Instruments for Financial Position and Financial Performance

Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs 13 and 14)

- AG4. If an entity designates a financial liability as at fair value through surplus or deficit, paragraph 13(a) requires it to disclose the amount of change in the fair value of the financial liability that is attributable to changes in the liability's credit risk. Paragraph 13(a)(i) permits an entity to determine this amount as

the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk. If the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, this amount 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 observed market price 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 observed market price 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 disclosed.

This example assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in interest rates are not significant. 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 disclosed in accordance with paragraph 13(a).

Other Disclosure—Accounting Policies (paragraph 25)

AG5. Paragraph 25 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

- (a) For financial assets or financial liabilities designated as at fair value through surplus or deficit:
 - (i) The nature of the financial assets or financial liabilities the entity has designated as at fair value through surplus or deficit;
 - (ii) The criteria for so designating such financial assets or financial liabilities on initial recognition; and

- (iii) How the entity has satisfied the conditions in paragraph 10, 13, or 14 of IPSAS 29 for such designation. For instruments designated in accordance with paragraph (b)(i) of the definition of a financial asset or financial liability at fair value through surplus or deficit in IPSAS 29, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph (b)(ii) of the definition of a financial asset or financial liability at fair value through surplus or deficit in IPSAS 29, that disclosure includes a narrative description of how designation at fair value through surplus or deficit is consistent with the entity's documented risk management or investment strategy.
- (b) The criteria for designating financial assets as available for sale.
- (c) Whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 40 of IPSAS 29).
- (d) When an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:
 - (i) The criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and
 - (ii) The criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph 20).
- (e) How net gains or net losses on each category of financial instrument are determined (see paragraph 24(a)), for example, whether the net gains or net losses on items at fair value through surplus or deficit include interest or revenue from dividends or similar distributions.
- (f) The criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph 24(e)).
- (g) When the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph 43(d)).
- (h) For financial guarantee contracts issued through a non-exchange transaction, where no fair value can be determined and a provision is recognized in accordance with IPSAS 19, *Provisions, Contingent*

Liabilities and Contingent Assets, disclosure of the circumstances that result in a provision being recognized.

Paragraph 137 of IPSAS 1 also requires entities to disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements.

Nature and Extent of Risks Arising from Financial Instruments (paragraphs 38–49)

- AG6. The disclosures required by paragraphs 38–49 shall be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete. The use of such cross-referencing may be subject to jurisdictional restrictions.

Quantitative Disclosures (paragraph 41)

- AG7. Paragraph 41(a) requires disclosures of summary quantitative data about an entity's exposure to risks based on the information provided internally to key management personnel of the entity. When an entity uses several methods to manage a risk exposure, the entity shall disclose information using the method or methods that provide the most relevant and faithfully representative information. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors* discusses relevance and faithful representation.
- AG8. Paragraph 41(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgment taking into account the circumstances of the entity. Disclosure of concentrations of risk shall include:
- (a) A description of how management determines concentrations;
 - (b) A description of the shared characteristic that identifies each concentration (e.g., counterparty, geographical area, currency, or market); and
 - (c) The amount of the risk exposure associated with all financial instruments sharing that characteristic.

Maximum Credit Risk Exposure (paragraph 43(a))

AG9. Paragraph 43(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:

- (a) Any amounts offset in accordance with IPSAS 28; and
- (b) Any impairment losses recognized in accordance with IPSAS 29.

AG10. Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:

- (a) Granting loans and receivables to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.
- (b) Entering into derivative contracts (e.g., foreign exchange contracts, interest rate swaps, and credit derivatives). When the resulting asset is measured at fair value, the maximum exposure to credit risk at the end of the reporting period will equal the carrying amount.
- (c) Granting financial guarantees. In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognized as a liability.
- (d) Making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognized as a liability.

Quantitative Liquidity Risk Disclosures (paragraphs 41(a), and 46(a) and (b))

AG11. In accordance with paragraph 41(a) an entity discloses summary quantitative data about its exposure to liquidity risk on the basis of the information provided internally to key management personnel. An entity shall explain how those data are determined. If the outflows of cash (or another financial asset) included in those data could either:

- (a) Occur significantly earlier than indicated in the data; or
- (b) Be for significantly different amounts from those indicated in the data (e.g., for a derivative that is included in the data on a net settlement

basis but for which the counterparty has the option to require gross settlement);

the entity shall state that fact and provide quantitative information that enables users of its financial statements to evaluate the extent of this risk unless that information is included in the contractual maturity analyses required by paragraph 46(a) or (b).

- AG12. In preparing the maturity analyses required by paragraph 46(a) and (b), an entity uses its judgment to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:
- (a) Not later than one month;
 - (b) Later than one month and not later than three months;
 - (c) Later than three months and not later than one year; and
 - (d) Later than one year and not later than five years.
- AG13. In complying with paragraph 46(a) and (b), an entity shall not separate an embedded derivative from a hybrid (combined) instrument. For such an instrument, an entity shall apply paragraph 46(a).
- AG14. Paragraph 46(b) requires an entity to disclose a quantitative maturity analysis for derivative financial liabilities that shows remaining contractual maturities if the contractual maturities are essential for an understanding of the timing of the cash flows. For example, this would be the case for:
- (a) An interest rate swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability.
 - (b) All loan commitments.
- AG15. Paragraph 46(a) and (b) requires an entity to disclose maturity analyses for financial liabilities that show the remaining contractual maturities for some financial liabilities. In this disclosure:
- (a) When a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (e.g., demand deposits) are included in the earliest time band.
 - (b) When an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.

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

AG16. The contractual amounts disclosed in the maturity analyses as required by paragraph 46(a) and (b) are the contractual undiscounted cash flows, for example:

- (a) Gross finance lease obligations (before deducting finance charges);
- (b) Prices specified in forward agreements to purchase financial assets for cash;
- (c) Net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged;
- (d) Contractual amounts to be exchanged in a derivative financial instrument (e.g., a currency swap) for which gross cash flows are exchanged; and
- (e) Gross loan commitments.

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

AG17. Paragraph 46(c) requires an entity to describe how it manages the liquidity risk inherent in the items disclosed in the quantitative disclosures required in paragraph 40(a) and (b). An entity shall disclose a maturity analysis of financial assets it holds for managing liquidity risk (e.g., financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities), if that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk.

AG18. Other factors that an entity might consider in providing the disclosure required in paragraph 40(c) include, but are not limited to, whether the entity:

- (a) Has committed borrowing facilities (e.g., commercial paper facilities) or other lines of credit (e.g., stand-by credit facilities) that it can access to meet liquidity needs;
- (b) Holds deposits at central banks to meet liquidity needs;

- (c) Has very diverse funding sources;
- (d) Has significant concentrations of liquidity risk in either its assets or its funding sources;
- (e) Has internal control processes and contingency plans for managing liquidity risk;
- (f) Has instruments that include accelerated repayment terms (e.g., on the downgrade of the entity's credit rating);
- (g) Has instruments that could require the posting of collateral (e.g., margin calls for derivatives);
- (h) Has instruments that allows the entity to choose whether it settles its financial liabilities by delivering cash (or another financial asset) or by delivering its own shares; or
- (i) Has instruments that are subject to master netting agreements.

Market Risk—Sensitivity Analysis (paragraphs 47 and 48)

AG19. Paragraph 47(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. In accordance with paragraph AG3, an entity decides how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. For example:

- (a) An entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading.
- (b) An entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

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

AG20. Paragraph 47(a) requires the sensitivity analysis to show the effect on surplus or deficit and net assets/equity of reasonably possible changes in the relevant risk variable (e.g., prevailing market interest rates, currency rates, equity prices, or commodity prices). For this purpose:

- (a) Entities are not required to determine what the surplus or deficit for the period would have been if relevant risk variables had been different. Instead, entities disclose the effect on surplus or deficit and net assets/equity at the end of the reporting period assuming that a reasonably possible change in the relevant risk variable had occurred at the end of the reporting period and had been applied to the risk exposures

in existence at that date. For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on surplus or deficit (i.e., interest expense) for the current year if interest rates had varied by reasonably possible amounts.

- (b) Entities are not required to disclose the effect on surplus or deficit and net assets/equity for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

AG21. In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:

- (a) The economic environments in which it operates. A reasonably possible change should not include remote or “worst case” scenarios or “stress tests”. Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable. For example, assume that interest rates are 5 percent and an entity determines that a fluctuation in interest rates of ± 50 basis points is reasonably possible. It would disclose the effect on surplus or deficit and net assets/equity if interest rates were to change to 4.5 percent or 5.5 percent. In the next period, interest rates have increased to 5.5 percent. The entity continues to believe that interest rates may fluctuate by ± 50 basis points (i.e., that the rate of change in interest rates is stable). The entity would disclose the effect on surplus or deficit and net assets/equity if interest rates were to change to 5 percent or 6 percent. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ± 50 basis points, unless there is evidence that interest rates have become significantly more volatile.
- (b) The time frame over which it is making the assessment. The sensitivity analysis shall show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

AG22. Paragraph 48 permits an entity to use a sensitivity analysis that reflects interdependencies between risk variables, such as a value-at-risk methodology, if it uses this analysis to manage its exposure to financial risks. This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain. Such an entity might comply with paragraph 48(a) by disclosing the type of value-at-risk model used (e.g., whether the model relies on Monte Carlo simulations), an explanation about how the model works and the main assumptions (e.g., the holding period and confidence level).

Entities might also disclose the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations, and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

- AG23. An entity shall provide sensitivity analyses for the whole of its operations, but may provide different types of sensitivity analysis for different classes of financial instruments.

Interest Rate Risk

- AG24. Interest rate risk arises on interest-bearing financial instruments recognized in the statement of financial position (e.g., loans and receivables and debt instruments issued) and on some financial instruments not recognized in the statement of financial position (e.g., some loan commitments).

Currency Risk

- AG25. Currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency (i.e., in a currency other than the functional currency in which they are measured). For the purpose of this Standard, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.
- AG26. A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

Other Price Risk

- AG27. Other price risk arises on financial instruments because of changes in, for example, commodity prices or equity prices. To comply with paragraph 47, an entity might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.
- AG28. Two examples of financial instruments that give rise to equity price risk are (a) a holding of equities in another entity, and (b) an investment in a trust that in turn holds investments in equity instruments. Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

- AG29. In accordance with paragraph 47(a), the sensitivity of surplus or deficit (that arises, for example, from instruments classified as at fair value through surplus or deficit and impairments of available-for-sale financial assets) is disclosed separately from the sensitivity of net assets/equity (that arises, for example, from instruments classified as available for sale).
- AG30. Financial instruments that an entity classifies as equity instruments are not remeasured. Neither surplus or deficit nor net assets/equity will be affected by the equity price risk of those instruments. Accordingly, no sensitivity analysis is required.

Appendix B

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 30.

Introduction

- BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in IPSAS 30, *Financial Instruments: Disclosures*. As this Standard is based on IFRS 7, *Financial Instruments: Disclosures* issued by the IASB, the Basis for Conclusions outlines only those areas where IPSAS 30 departs from the main requirements of IFRS 7.
- BC2. This project on financial instruments is noted as a key part of the IPSASB's convergence program which aims to converge IPSASs with IFRSs.
- BC3. In developing this Standard, the IPSASB agreed to retain the existing text of IFRS 7 wherever consistent with existing IPSASs, except to deal with any public sector specific issues which result in adding or deleting disclosures.
- BC4. In September 2007, the IASB issued amendments to IAS 1, *Presentation of Financial Statements* which introduced a new component into the presentation of financial statements called "comprehensive income." As the IPSASB has not yet considered this, along with some of the other amendments proposed in IAS 1, those amendments have not been included in IPSAS 30.

Concessionary Loans

- BC5. Concessionary loans are granted to or received by an entity on below market terms. Examples of concessionary loans granted by entities include loans to developing countries, small farms, student loans granted to qualifying students for university or college education, and housing loans granted to low income families. Such loans are a feature of the public sector and are often made to implement a government's or other public sector entity's social policies. The intention of a concessionary loan at the outset is to provide or receive resources on below market terms. For this reason, the IPSASB concluded that more comprehensive disclosures are required by public sector entities for concessionary loans and has included additional disclosure requirements for such loans in paragraph 37.

Revision of IPSAS 30 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

- BC6. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:
 - (a) Removes the standard paragraphs about the applicability of IPSASs to "public sector entities other than GBEs" from the scope section of each Standard;

- (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and
- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

IMPLEMENTATION GUIDANCE**CONTENTS**

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Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 30.

Introduction

- IG1. This guidance suggests possible ways to apply some of the disclosure requirements in IPSAS 30. The guidance does not create additional requirements.
- IG2. For convenience, each disclosure requirement in this Standard is discussed separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures might satisfy more than one requirement. For example, information about concentrations of risk might also convey information about exposure to credit or other risk.

Materiality

- IG3. IPSAS 1 notes that a specific disclosure requirement in an IPSAS need not be satisfied if the information is not material. IPSAS 1 defines materiality as follows:

Omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments made on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The nature or size of the item, or a combination of both, could be the determining factor.

- IG4. IPSAS 1 also explains that definition as follows:

Assessing whether an omission or misstatement could influence decisions of users, and so be material, requires consideration of the characteristics of those users. Users are assumed to have a reasonable knowledge of the public sector and economic activities and accounting and a willingness to study the information with reasonable diligence. Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making and evaluating decisions.

Classes of Financial Instruments and Level of Disclosure (paragraphs 9 and AG1–AG3)

- IG5. Paragraph AG3 states that “an entity decides in the light of its circumstances how much detail it provides to satisfy the requirements of this Standard, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics.” To satisfy the requirements, an entity may not need to disclose all the information suggested in this guidance.

- IG6. Paragraph 29(c) of IPSAS 1 requires an entity to “provide additional disclosures when compliance with the specific requirements in IPSASs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.”

Significance of Financial Instruments for Financial Position and Financial Performance (paragraphs 10–36, AG4 and AG5)

Financial Liabilities at Fair Value through Surplus or Deficit (paragraphs 13(a)(i) and AG4)

- IG7. The following example illustrates the calculation that an entity might perform in accordance with paragraph AG4 of Appendix A of the Standard.
- IG8. On January 1, 20X1, an entity issues a 10-year bond with a par value of CU150,000¹ and an annual fixed coupon rate of 8 percent, which is consistent with market rates for bonds with similar characteristics.
- IG9. The entity uses the London Interbank Offered Rate (LIBOR) as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 percent. At the end of the first year:
- (a) LIBOR has decreased to 4.75 percent.
 - (b) The fair value for the bond is CU153,811, consistent with an interest rate of 7.6 percent.²
- IG10. The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.
- IG11. The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

<p>[paragraph AG4(a)]</p> <p>First, the entity computes the liability’s internal rate of return at the start of the period using the observed market price of the liability and the liability’s contractual cash flows at the start of the period.</p> <p>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.</p>	<p>At the start of the period of a 10-year bond with a coupon of 8 percent, the bond’s internal rate of return is 8 percent.</p> <p>Because the observed (benchmark) interest rate (LIBOR) is 5 percent, the instrument-specific component of the internal rate of return is 3 percent.</p>
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¹ In this guidance monetary amounts are denominated in “currency units (CU).”

² This reflects a shift in LIBOR from 5 percent to 4.75 percent and a movement of 0.15 percent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

<p>[paragraph AG4(b)]</p> <p>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 accordance with paragraph AG4(a).</p>	<p>The contractual cash flows of the instrument at the end of the period are:</p> <ul style="list-style-type: none"> • Interest: CU12,000^(a) per year for each of years 2–10. • Principal: CU150,000 in year 10. <p>The discount rate to be used to calculate the present value of the bond is thus 7.75 percent, which is 4.75 percent end of period LIBOR rate, plus the 3 percent instrument-specific component.</p> <p>This gives a present value of CU152,367.^(b)</p>
<p>[paragraph AG4(c)]</p> <p>The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph AG4(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 disclosed.</p>	<p>The market price of the liability at the end of the period is CU153,811.^(c)</p> <p>Thus, the entity discloses CU1,444, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.</p>
(a) $CU150,000 \times 8\% = CU12,000$	
(b) $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$	
(c) $\text{market price} = [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$	

Defaults and Breaches (paragraphs 22 and 23)

IG12. Paragraphs 22 and 23 require disclosures when there are any defaults or breaches of loans payable. Any defaults or breaches may affect the classification of the liability as current or non-current in accordance with IPSAS 1.

Total Interest Expense (paragraph 24(b))

IG13. Total interest expense disclosed in accordance with paragraph 24(b) is a component of the finance costs, which paragraph 102(b) of IPSAS 1 requires to be presented separately in the statement of financial performance. The line item for finance costs may also include amounts associated with non-financial liabilities.

Fair Value (paragraphs 31–34)

IG14. IPSAS 30 requires disclosures about the level in the fair value hierarchy in which fair value measurements are categorized for assets and liabilities measured in the statement of financial position. A tabular format is required unless another format is more appropriate. An entity might disclose the following for assets to comply with paragraph 33(a). (Disclosure of comparative information is also required, but is not included in the following example).

Assets Measured at Fair Value				
Description	Dec 31, 20X2	Fair value measurement at end of the reporting period using:		
		Level 1 CU million	Level 2 CU million	Level 3 CU million
Financial assets at fair value through surplus or deficit				
Trading securities	100	40	55	5
Trading derivatives	39	17	20	2
Available-for-sale financial assets				
Equity investments	75	30	40	5
Total	214	87	115	12
Note: For liabilities, a similar table might be presented.				

- IG15. IPSAS 30 requires a reconciliation from beginning to ending balances for those assets and liabilities that are measured in the statement of financial position at fair value based on a valuation technique for which any significant input is not based on observable market data (Level 3). A tabular format is required unless another format is more appropriate. An entity might disclose the following for assets to comply with paragraph 33(b). (Disclosure of comparative information is also required, but is not included in the following example).

Assets Measured at Fair Value Based on Level 3				
Fair value measurement at the end of the reporting period				
	Financial assets at fair value through surplus or deficit	Available-for-sale financial assets	Total	
	Trading securities CU million	Trading derivatives CU million	Equity investments CU million	CU million
Opening balance	6	5	4	15
Total gains or losses				
in surplus or deficit	(2)	(2)	–	(4)
in net assets/ equity	–	–	(1)	(1)
Purchases	1	2	2	5
Issues	–	–	–	–
Settlements	–	(1)	–	(1)
Transfers out of Level 3	–	(2)	–	(2)
Closing balance	5	2	5	12
Total gains or losses for the period included in surplus or deficit for assets held at the end of the reporting period	(1)	(1)	–	(2)
(Note: For liabilities, a similar table might be presented.)				
Gains or losses included in surplus or deficit for the period (above) are presented in revenue as follows:				
				Revenue
Total gains or losses included in surplus or deficit for the period				(4)
Total gains or losses for the period included in surplus or deficit for assets held at the end of the reporting period				(2)
(Note: For liabilities, a similar table might be presented.)				

- IG16. The fair value at initial recognition of financial instruments that are not traded in active markets is determined in accordance with paragraph AG108 of IPSAS 29. However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognized in surplus or deficit in subsequent periods in accordance with IPSAS 29 and the entity's accounting policy. Such recognition reflects changes in factors

(including time) that market participants would consider in setting a price (see paragraph AG108 of IPSAS 29). Paragraph 33 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 34:

Background		
<p>On January 1, 20X1 an entity purchases for CU15 million financial assets that are not traded in an active market. The entity has only one class of such financial assets.</p> <p>The transaction price of CU15 million is the fair value at initial recognition.</p> <p>After initial recognition, the entity will apply a valuation technique to establish the financial assets' fair value. This valuation technique includes variables other than data from observable markets.</p> <p>At initial recognition, the same valuation technique would have resulted in an amount of CU14 million, which differs from fair value by CU1 million.</p> <p>The entity has existing differences of CU5 million at January 1, 20X1.</p>		
Application of Requirements		
<p>The entity's 20X2 disclosure would include the following:</p> <p><i>Accounting Policies</i></p> <p>The entity uses the following valuation technique to determine the fair value of financial instruments that are not traded in an active market: [description of technique not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with IPSAS 29, is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].</p> <p><i>In the Notes to the Financial Statements</i></p> <p>As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with IPSAS 29, the fair value of an instrument at inception is generally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].</p> <p>The differences yet to be recognized in surplus or deficit are as follows:</p>		
	Dec 31, X2	Dec 31, X1
	CU million	CU million
Balance at beginning of year	5.3	5.0
New transactions	–	1.0
Amounts recognized in surplus or deficit during the year	(0.7)	(0.8)
Other increases	–	0.2
Other decreases	(0.1)	(0.1)
Balance at end of year	4.5	5.3

Nature and Extent of Risks Arising from Financial Instruments (paragraphs 38–49 and AG6–AG30)

Qualitative Disclosures (paragraph 40)

IG17. The type of qualitative information an entity might disclose to meet the requirements in paragraph 40 includes, but is not limited to, a narrative description of:

- (a) The entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions.
- (b) The entity's policies and processes for accepting, measuring, monitoring, and controlling risk, which might include:
 - (i) The structure and organization of the entity's risk management function(s), including a discussion of independence and accountability;
 - (ii) The scope and nature of the entity's risk reporting or measurement systems;
 - (iii) The entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and
 - (iv) The entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices.
- (c) The entity's policies and procedures for avoiding excessive concentrations of risk.

IG18. Information about the nature and extent of risks arising from financial instruments is more useful if it highlights any relationship between financial instruments that can affect the amount, timing or uncertainty of an entity's future cash flows. The extent to which a risk exposure is altered by such relationships might be apparent to users from the disclosures required by this Standard, but in some cases further disclosures might be useful.

IG19. In accordance with paragraph 40(c), entities disclose any change in the qualitative information from the previous period and explain the reasons for the change. Such changes may result from changes in exposure to risk or from changes in the way those exposures are managed.

Quantitative Disclosures (paragraphs 41–49 and AG7–AG30)

IG20. Paragraph 41 requires disclosure of quantitative data about concentrations of risk. For example, concentrations of credit risk may arise from:

- (a) Industry sectors. Thus, if an entity's counterparties are concentrated in one or more industry sectors (such as retail or wholesale), it would

disclose separately exposure to risks arising from each concentration of counterparties.

- (b) Credit rating or other measure of credit quality. Thus, if an entity's counterparties are concentrated in one or more credit qualities (such as secured loans or unsecured loans) or in one or more credit ratings (such as investment grade or speculative grade), it would disclose separately exposure to risks arising from each concentration of counterparties.
- (c) Geographical distribution. Thus, if an entity's counterparties are concentrated in one or more geographical markets (such as Asia or Europe), it would disclose separately exposure to risks arising from each concentration of counterparties.
- (d) A limited number of individual counterparties or groups of closely related counterparties.

Similar principles apply to identifying concentrations of other risks, including liquidity risk and market risk. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realize liquid assets. Concentrations of foreign exchange risk may arise if an entity has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together.

- IG21. In accordance with paragraph AG8, disclosure of concentrations of risk includes a description of the shared characteristic that identifies each concentration. For example, the shared characteristic may refer to geographical distribution of counterparties by groups of countries, individual countries or regions within countries.
- IG22. When quantitative information at the end of the reporting period is unrepresentative of the entity's exposure to risk during the period, paragraph 42 requires further disclosure. To meet this requirement, an entity might disclose the highest, lowest, and average amount of risk to which it was exposed during the period. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest, and average exposures.

Credit Risk (paragraphs 43–45, AG9 and AG10)

- IG23. Paragraph 43 requires an entity to disclose information about its exposure to credit risk by class of financial instrument. Financial instruments in the

same class share economic characteristics with respect to the risk being disclosed (in this case, credit risk). For example, an entity might determine that residential mortgages, unsecured consumer loans, and commercial loans each have different economic characteristics.

Collateral and Other Credit Enhancements Pledged (paragraph 43(b))

IG24. Paragraph 43(b) requires an entity to describe collateral available as security for assets it holds and other credit enhancements obtained. An entity might meet this requirement by disclosing:

- (a) The policies and processes for valuing and managing collateral and other credit enhancements obtained;
- (b) A description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset in accordance with IPSAS 28);
- (c) The main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
- (d) Information about risk concentrations within the collateral or other credit enhancements.

Credit Quality (paragraph 43(c))

IG25. Paragraph 43(c) requires an entity to disclose information about the credit quality of financial assets with credit risk that are neither past due nor impaired. In doing so, an entity might disclose the following information:

- (a) An analysis of credit exposures using an external or internal credit grading system;
- (b) The nature of the counterparty;
- (c) Historical information about counterparty default rates; and
- (d) Any other information used to assess credit quality.

IG26. When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:

- (a) The amounts of credit exposures for each external credit grade;
- (b) The rating agencies used;
- (c) The amount of an entity's rated and unrated credit exposures; and
- (d) The relationship between internal and external ratings.

IG27. When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about:

- (a) The internal credit ratings process;
- (b) The amounts of credit exposures for each internal credit grade; and
- (c) The relationship between internal and external ratings.

Financial Assets that are either Past Due or Impaired (paragraph 44)

IG28. A financial asset is past due when the counterparty has failed to make a payment when contractually due. As an example, an entity enters into a lending agreement that requires interest to be paid every month. On the first day of the next month, if interest has not been paid, the loan is past due. Past due does not mean that a counterparty will never pay, but it can trigger various actions such as renegotiation, enforcement of covenants, or legal proceedings.

IG29. When the terms and conditions of financial assets that have been classified as past due are renegotiated, the terms and conditions of the new contractual arrangement apply in determining whether the financial asset remains past due.

IG30. Paragraph 44(a) requires an analysis by class of the age of financial assets that are past due but not impaired. An entity uses its judgment to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

- (a) Not more than three months;
- (b) More than three months and not more than six months;
- (c) More than six months and not more than one year; and
- (d) More than one year.

IG31. Paragraph 44(b) requires an analysis of impaired financial assets by class. This analysis might include:

- (a) The carrying amount, before deducting any impairment loss;
- (b) The amount of any related impairment loss; and
- (c) The nature and fair value of collateral available and other credit enhancements obtained.

Market Risk (paragraphs 47–49 and AG19–AG30)

IG32. Paragraph 47(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. There are three types of market risk: interest rate risk, currency risk, and other price risk. Other price risk may include

risks such as equity price risk, commodity price risk, prepayment risk (i.e., the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (e.g., a lessor of motor cars that writes residual value guarantees is exposed to residual value risk). Risk variables that are relevant to disclosing market risk include, but are not limited to:

- (a) The yield curve of market interest rates. It may be necessary to consider both parallel and non-parallel shifts in the yield curve.
- (b) Foreign exchange rates.
- (c) Prices of equity instruments.
- (d) Market prices of commodities.

IG33. Paragraph 47(a) requires the sensitivity analysis to show the effect on surplus or deficit and net assets/equity of reasonably possible changes in the relevant risk variable. For example, relevant risk variables might include:

- (a) Prevailing market interest rates, for interest-sensitive financial instruments such as a variable rate loan; or
- (b) Currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds.

IG34. For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:

- (a) Interest revenue and expense;
- (b) Other line items of surplus or deficit (such as trading gains and losses); and
- (c) When applicable, net assets/equity.

An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

IG35. Because the factors affecting market risk vary depending on the specific circumstances of each entity, the appropriate range to be considered in providing a sensitivity analysis of market risk varies for each entity and for each type of market risk.

IG36. The following example illustrates the application of the disclosure requirement in paragraph 47(a):

Interest Rate Risk

At December 31, 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, surplus for the year would have been CU1.7 million (20X1—CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings, and other revenue would have been CU2.8 million (20X1—CU3.2 million) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale. If interest rates had been 10 basis points higher, with all other variables held constant, surplus would have been CU1.5 million (20X1—CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings, revenue would have been CU3.0 million (20X1—CU3.4 million) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale. Surplus is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).^(a)

Foreign Currency Exchange Rate Risk

At December 31, 20X2, if the CU had weakened 10 percent against the US dollar with all other variables held constant, surplus for the year would have been CU2.8 million (20X1—CU6.4 million) lower, revenue would have been CU1.2 million (20X1—CU1.1 million) higher. Conversely, if the CU had strengthened 10 percent against the US dollar with all other variables held constant, surplus would have been CU2.8 million (20X1—CU6.4 million) higher, revenue would have been CU1.2 million (20X1—CU1.1 million) lower. The lower foreign currency exchange rate sensitivity in surplus in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt. Revenue is more sensitive in 20X2 than in 20X1 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt.

(a) Paragraph 46 requires disclosure of a maturity analysis of liabilities.

Other Market Risk Disclosures (paragraph 49)

IG37. Paragraph 49 requires the disclosure of additional information when the sensitivity analysis disclosed is unrepresentative of a risk inherent in a financial instrument. For example, this can occur when:

- (a) A financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis (e.g., options that remain out of (or in) the money for the chosen change in the risk variable);
- (b) Financial assets are illiquid (e.g., when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty); or
- (c) An entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

IG38. In the situation in paragraph IG37(a), additional disclosure might include:

- (a) The terms and conditions of the financial instrument (e.g., the options);
- (b) The effect on surplus or deficit if the term or condition were met (i.e., if the options were exercised); and
- (c) A description of how the risk is hedged.

For example, an entity may acquire a zero cost interest rate collar that includes an out-of-the-money leveraged written option (e.g., the entity pays ten times the amount of the difference between a specified interest rate floor and the current market interest rate). The entity may regard the collar as an inexpensive economic hedge against a reasonably possible increase in interest rates. However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates. Neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, the entity might provide the additional information described above.

IG39. In the situation described in paragraph IG38(b), additional disclosure might include the reasons for the lack of liquidity and how the entity hedges the risk.

IG40. In the situation described in paragraph IG38(c), additional disclosure might include:

- (a) The nature of the security (e.g., entity name);
- (b) The extent of holding (e.g., 15 percent of the issued shares);
- (c) The effect on surplus or deficit; and
- (d) How the entity hedges the risk.

Comparison with IFRS 7

IPSAS 30, *Financial Instruments: Disclosures* is drawn primarily from IFRS 7, *Financial Instruments: Disclosures* (originally issued in 2005, including amendments published to April 2009). The main differences between IPSAS 30 and IFRS 7 are as follows:

- IPSAS 30 contains requirements related to concessionary loans. IFRS 7 does not require disclosures relating to concessionary loans.
- In certain instances, IPSAS 30 uses different terminology from IFRS 7. The most significant examples are the use of the terms “revenue,” “statement of financial performance,” and “net assets/equity” in IPSAS 30. The equivalent terms in IFRS 7 are “income,” “statement of comprehensive income,” and “equity.”

IPSAS 31—INTANGIBLE ASSETS

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 38, *Intangible Assets* published by the International Accounting Standards Board (IASB). It also contains extracts from the Standing Interpretations Committee Interpretation 32 (SIC 32), *Intangible Assets—Web Site Costs*. Extracts from IAS 38 and SIC 32 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 31—INTANGIBLE ASSETS

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 31, *Intangible Assets* was issued in January 2010.

Since then, IPSAS 31 has been amended by the following IPSASs:

- IPSAS 40, *Public Sector Combinations* (issued January 2017)
- IPSAS 39, *Employee Benefits* (issued July 2016)
- *Impairment of Revalued Assets* (Amendments to IPSAS 21, *Impairment of Non-Cash-Generating Assets*, and IPSAS 26, *Impairment of Cash-Generating Assets*) (issued July 2016)
- *The Applicability of IPSASs* (issued April 2016)
- *Improvements to IPSASs 2015* (issued April 2016)
- IPSAS 37, *Joint Arrangements* (issued January 2015)
- IPSAS 35, *Consolidated Financial Statements* (issued January 2015)
- IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* (issued January 2015)
- *Improvements to IPSASs 2014* (issued January 2015)
- IPSAS 32, *Service Concession Arrangements: Grantor* (issued October 2011)
- *Improvements to IPSASs 2011* (issued October 2011)

Table of Amended Paragraphs in IPSAS 31

Paragraph Affected	How Affected	Affected By
Introduction section	Deleted	Improvements to IPSASs October 2011
3	Amended	Improvements to IPSASs April 2016 IPSAS 40 January 2017
4	Deleted	The Applicability of IPSASs April 2016

Paragraph Affected	How Affected	Affected By
5	Deleted	The Applicability of IPSASs April 2016
6	Amended	IPSAS 37 January 2015 IPSAS 35 January 2015 IPSAS 32 October 2011 IPSAS 39 July 2016 IPSAS 40 January 2017
18	Amended	IPSAS 40 January 2017
18A	New	IPSAS 40 January 2017
24	Amended	IPSAS 40 January 2017
26A	New	IPSAS 40 January 2017
28	Amended	Improvements to IPSASs April 2016
35	Amended	IPSAS 39 July 2016
39A	New	IPSAS 40 January 2017
39B	New	IPSAS 40 January 2017
39C	New	IPSAS 40 January 2017
39D	New	IPSAS 40 January 2017
39E	New	IPSAS 40 January 2017
40	Amended	IPSAS 40 January 2017
41	Amended	IPSAS 40 January 2017
64	Amended	IPSAS 39 July 2016
66	Amended	IPSAS 40 January 2017
67	Amended	IPSAS 40 January 2017
79	Amended	Improvements to IPSASs January 2015
91	Amended	Improvements to IPSASs January 2015
93A	New	IPSAS 40 January 2017

Paragraph Affected	How Affected	Affected By
96	Amended	Improvements to IPSASs April 2016
97	Amended	Improvements to IPSASs January 2015
97A	New	Improvements to IPSASs January 2015
97B	New	Improvements to IPSASs January 2015
97C	New	Improvements to IPSASs January 2015
110	Amended	Impairment of Revalued Assets July 2016
114A	New	IPSAS 40 January 2017
116	Amended	Improvements to IPSASs April 2016
117	Amended	Improvements to IPSASs April 2016 IPSAS 40 January 2017
129	Deleted	IPSAS 33 January 2015
130	Deleted	IPSAS 33 January 2015
131	Deleted	IPSAS 33 January 2015
131A	New	Improvements to IPSASs January 2015
132A	New	IPSAS 32 October 2011
132B	New	Improvements to IPSASs January 2015
132C	New	IPSAS 33 January 2015
132D	New	IPSAS 37 January 2015 IPSAS 35 January 2015
132E	New	Improvements to IPSASs April 2016

Paragraph Affected	How Affected	Affected By
132F	New	The Applicability of IPSASs April 2016
132G	New	Impairment of Revalued Assets July 2016
132H	New	IPSAS 39 July 2016
132I	New	IPSAS 40 January 2017
133	Amended	IPSAS 33 January 2015

IPSAS 31—INTANGIBLE ASSETS

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International Public Sector Accounting Standard 31, *Intangible Assets*, is set out in paragraphs 1–133. All the paragraphs have equal authority. IPSAS 31 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognize an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets, and requires specified disclosures about intangible assets.

Scope

2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for intangible assets.**
3. **This Standard shall be applied in accounting for intangible assets, except:**
 - (a) **Intangible assets that are within the scope of another Standard;**
 - (b) **Financial assets, as defined in IPSAS 28, *Financial Instruments: Presentation*;**
 - (c) **The recognition and measurement of exploration and evaluation assets (see the relevant international or national accounting standard dealing with exploration for, and evaluation of, mineral resources);**
 - (d) **Expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources;**
 - (e) [Deleted]
 - (f) [Deleted]
 - (g) **Powers and rights conferred by legislation, a constitution, or by equivalent means;**
 - (h) **Deferred tax assets (see the relevant international or national accounting standard dealing with income taxes);**
 - (i) **Deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of the relevant international or national accounting standard dealing with insurance contracts. In cases where the relevant international or national accounting standard does not set out specific disclosure requirements for those intangible assets, the disclosure requirements in this Standard apply to those intangible assets; and**
 - (j) [Deleted]

- (k) **In respect of intangible heritage assets. However, the disclosure requirements of paragraphs 115–127 apply to those heritage assets that are recognized.**
4. [Deleted]
 5. [Deleted]
 6. If another IPSAS prescribes the accounting for a specific type of intangible asset, an entity applies that IPSAS instead of this Standard. For example, this Standard does not apply to:
 - (a) Intangible assets held by an entity for sale in the ordinary course of operations (see IPSAS 11, *Construction Contracts*, and IPSAS 12, *Inventories*);
 - (b) Leases that are within the scope of IPSAS 13, *Leases*;
 - (c) Assets arising from employee benefits (see *IPSAS 39, Employee Benefits*);
 - (d) Financial assets as defined in IPSAS 28. The recognition and measurement of some financial assets are covered by IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements* and *IPSAS 36, Investments in Associates and Joint Ventures*;
 - (e) Recognition and initial measurement of service concession assets that are within the scope of IPSAS 32, *Service Concession Assets: Grantor*. However, this Standard applies to the subsequent measurement and disclosure of such assets; and
 - (f) Goodwill (see IPSAS 40, *Public Sector Combinations*).
 7. Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a license or patent), or film. In determining whether an asset that incorporates both intangible and tangible elements should be treated under IPSAS 17, *Property, Plant, and Equipment*, or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant. For example, the navigation software for a fighter aircraft is integral to the aircraft and is treated as property, plant and equipment. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.
 8. This Standard applies to, among other things, expenditure on advertising, training, start-up, research, and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical

substance (e.g., a prototype), the physical element of the asset is secondary to its intangible component, i.e., the knowledge embodied in it.

9. In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee accounts for an intangible asset held under a finance lease in accordance with this Standard. Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents, and copyrights are excluded from the scope of IPSAS 13 and are within the scope of this Standard.
10. Exclusions from the scope of a Standard may occur if activities or transactions are so specialized that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the accounting for expenditure on the exploration for, or development and extraction of, oil, gas, and mineral deposits in extractive industries, and in the case of insurance contracts. Therefore, this Standard does not apply to expenditure on such activities and contracts. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure incurred (such as start-up costs), in extractive industries, or by insurers.

Intangible Heritage Assets

11. This Standard does not require an entity to recognize intangible heritage assets that would otherwise meet the definition of, and recognition criteria for, intangible assets. If an entity does recognize intangible heritage assets, it must apply the disclosure requirements of this Standard and may, but is not required to, apply the measurement requirements of this Standard.
12. Some intangible assets are described as intangible heritage assets because of their cultural, environmental, or historical significance. Examples of intangible heritage assets include recordings of significant historical events and rights to use the likeness of a significant public person on, for example, postage stamps or collectible coins. Certain characteristics, including the following, are often displayed by intangible heritage assets (although these characteristics are not exclusive to such assets):
 - (a) Their value in cultural, environmental, and historical terms is unlikely to be fully reflected in a financial value based purely on a market price;
 - (b) Legal and/or statutory obligations may impose prohibitions or severe restrictions on disposal by sale;
 - (c) Their value may increase over time; and
 - (d) It may be difficult to estimate their useful lives, which in some cases could be several hundred years.
13. Public sector entities may have large holdings of intangible heritage assets that have been acquired over many years and by various means, including

purchase, donation, bequest, and sequestration. These assets are rarely held for their ability to generate cash inflows, and there may be legal or social obstacles to using them for such purposes.

14. Some intangible heritage assets have future economic benefits or service potential other than their heritage value, for example, royalties paid to the entity for use of an historical recording. In these cases, an intangible heritage asset may be recognized and measured on the same basis as other items of cash-generating intangible assets. For other intangible heritage assets, their future economic benefit or service potential is limited to their heritage characteristics. The existence of both future economic benefits and service potential can affect the choice of measurement base.
15. The disclosure requirements in paragraphs 117–124 require entities to make disclosures about recognized intangible assets. Therefore, entities that recognize intangible heritage assets are required to disclose in respect of those assets such matters as, for example:
 - (a) The measurement basis used;
 - (b) The amortization method used, if any;
 - (c) The gross carrying amount;
 - (d) The accumulated amortization at the end of the period, if any; and
 - (e) A reconciliation of the carrying amount at the beginning and end of the period showing certain components thereof.

Definitions

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

Amortization is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Carrying amount is the amount at which an asset is recognized after deducting any accumulated amortization and accumulated impairment losses.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

An intangible asset is an identifiable nonmonetary asset without physical substance.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

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

Intangible Assets

17. Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance, or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes, or systems, licenses, intellectual property, and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, lists of users of a service, acquired fishing licenses, acquired import quotas, and relationships with users of a service.

Identifiability

18. Not all the items described in paragraph 17 meet the definition of an intangible asset, i.e., identifiability, control over a resource, and existence of future economic benefits or service potential. If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognized as an expense when it is incurred. However, if the item is acquired in an acquisition, it forms part of the goodwill recognized at the acquisition date (see paragraph 66).
- 18A. The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill recognized in an acquisition is an asset representing the future economic benefits arising from other assets acquired in an acquisition that are not individually identified and separately recognized. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements.
19. **An asset is identifiable if it either:**
 - (a) **Is separable, i.e., is capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or**
 - (b) **Arises from binding arrangements (including rights from contracts or other legal rights), regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.**

20. For the purposes of this Standard, a binding arrangement describes an arrangement that confers similar rights and obligations on the parties to it as if it were in the form of a contract.

Control of an Asset

21. An entity controls an asset if the entity has the power to obtain the future economic benefits or service potential flowing from the underlying resource and to restrict the access of others to those benefits or that service potential. The capacity of an entity to control the future economic benefits or service potential from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits or service potential in some other way.
22. Scientific or technical knowledge may give rise to future economic benefits or service potential. An entity controls those benefits or that service potential if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted), or by a legal duty on employees to maintain confidentiality.
23. An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits or service potential from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits or service potential arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits or service potential expected from it, and it also meets the other parts of the definition.
24. An entity may have a portfolio of users of its services or its success rate in reaching intended users of its services and expect that, because of its efforts in building relationships with users of its services, those users will continue to use its services. However, in the absence of legal rights to protect, or other ways to control the relationships with users of a service or the loyalty of those users, the entity usually has insufficient control over the expected economic benefits or service potential from relationships with users of a service and loyalty for such items (e.g., portfolio of users of a service, market shares or success rates of a service, relationships with, and loyalty of, users of a service) to meet the definition of intangible assets. In the absence of legal rights to protect such relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of an acquisition)

provide evidence that the entity is nonetheless able to control the expected future economic benefits or service potential flowing from the relationships with the users of a service. Because such exchange transactions also provide evidence that the relationships with users of a service are separable, those relationships meet the definition of an intangible asset.

Future Economic Benefits or Service Potential

25. The future economic benefits or service potential flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production or service process may reduce future production or service costs or improve service delivery rather than increase future revenues (e.g., an on-line system that allows citizens to renew driving licenses more quickly on-line, resulting in a reduction in office staff required to perform this function while increasing the speed of processing).

Recognition and Measurement

26. The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

- (a) The definition of an intangible asset (see paragraphs 17–25); and
- (b) The recognition criteria (see paragraphs 28–30).

This requirement applies to the cost measured at recognition (the cost in an exchange transaction or to internally generate an intangible asset, or the fair value of an intangible asset acquired through a non-exchange transaction) and those incurred subsequently to add to, replace part of, or service it.

- 26A. Paragraphs 32–39 deal with the application of the recognition criteria to separately acquired intangible assets, and paragraphs 39A–41 deal with their application to intangible assets acquired in a public sector combination. Paragraphs 42–43 deal with the initial measurement of intangible assets acquired through non-exchange transactions, paragraphs 44–45 with exchanges of intangible assets, and paragraphs 46–48 with the treatment of internally generated goodwill. Paragraphs 49–65 deal with the initial recognition and measurement of internally generated intangible assets.
27. The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly, most subsequent expenditures are likely to maintain the expected future economic benefits or service potential embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in this Standard. In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the entity's operations as a whole. Therefore, only rarely will subsequent expenditure—

expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset—be recognized in the carrying amount of an asset. Consistent with paragraph 61, subsequent expenditure on brands, mastheads, publishing titles, lists users of a service, and items similar in substance (whether externally acquired or internally generated) is always recognized in surplus or deficit as incurred. This is because such expenditure cannot be distinguished from expenditure to develop the entity's operations as a whole.

28. **An intangible asset shall be recognized if, and only if:**
 - (a) **It is probable that the expected future economic benefits or service potential that are attributable to the asset will flow to the entity; and**
 - (b) **The cost or fair value of the asset can be measured reliably¹.**
29. **An entity shall assess the probability of expected future economic benefits or service potential using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.**
30. An entity uses judgement to assess the degree of certainty attached to the flow of future economic benefits or service potential that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.
31. **An intangible asset shall be measured initially at cost in accordance with paragraphs 32–43. Where an intangible asset is acquired through a non-exchange transaction, its initial cost at the date of acquisition, shall be measured at its fair value as at that date.**

Separate Acquisition

32. Normally, the price an entity pays to acquire separately an intangible asset will reflect expectations about the probability that the expected future economic benefits or service potential embodied in the asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits or service potential, even if there is uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion in paragraph 28(a) is always considered to be satisfied for separately acquired intangible assets.

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

33. In addition, the cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.
34. The cost of a separately acquired intangible asset comprises:
 - (a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
 - (b) Any directly attributable cost of preparing the asset for its intended use.
35. Examples of directly attributable costs are:
 - (a) Costs of employee benefits (as defined in IPSAS 39) arising directly from bringing the asset to its working condition;
 - (b) Professional fees arising directly from bringing the asset to its working condition; and
 - (c) Costs of testing whether the asset is functioning properly.
36. Examples of expenditures that are not part of the cost of an intangible asset are:
 - (a) Costs of introducing a new product or service (including costs of advertising and promotional activities);
 - (b) Costs of conducting operations in a new location or with a new class of users of a service (including costs of staff training); and
 - (c) Administration and other general overhead costs.
37. Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an intangible asset are not included in the carrying amount of that asset. For example, the following costs are not included in the carrying amount of an intangible asset:
 - (a) Costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and
 - (b) Initial operating deficits, such as those incurred while demand for the asset's output builds up.
38. Some operations occur in connection with the development of an intangible asset, but are not necessary to bring the asset to the condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the development activities. Because incidental operations are not necessary to bring an asset to the condition necessary for it to be capable of operating in the manner intended

by management, the revenue and related expenses of incidental operations are recognized immediately in surplus or deficit, and included in their respective classifications of revenue and expense.

39. If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognized as interest expense over the period of credit unless it is capitalized in accordance with the capitalization treatment permitted in IPSAS 5, *Borrowing Costs*.

Acquisition of an intangible asset as part of an acquisition (public sector combination)

- 39A. In accordance with IPSAS 40, if an intangible asset is acquired in an acquisition, the cost of that intangible asset is its fair value at the acquisition date. The fair value of an intangible asset will reflect market participants' expectations at the acquisition date about the probability that the expected future economic benefits or service potential embodied in the asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits or service potential, even if there is uncertainty about the timing or the amount of the inflow. Therefore, the probability recognition criterion in paragraph 28(a) is always considered to be satisfied for intangible assets acquired in acquisitions. If an asset acquired in an acquisition is separable or arises from binding arrangements (including rights from contracts or other legal rights), sufficient information exists to measure reliably the fair value of the asset. Thus, the reliable measurement criterion in paragraph 28(b) is always considered to be satisfied for intangible assets acquired in acquisitions.
- 39B. In accordance with this Standard and IPSAS 40, an acquirer recognizes at the acquisition date, separately from goodwill, an intangible asset of the acquired operation, irrespective of whether the asset had been recognized by the acquired operation before the acquisition. This means that the acquirer recognizes as an asset separately from goodwill an in-process research and development project of the acquired operation if the project meets the definition of an intangible asset. An acquired operation's in-process research and development project meets the definition of an intangible asset when it:
- (a) Meets the definition of an asset; and
 - (b) Is identifiable, i.e., is separable or arises from binding arrangements (including rights from contracts or other legal rights).

Intangible asset acquired in an acquisition (public sector combination)

- 39C. If an intangible asset acquired in an acquisition is separable or arises from a binding arrangement (including rights from contracts or other legal rights), sufficient information exists to measure reliably the fair value of the asset. When, for the estimates used to measure an intangible asset's fair value, there

is a range of possible outcomes with different probabilities that uncertainty enters into the measurement of the asset's fair value.

- 39D. An intangible asset acquired in an acquisition might be separable, but only together with a related binding arrangement, identifiable asset or liability. In such cases, the acquirer recognizes the intangible asset separately from goodwill, but together with the related item.
- 39E. The acquirer may recognize a group of complementary intangible assets as a single asset provided the individual assets have similar useful lives. For example, the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise.

Subsequent Expenditure on an Acquired In-process Research and Development Project

- 40. **Research or development expenditure that:**
 - (a) **Relates to an in-process research or development project acquired separately or in an acquisition and recognized as an intangible asset; and**
 - (b) **Is incurred after the acquisition of that project;****shall be accounted for in accordance with paragraphs 52–60.**
- 41. Applying the requirements in paragraphs 52–60 means that subsequent expenditure on an in-process research or development project acquired separately or in an acquisition and recognized as an intangible asset is:
 - (a) Recognized as an expense when incurred if it is research expenditure;
 - (b) Recognized as an expense when incurred if it is development expenditure that does not satisfy the criteria for recognition as an intangible asset in paragraph 55; and
 - (c) Added to the carrying amount of the acquired in-process research or development project if it is development expenditure that satisfies the recognition criteria in paragraph 55.

Intangible Assets Acquired through Non-Exchange Transactions

- 42. In some cases, an intangible asset may be acquired through a non-exchange transaction. This may happen when another public sector entity transfers to an entity in a non-exchange transaction, intangible assets such as airport landing rights, licenses to operate radio or television stations, import licenses or quotas or rights to access other restricted resources. A private citizen, for

example a Nobel Prize winner, may bequeath his or her personal papers, including the copyright to his or her publications to the national archives (a public sector entity) in a non-exchange transaction.

43. Under these circumstances the cost of the item is its fair value at the date it is acquired. For the purposes of this Standard, the measurement at recognition of an intangible asset acquired through a non-exchange transaction, at its fair value consistent with the requirements of paragraph 74, does not constitute a revaluation. Accordingly, the revaluation requirements in paragraph 74, and the supporting commentary in paragraphs 75–86 only apply when an entity elects to revalue an intangible item in subsequent reporting periods.

Exchanges of Assets

44. One or more intangible assets may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an intangible asset is measured at fair value unless the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognize the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.
45. Paragraph 28(b) specifies that a condition for the recognition of an intangible asset is that the cost of the asset can be measured reliably. The fair value of an intangible asset for which comparable market transactions do not exist is reliably measurable if:
 - (a) The variability in the range of reasonable fair value estimates is not significant for that asset: or
 - (b) The probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

If an entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Internally Generated Goodwill

46. **Internally generated goodwill shall not be recognized as an asset.**
47. In some cases, expenditure is incurred to generate future economic benefits or service potential, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is

often described as contributing to internally generated goodwill. Internally generated goodwill is not recognized as an asset because it is not an identifiable resource (i.e., it is not separable nor does it arise from binding arrangements (including rights from contracts or other legal rights) controlled by the entity that can be measured reliably at cost.

48. Differences between the market value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

Internally Generated Intangible Assets

49. It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:
- (a) Identifying whether and when there is an identifiable asset that will generate expected future economic benefits or service potential; and
 - (b) Determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity applies the requirements and guidance in paragraphs 50–65 to all internally generated intangible assets.

50. To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:
- (a) A research phase; and
 - (b) A development phase.

Although the terms “research” and “development” are defined, the terms “research phase” and “development phase” have a broader meaning for the purpose of this Standard.

51. If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

52. **No intangible asset arising from research (or from the research phase of an internal project) shall be recognized. Expenditure on research (or on the research phase of an internal project) shall be recognized as an expense when it is incurred.**

53. In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits or service potential. Therefore, this expenditure is recognized as an expense when it is incurred.
54. Examples of research activities are:
 - (a) Activities aimed at obtaining new knowledge;
 - (b) The search for, evaluation and final selection of, applications of research findings or other knowledge;
 - (c) The search for alternatives for materials, devices, products, processes, systems, or services; and
 - (d) The formulation, design, evaluation, and final selection of possible alternatives for new or improved materials, devices, products, processes, systems, or services.

Development Phase

55. **An intangible asset arising from development (or from the development phase of an internal project) shall be recognized if, and only if, an entity can demonstrate all of the following:**
 - (a) **The technical feasibility of completing the intangible asset so that it will be available for use or sale;**
 - (b) **Its intention to complete the intangible asset and use or sell it;**
 - (c) **Its ability to use or sell the intangible asset;**
 - (d) **How the intangible asset will generate probable future economic benefits or service potential. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;**
 - (e) **The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and**
 - (f) **Its ability to measure reliably the expenditure attributable to the intangible asset during its development.**
56. In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits or service potential. This is because the development phase of a project is further advanced than the research phase.
57. Examples of development activities are:

- (a) The design, construction, and testing of pre-production or pre-use prototypes and models;
- (b) The design of tools, jigs, moulds, and dies involving new technology;
- (c) The design, construction, and operation of a pilot plant or operation that is not of a scale economically feasible for commercial production or use in providing services;
- (d) The design, construction, and testing of a chosen alternative for new or improved materials, devices, products, processes, systems, or services; and
- (e) Website costs and software development costs.

58. To demonstrate how an intangible asset will generate probable future economic benefits or service potential, an entity assesses the future economic benefits or service potential to be received from the asset using the principles in either IPSAS 21, *Impairment of Non-Cash-Generating Assets* or IPSAS 26, *Impairment of Cash-Generating Assets*, as appropriate. If the asset will generate economic benefits or service potential only in combination with other assets, the entity applies the concept of cash-generating units in IPSAS 26.
59. Availability of resources to complete, use, and obtain the benefits from an intangible asset can be demonstrated by, for example, an operating plan showing the technical, financial, and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's or funder's indication of its willingness to fund the plan.
60. An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing logos, copyrights or licenses, or developing computer software.
61. **Internally generated brands, mastheads, publishing titles, lists of users of a service, and items similar in substance shall not be recognized as intangible assets.**
62. Expenditure on internally generated brands, mastheads, publishing titles, lists of users of a service, and items similar in substance cannot be distinguished from the cost of developing the entity's operations as a whole. Therefore, such items are not recognized as intangible assets.

Cost of an Internally Generated Intangible Asset

63. The cost of an internally generated intangible asset for the purpose of paragraph 31 is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in paragraphs 28, 29,

and 55. Paragraph 70 prohibits reinstatement of expenditure previously recognized as an expense.

64. The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:
- (a) Costs of materials and services used or consumed in generating the intangible asset;
 - (b) Costs of employee benefits (as defined in IPSAS 39) arising from the generation of the intangible asset;
 - (c) Fees to register a legal right; and
 - (d) Amortization of patents and licenses that are used to generate the intangible asset.

IPSAS 5 specifies criteria for the recognition of interest as an element of the cost of an asset that is a qualifying asset.

65. The following are not components of the cost of an internally generated intangible asset:
- (a) Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;
 - (b) Identified inefficiencies and initial operating deficits incurred before the asset achieves planned performance; and
 - (c) Expenditure on training staff to operate the asset.

Recognition of an Expense

66. **Expenditure on an intangible item shall be recognized as an expense when it is incurred unless:**
- (a) **It forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 26–65); or**
 - (b) **The item is acquired in an acquisition and cannot be recognized as an intangible asset. If this is the case, it forms part of the amount recognized as goodwill at the acquisition date (see IPSAS 40).**
67. In some cases, expenditure is incurred to provide future economic benefits or service potential to an entity, but no intangible asset or other asset is acquired or created that can be recognized. In the case of the supply of goods, the entity recognizes such expenditure as an expense when it has a right to access those goods. In the case of the supply of services, the entity recognizes

the expenditure as an expense when it receives the services. For example, expenditure on research is recognized as an expense when it is incurred (see paragraph 52), except when it is acquired as part of an acquisition. Other examples of expenditure that is recognized as an expense when it is incurred include:

- (a) Expenditure on start-up activities (i.e., start-up costs), unless this expenditure is included in the cost of an item of property, plant, and equipment in accordance with IPSAS 17. Start-up costs may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or operation (i.e., pre-opening costs), or expenditures for starting new operations or launching new products or processes (i.e., pre-operating costs);
- (b) Expenditure on training activities;
- (c) Expenditure on advertising and promotional activities (including mail order catalogues and information pamphlets); and
- (d) Expenditure on relocating or reorganizing part or all of an entity.

68. An entity has a right to access goods when it owns them. Similarly, it has a right to access goods when they have been constructed by a supplier in accordance with the terms of a supply contract and the entity could demand delivery of them in return for payment. Services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service, for example, to deliver information about a service to users of that service.

69. Paragraph 66 does not preclude an entity from recognizing a prepayment as an asset when payment for goods has been made in advance of the entity obtaining a right to access those goods. Similarly, paragraph 66 does not preclude an entity from recognizing a prepayment as an asset when payment for services has been made in advance of the entity receiving those services.

Past Expenses not to be Recognized as an Asset

70. **Expenditure on an intangible item that was initially recognized as an expense under this Standard shall not be recognized as part of the cost of an intangible asset at a later date.**

Subsequent Measurement

71. **An entity shall choose either the cost model in paragraph 73 or the revaluation model in paragraph 74 as its accounting policy. If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.**

72. A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. The items within a class of intangible assets are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements representing a mixture of costs and values as at different dates.

Cost Model

73. **After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortization and any accumulated impairment losses.**

Revaluation Model

74. **After initial recognition, an intangible asset shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortization. For the purpose of revaluations under this Standard, fair value shall be determined by reference to an active market. Revaluations shall be made with such regularity that at the reporting date the carrying amount of the asset does not differ materially from its fair value.**
75. The revaluation model does not allow:
- (a) The revaluation of intangible assets that have not previously been recognized as assets; or
 - (b) The initial recognition of intangible assets at amounts other than cost.
76. The revaluation model is applied after an asset has been initially recognized at cost. However, if only part of the cost of an intangible asset is recognized as an asset because the asset did not meet the criteria for recognition until part of the way through the process (see paragraph 63), the revaluation model may be applied to the whole of that asset. Also, the revaluation model may be applied to an intangible asset that was received through a non-exchange transaction (see paragraphs 42–43).
77. It is uncommon for an active market to exist for an intangible asset, although this may happen. For example, in some jurisdictions, an active market may exist for freely transferable homogeneous classes of licenses or production quotas the entity has acquired from another entity. However, an active market cannot exist for brands, newspaper mastheads, music and film publishing rights, patents, or trademarks, because each such asset is unique. Also, although intangible assets are bought and sold, contracts are negotiated between individual buyers and sellers, and transactions are relatively infrequent. For these reasons, the price paid for one asset may not provide sufficient evidence of the fair value of another. Moreover, prices are often not available to the public.

78. The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued. If the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. Some intangible assets may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for intangible assets with only insignificant movements in fair value.
79. When an intangible asset is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:
- (a) The gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated amortization at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or
 - (b) The accumulated amortization is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated amortization forms part of the increase or decrease in the carrying amount that is accounted for in accordance with paragraphs 84 and 85.

80. **If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset shall be carried at its cost less any accumulated amortization and impairment losses.**
81. **If the fair value of a revalued intangible asset can no longer be determined by reference to an active market, the carrying amount of the asset shall be its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortization and any subsequent accumulated impairment losses.**
82. The fact that an active market no longer exists for a revalued intangible asset may indicate that the asset may be impaired and that it needs to be tested in accordance with IPSAS 21 or IPSAS 26, as appropriate.
83. If the fair value of the asset can be determined by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date.
84. **If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be credited directly to revaluation surplus.**

However, the increase shall be recognized in surplus or deficit to the extent that it reverses a revaluation decrease of the same asset previously recognized in surplus or deficit.

85. **If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in surplus or deficit. However, the decrease shall be recognized directly in net assets/equity to the extent of any credit balance in the revaluation surplus in respect of that asset. The decrease recognized directly in net assets/equity reduces the amount accumulated in net assets/equity under the heading of revaluation surplus.**
86. The cumulative revaluation surplus included in net assets/equity may be transferred directly to accumulated surpluses or deficits when the surplus is realized. The whole surplus may be realized on the retirement or disposal of the asset. However, some of the surplus may be realized as the asset is used by the entity; in such a case, the amount of the surplus realized is the difference between amortization based on the revalued carrying amount of the asset and amortization that would have been recognized based on the asset's historical cost. The transfer from revaluation surplus to accumulated surpluses or deficits is not made through surplus or deficit.

Useful Life

87. **An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for, or provide service potential to, the entity.**
88. The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortized (see paragraphs 96–105), and an intangible asset with an indefinite useful life is not (see paragraphs 106–109). The Illustrative Examples accompanying this Standard illustrate the determination of useful life for different intangible assets, and the subsequent accounting for those assets based on the useful life determinations.
89. Many factors are considered in determining the useful life of an intangible asset, including:
 - (a) The expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team;
 - (b) Typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way;

- (c) Technical, technological, commercial, or other types of obsolescence;
- (d) The stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;
- (e) Expected actions by competitors or potential competitors;
- (f) The level of maintenance expenditure required to obtain the expected future economic benefits or service potential from the asset and the entity's ability and intention to reach such a level;
- (g) The period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and
- (h) Whether the useful life of the asset is dependent on the useful life of other assets of the entity.

90. The term "indefinite" does not mean "infinite." The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level. A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.
91. Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it will often be the case that their useful life is short. Expected future reductions in the selling price of an item that was produced using an intangible asset could indicate the expectation of technological or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits or service potential embodied in the asset.
92. The useful life of an intangible asset may be very long or even indefinite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.
93. **The useful life of an intangible asset that arises from binding arrangements (including rights from contracts or other legal rights) shall not exceed the period of the binding arrangement (including rights from contracts or other legal rights), but may be shorter depending on the period over which the entity expects to use the asset. If the binding arrangements (including rights from contracts or other legal rights) are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.**

93A. The useful life of:

- (a) **A license or similar right previously granted by one combining operation to another combining operation that is recognized by the resulting entity in an amalgamation; or**
- (b) **A reacquired right recognized as an intangible asset in an acquisition**

is the remaining period of the binding arrangement (including rights from contracts or other legal rights) in which the right was granted and shall not include renewal periods.

94. There may be economic, political, social, and legal factors influencing the useful life of an intangible asset. Economic, political, or social factors determine the period over which future economic benefits or service potential will be received by the entity. Legal factors may restrict the period over which the entity controls access to such economic benefits or service potential. The useful life is the shorter of the periods determined by these factors.
95. Existence of the following factors, among others, indicates that an entity would be able to renew the binding arrangements (including rights from contracts or other legal rights) without significant cost:
- (a) There is evidence, possibly based on experience, that the binding arrangements (including rights from contracts or other legal rights) will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;
 - (b) There is evidence that any conditions necessary to obtain renewal will be satisfied; and
 - (c) The cost to the entity of renewal is not significant when compared with the future economic benefits or service potential expected to flow to the entity from renewal.

If the cost of renewal is significant when compared with the future economic benefits or service potential expected to flow to the entity from renewal, the “renewal” cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.

Intangible Assets with Finite Useful Lives

Amortization Period and Amortization Method

96. **The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life. Amortization shall begin when the asset is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Amortization shall cease at the date that the asset is derecognized. The amortization method used shall reflect**

the pattern in which the asset's future economic benefits or service potential are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. The amortization charge for each period shall be recognized in surplus or deficit unless this or another Standard permits or requires it to be included in the carrying amount of another asset.

97. A variety of amortization methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method, and the units of production method. The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits or service potential embodied in the asset and is applied consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits or service potential.
- 97A. There is a rebuttable presumption that an amortization method that is based on the revenue generated by an activity that includes the use of an intangible asset is inappropriate. The revenue generated by an activity that includes the use of an intangible asset typically reflects factors that are not directly linked to the consumption of the economic benefits or service potential embodied in the intangible asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed. This presumption can be overcome only in the limited circumstances:
- (a) In which the intangible asset is expressed as a measure of revenue, as described in paragraph 97C; or
 - (b) When it can be demonstrated that revenue and the consumption of the economic benefits or service potential of the intangible asset are highly correlated.
- 97B. In choosing an appropriate amortization method in accordance with paragraph 97, an entity could determine the predominant limiting factor that is inherent in the intangible asset. For example, the contract that sets out the entity's rights over its use of an intangible asset might specify the entity's use of the intangible asset as a predetermined number of years (i.e., time), as a number of units produced or as a fixed total amount of revenue to be generated. Identification of such a predominant limiting factor could serve as the starting point for the identification of the appropriate basis of amortization, but another basis may be applied if it more closely reflects the expected pattern of consumption of economic benefits or service potential.
- 97C. In the circumstance in which the predominant limiting factor that is inherent in an intangible asset is the achievement of a revenue threshold, the revenue to be generated can be an appropriate basis for amortization. For example, the

right to operate a toll road could be based on a fixed total amount of revenue to be generated from cumulative tolls charged (for example, a contract could allow operation of the toll road until the cumulative amount of tolls generated from operating the road reaches CU100 million). In the case in which revenue has been established as the predominant limiting factor in the contract for the use of the intangible asset, the revenue that is to be generated might be an appropriate basis for amortizing the intangible asset, provided that the contract specifies a fixed total amount of revenue to be generated on which amortization is to be determined.

98. Amortization is usually recognized in surplus or deficit. However, sometimes the future economic benefits or service potential embodied in an asset are absorbed in producing other assets. In this case, the amortization charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the amortization of intangible assets used in a production process is included in the carrying amount of inventories (see IPSAS 12).

Residual Value

99. **The residual value of an intangible asset with a finite useful life shall be assumed to be zero unless:**
 - (a) **There is a commitment by a third party to acquire the asset at the end of its useful life; or**
 - (b) **There is an active market for the asset, and:**
 - (i) **Residual value can be determined by reference to that market; and**
 - (ii) **It is probable that such a market will exist at the end of the asset's useful life.**
100. The depreciable amount of an asset with a finite useful life is determined after deducting its residual value. A residual value other than zero implies that an entity expects to dispose of the intangible asset before the end of its economic life.
101. An estimate of an asset's residual value is based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used. The residual value is reviewed at least at each reporting date. A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*.
102. The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortization

charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

Review of Amortization Period and Amortization Method

103. **The amortization period and the amortization method for an intangible asset with a finite useful life shall be reviewed at least at each reporting date. If the expected useful life of the asset is different from previous estimates, the amortization period shall be changed accordingly. If there has been a change in the expected pattern of consumption of the future economic benefits or service potential embodied in the asset, the amortization method shall be changed to reflect the changed pattern. Such changes shall be accounted for as changes in accounting estimates in accordance with IPSAS 3.**
104. During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the recognition of an impairment loss may indicate that the amortization period needs to be changed.
105. Over time, the pattern of future economic benefits or service potential expected to flow to an entity from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortization is appropriate rather than a straight-line method. Another example is if use of the rights represented by a license is deferred pending action on other components of the entity's strategic plan. In this case, economic benefits or service potential that flow from the asset may not be received until later periods.

Intangible Assets with Indefinite Useful Lives

106. **An intangible asset with an indefinite useful life shall not be amortized.**
107. In accordance with IPSAS 21 and IPSAS 26, an entity is required to test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment by comparing its recoverable service amount or its recoverable amount, as appropriate, with its carrying amount:
 - (a) Annually; and
 - (b) Whenever there is an indication that the intangible asset may be impaired.

Review of Useful Life Assessment

108. **The useful life of an intangible asset that is not being amortized shall be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from**

indefinite to finite shall be accounted for as a change in an accounting estimate in accordance with IPSAS 3.

109. In accordance with either IPSAS 21 or IPSAS 26, as appropriate, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment by comparing its recoverable service amount or its recoverable amount, determined in accordance with either IPSAS 21 or IPSAS 26, as appropriate, with its carrying amount, and recognizing any excess of the carrying amount over the recoverable service amount or recoverable amount as appropriate, as an impairment loss.

Recoverability of the Carrying Amount—Impairment Losses

110. To determine whether an intangible asset is impaired, an entity applies either IPSAS 21 or IPSAS 26, as appropriate. Those Standards explain when and how an entity reviews the carrying amount of its assets, how it determines the recoverable service amount or recoverable amount of an asset, as appropriate, and when it recognizes or reverses an impairment loss.

Retirements and Disposals

111. **An intangible asset shall be derecognized:**
- (a) **On disposal (including disposal through a non-exchange transaction); or**
 - (b) **When no future economic benefits or service potential are expected from its use or disposal.**
112. **The gain or loss arising from the derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It shall be recognized in surplus or deficit when the asset is derecognized (unless IPSAS 13 requires otherwise on a sale and leaseback).**
113. The disposal of an intangible asset may occur in a variety of ways (e.g., by sale, by entering into a finance lease, or through a non-exchange transaction). In determining the date of disposal of such an asset, an entity applies the criteria in *IPSAS 9, Revenue from Exchange Transactions* for recognizing revenue from the sale of goods. IPSAS 13 applies to disposal by a sale and leaseback.
114. If, in accordance with the recognition principle in paragraph 28, an entity recognizes in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognizes the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an

indication of what the cost of the replaced part was at the time it was acquired or internally generated.

- 114A. In the case of:
- (a) A license or similar right previously granted by one combining operation to another combining operation that is recognized by the resulting entity in an amalgamation; or
 - (b) A reacquired right recognized as an intangible asset in an acquisition, if the right is subsequently reissued (sold) to a third party, the related carrying amount, if any, shall be used in determining the gain or loss on reissue.
115. The consideration receivable on disposal of an intangible asset is recognized initially at its fair value. If payment for the intangible asset is deferred, the consideration received is recognized initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognized as interest revenue in accordance with IPSAS 9 reflecting the effective yield on the receivable.
116. Amortization of an intangible asset with a finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated.

Disclosure

General

117. **An entity shall disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:**
- (a) **Whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortization rates used;**
 - (b) **The amortization methods used for intangible assets with finite useful lives;**
 - (c) **The gross carrying amount and any accumulated amortization (aggregated with accumulated impairment losses) at the beginning and end of the period;**
 - (d) **The line item(s) of the statement of financial performance in which any amortization of intangible assets is included;**
 - (e) **A reconciliation of the carrying amount at the beginning and end of the period showing:**

- (i) **Additions, indicating separately those from internal development, those acquired separately, and those acquired through acquisitions;**
 - (ii) **Disposals;**
 - (iii) **Increases or decreases during the period resulting from revaluations under paragraphs 74, 84 and 85 (if any);**
 - (iv) **Impairment losses recognized in surplus or deficit during the period in accordance with IPSAS 21 or IPSAS 26 (if any);**
 - (v) **Impairment losses reversed in surplus or deficit during the period in accordance with IPSAS 21 or IPSAS 26 (if any);**
 - (vi) **Any amortization recognized during the period;**
 - (vii) **Net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and**
 - (viii) **Other changes in the carrying amount during the period.**
118. A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:
- (a) Brand names;
 - (b) Mastheads and publishing titles;
 - (c) Computer software;
 - (d) Licenses;
 - (e) Copyrights, patents, and other industrial property rights, service, and operating rights;
 - (f) Recipes, formulae, models, designs, and prototypes; and
 - (g) Intangible assets under development.
- The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.
119. An entity discloses information on impaired intangible assets in accordance with IPSAS 21 or IPSAS 26 in addition to the information required by paragraph 117(e)(iii)–(v).
120. IPSAS 3 requires an entity to disclose the nature and amount of a change in an accounting estimate that has a material effect in the current period or is

expected to have a material effect in subsequent periods. Such disclosure may arise from changes in:

- (a) The assessment of an intangible asset's useful life;
- (b) The amortization method; or
- (c) Residual values.

121. An entity shall also disclose:

- (a) **For an intangible asset assessed as having an indefinite useful life, the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.**
- (b) **A description, the carrying amount, and remaining amortization period of any individual intangible asset that is material to the entity's financial statements.**
- (c) **For intangible assets acquired through a non-exchange transaction and initially recognized at fair value (see paragraphs 42–43):**
 - (i) **The fair value initially recognized for these assets;**
 - (ii) **Their carrying amount; and**
 - (iii) **Whether they are measured after recognition under the cost model or the revaluation model.**
- (d) **The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities.**
- (e) **The amount of contractual commitments for the acquisition of intangible assets.**

122. When an entity describes the factor(s) that played a significant role in determining that the useful life of an intangible asset is indefinite, the entity considers the list of factors in paragraph 89.

Intangible Assets Measured after Recognition using the Revaluation Model

- 123. If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:**

- (a) **By class of intangible assets:**
 - (i) **The effective date of the revaluation;**
 - (ii) **The carrying amount of revalued intangible assets; and**

- (iii) **The carrying amount that would have been recognized had the revalued class of intangible assets been measured after recognition using the cost model in paragraph 73;**
 - (b) **The amount of the revaluation surplus that relates to intangible assets at the beginning and end of the reporting period, indicating the changes during the reporting period and any restrictions on the distribution of the balance to owners; and**
 - (c) **The methods and significant assumptions applied in estimating the assets' fair values.**
124. It may be necessary to aggregate the classes of revalued assets into larger classes for disclosure purposes. However, classes are not aggregated if this would result in the combination of a class of intangible assets that includes amounts measured under both the cost and revaluation models.

Research and Development Expenditure

125. **An entity shall disclose the aggregate amount of research and development expenditure recognized as an expense during the period.**
126. Research and development expenditure comprises all expenditure that is directly attributable to research or development activities (see paragraphs 64 and 65 for guidance on the type of expenditure to be included for the purpose of the disclosure requirement in paragraph 125).

Other Information

127. An entity is encouraged, but not required, to disclose the following information:
- (a) A description of any fully amortized intangible asset that is still in use; and
 - (b) A brief description of significant intangible assets controlled by the entity but not recognized as assets because they did not meet the recognition criteria in this Standard.

Transitional Provisions

128. **An entity that has previously recognized intangible assets shall apply this Standard retrospectively in accordance with IPSAS 3.**
129. [Deleted]
130. [Deleted]
131. [Deleted]
- 131A. Paragraph 79 was amended by *Improvements to IPSASs 2014* issued in January 2015. An entity shall apply that amendment to all revaluations recognized in

annual periods beginning on or after the date of initial application of that amendment and in the immediately preceding annual period.

Effective Date

132. An entity shall apply this Standard for annual financial statements covering periods beginning on or after April 1, 2011. Earlier application is encouraged. If an entity applies this Standard for a period beginning before April 1, 2011, it shall disclose that fact and apply IPSAS 21 and IPSAS 26 at the same time.
- 132A. Paragraph 6 was amended by IPSAS 32, *Service Concession Arrangements: Grantor* issued in October 2011. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2014. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2014, it shall disclose that fact and at the same time apply IPSAS 32, the amendments to paragraphs 6 and 42A of IPSAS 5, the amendments to paragraphs 25–27 and 85B of IPSAS 13, the amendments to paragraphs 5, 7 and 107C of IPSAS 17 and the amendments to paragraphs 2 and 125A of IPSAS 29.
- 132B. Paragraphs 79, 91 and 97 were amended and paragraphs 97A, 97B, 97C and 131A added by *Improvements to IPSASs 2014* issued in January 2015. An entity shall apply those amendments prospectively for annual financial statements covering periods beginning on or after January 1, 2015. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2015, it shall disclose that fact.
- 132C. Paragraphs 129, 130, 131 and 133 were amended by IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* issued in January 2015. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is permitted. If an entity applies IPSAS 33 for a period beginning before January 1, 2017, the amendments shall also be applied for that earlier period.
- 132D. IPSAS 35, *Consolidated Financial Statements* and IPSAS 37, *Joint Arrangements* issued in January 2015, amended paragraph 6(d). An entity shall apply that amendment when it applies IPSAS 35 and IPSAS 37.
- 132E. Paragraphs 3, 96, 116 and 117 were amended by *Improvements to IPSASs 2015*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies

the amendments for a period beginning before January 1, 2017, it shall disclose that fact.

- 132F. Paragraphs 4 and 5 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.
- 132G. *Impairment of Revalued Assets* (Amendments to IPSASs 21 and 26) amended paragraph 110. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies that amendment for a period beginning before January 1, 2018, it shall disclose that fact.
- 132H. Paragraphs 6, 35 and 64 were amended by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.
- 132I. Paragraphs 3, 6, 18, 24, 40, 41, 66, 67, and 117 were amended and paragraphs 18A, 26A, 39A–39E, 93A and 114A were added by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments prospectively for annual financial statements covering periods beginning on or after January 1, 2019. Therefore, amounts recognized for intangible assets and goodwill in prior public sector combinations shall not be adjusted. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2019 it shall disclose that fact and apply IPSAS 40 at the same time.
133. When an entity adopts the accrual basis IPSASs of accounting as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 31.

Website Costs

- AG1. An entity may incur internal expenditure on the development and operation of its own website for internal or external access. A website designed for external access may be used for various purposes such as to disseminate information, create awareness of services, request comment on draft legislation, promote and advertise an entity's own services and products, provide electronic services, and sell services and products. A website designed for internal access may be used to store entity policies and details of users of a service, and search relevant information.
- AG2. The stages of a website's development can be described as follows:
- (a) Planning—including undertaking feasibility studies, defining objectives and specifications, evaluating alternatives, and selecting preferences;
 - (b) Application and Infrastructure Development—including obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications, and stress testing;
 - (c) Graphical Design Development—including designing the appearance of web pages; and
 - (d) Content Development—including creating, purchasing, preparing, and uploading information, either textual or graphical in nature, on the website before the completion of the website's development. This information may either be stored in separate databases that are integrated into (or accessed from) the website or coded directly into the web pages.
- AG3. Once development of a website has been completed, the Operating stage begins. During this stage, an entity maintains and enhances the applications, infrastructure, graphical design, and content of the website.
- AG4. When accounting for internal expenditure on the development and operation of an entity's own website for internal or external access, the issues are:
- (a) Whether the website is an internally generated intangible asset that is subject to the requirements of this Standard; and
 - (b) The appropriate accounting treatment of such expenditure.

- AG5. This Application Guidance does not apply to expenditure on purchasing, developing, and operating hardware (e.g., web servers, staging servers, production servers, and Internet connections) of a website. Such expenditure is accounted for under IPSAS 17. Additionally, when an entity incurs expenditure on an Internet service provider hosting the entity's website, the expenditure is recognized as an expense when the services are received.
- AG6. IPSAS 31 does not apply to intangible assets held by an entity for sale in the ordinary course of operations (see IPSAS 11 and IPSAS 12) or leases that fall within the scope of IPSAS 13. Accordingly, this Application Guidance does not apply to expenditure on the development or operation of a website (or website software) for sale to another entity. When a website is leased under an operating lease, the lessor applies this Application Guidance. When a website is leased under a finance lease, the lessee applies this Application Guidance after initial recognition of the leased asset.
- AG7. An entity's own website that arises from development and is for internal or external access is an internally generated intangible asset that is subject to the requirements of this Standard.
- AG8. A website arising from development is recognized as an intangible asset if, and only if, in addition to complying with the general requirements described in paragraph 28 of this Standard for recognition and initial measurement, an entity can satisfy the requirements in paragraph 55 of this Standard. In particular, an entity may be able to satisfy the requirement to demonstrate how its website will generate probable future economic benefits or service potential in accordance with paragraph 55(d) of this Standard when, for example, the website is capable of generating revenues, including direct revenues from enabling orders to be placed, or providing services using the website, rather than at a physical location using civil servants. An entity is not able to demonstrate how a website developed solely or primarily for promoting and advertising its own services and products will generate probable future economic benefits or service potential, and consequently all expenditure on developing such a website is recognized as an expense when incurred.
- AG9. Any internal expenditure on the development and operation of an entity's own website is accounted for in accordance with this Standard. The nature of each activity for which expenditure is incurred (e.g., training employees and maintaining the website) and the website's stage of development or post-development are evaluated to determine the appropriate accounting treatment (additional guidance is provided in the table included at the end of the Illustrative Examples). For example:

- (a) The Planning stage is similar in nature to the research phase in paragraphs 52–54 of this Standard. Expenditure incurred in this stage is recognized as an expense when it is incurred;
- (b) The Application and Infrastructure Development stage, the Graphical Design stage, and the Content Development stage, to the extent that content is developed for purposes other than to advertise and promote an entity's own services and products, are similar in nature to the development phase in paragraphs 55–62 of this Standard. Expenditure incurred in these stages is included in the cost of a website recognized as an intangible asset in accordance with paragraph AG8 when the expenditure can be directly attributed and is necessary to creating, producing or preparing the website for it to be capable of operating in the manner intended by management. For example, expenditure on purchasing or creating content (other than content that advertises and promotes an entity's own services and products) specifically for a website, or expenditure to enable use of the content (e.g., a fee for acquiring a license to reproduce) on the website, is included in the cost of development when this condition is met. However, in accordance with paragraph 83 of this Standard, expenditure on an intangible item that was initially recognized as an expense in previous financial statements is not recognized as part of the cost of an intangible asset at a later date (e.g., if the costs of a copyright have been fully amortized, and the content is subsequently provided on a website);
- (c) Expenditure incurred in the Content Development stage, to the extent that content is developed to advertise and promote an entity's own services and products (e.g., digital photographs of products), is recognized as an expense when incurred in accordance with paragraph 67(c) of this Standard. For example, when accounting for expenditure on professional services for taking digital photographs of an entity's own products and for enhancing their display, expenditure is recognized as an expense as the professional services are received during the process, not when the digital photographs are displayed on the website; and
- (d) The Operating stage begins once development of a website is complete. Expenditure incurred in this stage is recognized as an expense when it is incurred unless it meets the recognition criteria in paragraph 28 of this Standard.

- AG10. A website that is recognized as an intangible asset under paragraph AG8 of this Application Guidance is measured after initial recognition by applying the requirements of paragraphs 71–86 of this Standard. The best estimate of a website’s useful life should be short, as described in paragraph 91.
- AG11. The guidance in paragraphs AG1–AG10 does not specifically apply to software development costs. However, an entity may apply the principles in these paragraphs.

Appendix B

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 31.

Background

- BC1. The IPSASB's IFRSs Convergence Program is an important element in IPSASB's work program. The IPSASB's policy is to converge accrual basis IPSASs with IFRSs issued by the IASB where appropriate for public sector entities.
- BC2. Accrual basis IPSASs that are converged with IFRSs maintain the requirements, structure and text of the IFRSs, unless there is a public sector specific reason for a departure. Departure from the equivalent IFRS occurs when requirements or terminology in the IFRS are not appropriate for the public sector, or when inclusion of additional commentary or examples is necessary to illustrate certain requirements in the public sector context. Differences between IPSASs and their equivalent IFRSs are identified in the *Comparison with IFRS* included in each IPSAS. The Comparison with IAS 38 references the December 31, 2008 version of IAS 38.

Scope

- BC3. The Board considered whether powers and rights conferred by legislation, a constitution, or by equivalent means should be included in the scope of the Standard. The Board has not formed a view on this topic and therefore, these powers and rights are excluded from the scope of this Standard. The Board is currently developing a Conceptual Framework and will reconsider, if necessary, the applicability of this Standard to powers and rights conferred by legislation, a constitution, or by equivalent means.
- BC4. IAS 38 contains requirements and guidance on goodwill and intangible assets acquired in a business combination. In issuing IPSAS 31, the IPSASB considered whether goodwill and intangible assets acquired in a business combination should be included in the scope of this Standard. The IPSASB had not yet issued an IPSAS dealing with business combinations and considered it likely that a number of public sector specific issues will arise when combinations of public sector entities take place. The IPSASB concluded at that time that goodwill and intangible assets acquired in a business combination should not be included in the scope of this Standard. In accordance with the hierarchy in IPSAS 3, *Accounting Policies, Changes in Accounting Policies and Errors*, users were referred to the requirements of the relevant international or national accounting standards dealing with goodwill and intangible assets acquired in a business combination.
- BC4A. Subsequently, the IPSASB issued IPSAS 40, *Public Sector Combinations*. IPSAS 40 specifies the accounting for public sector combinations, including the initial recognition and measurement of intangible assets.

IPSAS 40 does not specify the subsequent measurement and disclosure of intangible assets recognized as part of a public sector combination. Consequently, the IPSASB reconsidered whether goodwill and intangible assets recognized in a public sector combination should be included in the scope of this Standard. The IPSASB agreed that such assets should be included in the scope of this Standard as a result of the IPSASB issuing IPSAS 40, and amended the Standard accordingly.

- BC5. IAS 38 contains requirements on exchanges of assets when the exchange transaction lacks commercial substance. The IPSASB considered whether this guidance is necessary and concluded that it was not necessary because this issue is addressed in IPSAS 23.
- BC6. The IASB has issued an Interpretation of IAS 38 dealing with accounting for website costs. The IPSASB believes the guidance contained in SIC 32 is relevant to the public sector. Accordingly, IPSAS 31 includes as application guidance the definitions and guidance contained in SIC 32. This application guidance is an integral part of IPSAS 31. The appendix in SIC 32 that illustrates the relevant accounting principles and how they are linked to IPSAS 31 is included in the illustrative examples.
- BC7. The Standard does not address emissions trading schemes. The IPSASB noted that, emissions trading schemes a government has established are a type of powers and rights conferred by legislation, a constitution, or by equivalent means, which are excluded from the scope of the Standard (see paragraph BC3). A government may acquire permits under emissions trading schemes. v treatment of such permits is currently being studied by some international and national standard-setting bodies and a consensus has not been reached on the appropriate accounting treatment. The IPSASB will reconsider, if necessary, the applicability of this Standard to emissions trading schemes.

Intangible Assets Acquired through a Non-Exchange Transaction

- BC8. IPSAS 23 prescribes the initial recognition, initial measurement and disclosure of assets and liabilities arising from non-exchange revenue transactions. This Standard addresses the circumstance where an intangible asset is acquired through a non-exchange transaction. The IPSASB agreed that, for intangible assets arising from such transactions, an entity applies the requirements of IPSAS 23 in conjunction with this Standard for initial measurement of the intangible asset and, accordingly, considers directly attributable costs specified in this Standard.

Revaluation Model

BC9. The revaluation model proposed in IPSAS 31 is similar to that in IAS 38 which requires revaluations to be accounted for on an asset-by-asset basis. IPSAS 17, *Property, Plant, and Equipment* requires revaluations to be accounted for by class of assets rather than by individual asset. The IPSASB considered this approach for intangible assets, but concluded that it was not necessary because intangible assets differ from property, plant, and equipment in that they are less likely to be homogeneous. One of the major types of intangible assets of public sector entities is internally-developed software, for which detailed information is available on an individual asset basis. Consequently, the IPSASB concluded that it was appropriate to require revalued intangible assets to be accounted for on an asset-by-asset basis.

Revision of IPSAS 31 as a result of IASB's *Improvements to IFRSs* and *Narrow Scope Amendments* issued in December 2013 and May 2014

BC10. The IPSASB reviewed the revisions to IAS 38 included in the *Improvements to IFRSs* and *Clarification of Acceptable Methods of Depreciation and Amortisation* issued by the IASB in December 2013 and May 2014 and generally concurred that there was no public sector specific reason for not adopting the amendments.

Revision of IPSAS 31 as a result of Part II of *Improvements to IPSASs 2015*: issues raised by stakeholders

BC11. Stakeholders indicated that IPSASs referred to non-current assets held for sale and disposal groups inconsistently. The IPSASB concluded that IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, may only be appropriate for the public sector in certain circumstances, for the following reasons:

- (a) Sales of assets in the public sector may not be completed within one year because of the levels of approval required. This raises questions about the relevance and consistency of information provided in accordance with IFRS 5. In particular, the IPSASB notes that, under IFRS 5, non-current assets held for sale are not depreciated. The IPSASB has concerns that not depreciating assets for an extended period of time may be inappropriate.

- (b) Many assets in the public sector are disposed of through a transfer or distribution for no or nominal consideration. As IFRS 5 deals with sales at fair value, the measurement and disclosure requirements may not provide relevant information for these transfers. However, the IPSASB recognizes that the measurement and disclosure requirements in IFRS 5 may be appropriate where sales are intended to take place at fair value.
- (c) Many discontinued operations in the public sector are operations that previously provided services at no or nominal cost. As IFRS 5 deals with discontinued operations that were either cash-generating units or a group of cash-generating units prior to disposal or being classified as held for sale, the disclosure requirements may not provide relevant information for public sector discontinued operations. However, the IPSASB recognizes that the disclosure requirements in IFRS 5 may be appropriate where discontinued operations were previously either cash-generating units or one or more groups of cash generating units.

Because the IPSASB had concluded that IFRS 5 would only be appropriate in the public sector in limited circumstances, the IPSASB agreed to remove references in IPSAS to international or national accounting standards dealing with non-current assets held for sale and discontinued operations. The IPSASB had concerns that retaining this reference may result in entities following the requirements of IFRS 5 in circumstances where this may not be appropriate. The IPSASB noted that IPSAS 3 provides guidance on selecting accounting policies for transactions that are not specifically addressed in IPSASs. This guidance would permit entities to adopt an accounting policy that is consistent with IFRS 5 where the entity considers this is appropriate.

Revision of IPSAS 31 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

BC12. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

- (a) Removes the standard paragraphs about the applicability of IPSASs to “public sector entities other than GBEs” from the scope section of each Standard;
- (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and

- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

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Illustrative Examples

These examples accompany, but are not part of, IPSAS 31.

Recognition and Measurement of an Internally-Generated Intangible Asset

Example Applying Paragraph 63 of this Standard

- IE1. An entity developed a new system to schedule court cases more effectively that will result in increased service delivery. During the financial year ending March 31, 20X8, expenditure incurred for the development of the system was CU1,000,² of which CU900 was incurred before March 1, 20X8 and CU100 was incurred between March 1, 20X8 and March 31, 20X8. The entity is able to demonstrate that, at March 1, 20X8, the newly developed system met the criteria for recognition as an intangible asset. The recoverable service amount of the system (including future cash outflows to complete the development before it is available for use) is estimated to be CU500.
- IE2. At the end of the financial year, the developed system is recognized as an intangible asset at a cost of CU100 (expenditure incurred since the date when the recognition criteria were met, i.e., March 1, 20X8). The CU900 expenditure incurred before March 1, 20X8 is recognized as an expense because the recognition criteria were not met until March 1, 20X8. This expenditure does not form part of the cost of the system recognized in the statement of financial position.
- IE3. During the financial year ending March 31, 20X9, expenditure incurred is CU2,000. At the end of this financial year, the recoverable service amount of the system (including future cash outflows to complete the system before it is available for use) is estimated to be CU1,900.
- IE4. As at March 31, 20X9, the cost of the developed system is CU2,100 (CU100 expenditure recognized at the end of 20X8 plus CU2,000 expenditure recognized in the 20X9 financial year). The entity recognizes an impairment loss of CU200 to adjust the carrying amount of the developed system before the impairment loss (CU2,100) to its recoverable service amount (CU1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in IPSAS 21 are met.

Example Applying Paragraphs 55–65 of this Standard

- IE5. An entity is developing a system which produces statistical reports for its internal use and for sale to third-parties. The system is technically feasible, the entity is aware that there is a demand for this type of report and which third-parties are willing to pay for the product and therefore will generate probable

² In this Standard, monetary amounts are denominated in “currency units” (CU).

future economic benefits. The expenditure attributable to the development of this system can be identified and measured reliably.

Assessing the Useful Lives of Intangible Assets

- IE6. The following guidance provides examples on determining the useful life of an intangible asset in accordance with this Standard.
- IE7. Each of the following examples describes an acquired intangible asset, the facts and circumstances surrounding the determination of its useful life, and the subsequent accounting based on that determination.

An Acquired Patent with a Finite Useful Life

- IE8. Entity A acquires a patent over a formula for a vaccine, from Entity B to secure Entity A's ability to provide free vaccinations to its constituents. The vaccine protected by the patent is expected to be a source of service potential for at least 15 years. Entity A has a commitment from Entity C to purchase that patent in five years for 60 per cent of the fair value of the patent at the date it was acquired, and Entity A intends to sell the patent in five years.
- IE9. The patent would be amortized over its five-year useful life to Entity A, with a residual value equal to 60 per cent of the patent's fair value at the date it was acquired. The patent would also be reviewed for impairment in accordance with IPSAS 21.

An Acquired Patent with an Indefinite Useful Life

- IE10. Entity A acquires an asset, the patent over a formula for a vaccine, from Entity B to secure Entity A's ability to provide free vaccinations to its constituents. It is expected that the formula will need to be slightly modified every 10 years to maintain its efficacy. There is evidence to support ongoing renewal of the patent. A contract with Entity B stipulates that Entity B will maintain the efficacy of the formula continuously, and evidence supports its ability to do so. The costs to renew the patent and maintain the efficacy of the formula are expected to be insignificant and will be paid to the Entity B when the improvements are made.
- IE11. An analysis of product lifecycle studies, and demographic and environmental trends, provides evidence that the patent will provide service potential to Entity A by enabling it to deliver its vaccination program for an indefinite period. Accordingly, the patent would be treated as having an indefinite useful life. Therefore, the patent would not be amortized unless its useful life is determined to be finite. The patent would be tested for impairment in accordance with IPSAS 21.

An Acquired Copyright that has a Remaining Legal Life of 50 Years

- IE12. Entity A acquires a copyright from Entity B to enable it to reproduce and sell the copyrighted material on a cost-recovery basis to its constituency. An analysis of the habits of the entity's constituency and other trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.
- IE13. The copyright would be amortized over its 30-year estimated useful life. The copyright also would be reviewed for impairment in accordance with IPSAS 21.

An Acquired Broadcasting License that Expires in Five Years—Part A

- IE14. Entity A acquires a broadcasting license from Entity B. Entity A intends to provide free broadcasting services in the community. The broadcasting license is renewable every 10 years if Entity A provides at least an average level of service to its users of its service and complies with the relevant legislative requirements. The license may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition. Entity A intends to renew the license indefinitely and evidence supports its ability to do so. Historically, there has been no compelling challenge to the license renewal. The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future. Therefore, the license is expected to contribute to Entity A's ability to provide free broadcasting services indefinitely.
- IE15. Entity B does not recognize its power to grant broadcasting licenses as an intangible asset. The broadcasting license would be treated by Entity A as having an indefinite useful life because it is expected to contribute to the entity's ability to provide free broadcasting services indefinitely. Therefore, the license would not be amortized until its useful life is determined to be finite. The license would be tested for impairment in accordance with IPSAS 21.

An Acquired Broadcasting License that Expires in Five Years—Part B

- IE16. The licensing authority subsequently decides that it will no longer renew broadcasting licenses, but rather will auction the licenses. At the time the licensing authority's decision is made, Entity A's broadcasting license has three years until it expires. Entity A expects that the license will continue to provide service potential until the license expires.
- IE17. Because the broadcasting license can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired license would be amortized by Entity A over its remaining three-year useful life and immediately tested for impairment in accordance with IPSAS 21.

An Acquired Right to Operate a Public Transit Route Between Two Cities that Expires in Three Years

- IE18. Entity A acquires from Entity B a right to operate a public transit route between two cities, which generates revenues. The transit route may be renewed every five years, and Entity A intends to comply with the applicable rules and regulations surrounding renewal. Transit route renewals are routinely granted at a minimal cost and historically have been renewed when the entity that holds the rights to the route has complied with the applicable rules and regulations. Entity A expects to provide transit services on the route indefinitely. An analysis of demand and cash flows supports those assumptions.
- IE19. Because the facts and circumstances support the public transit route providing cash flows to Entity A for an indefinite period of time, the intangible asset related to the transit route is treated as having an indefinite useful life. Therefore, the intangible asset would not be amortized until its useful life is determined to be finite. It would be tested for impairment in accordance with IPSAS 26 annually and whenever there is an indication that it may be impaired.

An Acquired List of Property Owners

- IE20. A local authority (Entity A) acquires a list of property owners from another public sector entity which is responsible for registering property deeds (Entity B). Entity B is at another level of government, and is not part of Entity A's reporting entity. Entity A intends to use the list to generate tax revenues and Entity A expects that it will be able to derive benefit from the information on the acquired list³ for at least one year, but no more than three years.
- IE21. The list of property owners would be amortized over Entity A's best estimate of its useful life, say 18 months. Although Entity B may intend to add property owner names and other information to the list in the future, the expected benefits to Entity A of the acquired list relate only to the property owners on that list at the date Entity A acquired the list. The list of property owners also would be reviewed for impairment in accordance with IPSAS 21 by assessing annually and whenever there is any indication that it may be impaired.

³ Although the local authority may intend to add property owners and other information to the database in the future, the expected benefits of the acquired database relate only to the property owners on that database at the date it was acquired. Subsequent additions would be considered to be internally-developed intangible assets, and accounted for in accordance with this Standard.

Examples Illustrating the Application Guidance

- IE22. The purpose of the table is to illustrate examples of expenditure that occur during each of the stages described in paragraphs AG2–AG3 and to illustrate application of paragraphs AG4–AG11 to assist in clarifying their meaning. It is not intended to be a comprehensive checklist of expenditure that might be incurred.

STAGE/NATURE OF EXPENDITURE	ACCOUNTING TREATMENT
Planning	
<ul style="list-style-type: none"> • Undertaking feasibility studies; • Defining hardware and software specifications; • Evaluating alternative products and suppliers; and • Selecting preferences. 	Recognize as an expense when incurred in accordance with paragraph 52 of this Standard.
Application and Infrastructure Development	
<ul style="list-style-type: none"> • Purchasing or developing hardware. • Obtaining a domain name; • Developing operating software (e.g., operating system and server software); • Developing code for the application; • Installing developed applications on the web server; and • Stress testing. 	<p>Apply the requirements of IPSAS 17.</p> <p>Recognize as an expense when incurred, unless the expenditure can be directly attributed to preparing the website to operate in the manner intended by management, and the website meets the recognition criteria in paragraphs 28 and 55⁴ of this Standard.</p>
Graphical Design Development	
<ul style="list-style-type: none"> • Designing the appearance (e.g., layout and color) of web pages. 	Recognize as an expense when incurred, unless the expenditure can be directly attributed to preparing the website to operate in the manner intended by management, and the website meets the recognition criteria in paragraphs 28 and 55 ⁵ of this Standard.
Content Development	
<ul style="list-style-type: none"> • Creating, purchasing, preparing (e.g., creating links and identifying tags), and uploading 	Recognize as an expense when incurred in accordance with paragraph 67(c) of this Standard to the extent that content

⁴ All expenditure on developing a website solely or primarily for promoting, advertising, or providing information to the public at large regarding the entity's own products and services is recognized an expense when incurred in accordance with paragraph 66 of this Standard.

⁵ See footnote 3.

STAGE/NATURE OF EXPENDITURE	ACCOUNTING TREATMENT
<p>information, either textual or graphic in nature, on the website before the completion of the website's development. Examples of content include information about an entity, services, or products, and topics that subscribers access.</p>	<p>is developed to advertise and promote an entity's own services and products (e.g., digital photographs of products). Otherwise, recognize as an expense when incurred, unless the expenditure can be directly attributed to preparing the website to operate in the manner intended by management, and the website meets the recognition criteria in paragraphs 28 and 55⁶ of this Standard.</p>
Operating	
<ul style="list-style-type: none"> • Updating graphics and revising content; • Adding new functions, features, and content; • Registering the website with search engines; • Backing up data; • Reviewing security access; and • Analyzing usage of the website. 	<p>Assess whether it meets the definition of an intangible asset and the recognition criteria set out in paragraph 28 of this Standard, in which case the expenditure is recognized in the carrying amount of the website asset.</p>
Other	
<ul style="list-style-type: none"> • Selling, administrative, and other general overhead expenditure unless it can be directly attributed to preparing the website for use to operate in the manner intended by management; • Clearly identified inefficiencies and initial operating deficits incurred before the website achieves planned performance (e.g., false-start testing); and • Training employees to operate the website. 	<p>Recognize as an expense when incurred in accordance with paragraphs 63–69 of this Standard.</p>

⁶ See footnote 3.

Comparison with IAS 38

IPSAS 31, *Intangible Assets* is drawn primarily from IAS 38, *Intangible Assets* (as at December 31, 2008). The main differences between IPSAS 31 and IAS 38 are as follows:

- IPSAS 31 includes a scope exclusion for the powers and rights conferred by legislation, a constitution, or by equivalent means.
- IPSAS 31 incorporates the guidance contained in the Standing Interpretation Committee's Interpretation 32, *Intangible Assets—Web Site Costs* as Application Guidance to illustrate the relevant accounting principles.
- IPSAS 31 does not require or prohibit the recognition of intangible heritage assets. An entity that recognizes intangible heritage assets is required to comply with the disclosure requirements of this Standard with respect to those intangible heritage assets that have been recognized and may, but is not required to, comply with other requirements of this Standard in respect of those intangible heritage assets. IAS 38 does not have similar guidance.
- IAS 38 contains guidance on intangible assets acquired by way of a government grant. Paragraphs 31 of IPSAS 31 modifies this guidance to refer to intangible assets acquired through non-exchange transactions. IPSAS 31 states that where an intangible asset is acquired through a non-exchange transaction, the cost is its fair value as at the date it is acquired.
- IAS 38 provides guidance on exchanges of assets when an exchange transaction lacks commercial substance. IPSAS 31 does not include this guidance.
- The examples included in IAS 38 have been modified to better address public sector circumstances.
- IPSAS 31 uses different terminology, in certain instances, from IAS 38. The most significant examples are the use of the terms "revenue," "statement of financial performance," "surplus or deficit," "future economic benefits or service potential," "accumulated surpluses or deficits," "operating/operation," "rights from binding arrangements (including rights from contracts or other legal rights)," and "net assets/equity" in IPSAS 31. The equivalent terms in IAS 38 are "income," "statement of comprehensive income," "profit or loss," "future economic benefits," "retained earnings," "business," "contractual or other legal rights," and "equity."

IPSAS 32—SERVICE CONCESSION ARRANGEMENTS: GRANTOR

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) sets out the accounting requirements of the grantor in a service concession arrangement. It is adapted from Interpretation 12 (IFRIC 12), *Service Concession Arrangements*, developed by the International Financial Reporting Interpretations Committee and published by the International Accounting Standards Board (IASB). IFRIC 12 sets out the accounting requirements of the operator in a service concession arrangement. This IPSAS also contains extracts from Interpretation 29 (SIC-29), *Service Concession Arrangements: Disclosures*, developed by the Standing Interpretations Committee and published by the IASB. Extracts from IFRIC 12 and SIC-29 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 32—SERVICE CONCESSION ARRANGEMENTS: GRANTOR

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 32, *Service Concession Arrangements: Grantor* was issued in October 2011.

Since then, IPSAS 27 has been amended by the following IPSASs:

- *The Applicability of IPSASs* (issued April 2016)
- *Improvements to IPSASs 2015* (issued April 2016)
- IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* (issued January 2015)

Table of Amended Paragraphs in IPSAS 32

Paragraph Affected	How Affected	Affected By
3	Deleted	The Applicability of IPSASs April 2016
4	Deleted	The Applicability of IPSASs April 2016
13	Amended	Improvements to IPSASs April 2016
32	Amended	Improvements to IPSASs April 2016
33	Amended	Improvements to IPSASs April 2016
35	Deleted	IPSAS 33 January 2015
35A	New	Improvements to IPSASs April 2016
35B	New	Improvements to IPSASs April 2016
36A	New	IPSAS 33 January 2015
36B	New	Improvements to IPSASs April 2016

Paragraph Affected	How Affected	Affected By
36C	New	The Applicability of IPSASs April 2016
37	Amended	IPSAS 33 January 2015
AG20	Amended	Improvements to IPSASs April 2016
AG35	Amended	Improvements to IPSASs April 2016
AG68	Deleted	IPSAS 33 January 2015
AG69	Deleted	IPSAS 33 January 2015
AG70	Deleted	IPSAS 33 January 2015
AG71	Deleted	IPSAS 33 January 2015
AG72	Deleted	IPSAS 33 January 2015
AG73	Deleted	IPSAS 33 January 2015

IPSAS 32—SERVICE CONCESSION ARRANGEMENTS: GRANTOR

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International Public Sector Accounting Standard 32, *Service Concession Arrangements: Grantor* is set out in paragraphs 1–37. All the paragraphs have equal authority. IPSAS 32 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to prescribe the accounting for service concession arrangements by the grantor, a public sector entity.

Scope (see paragraphs AG1–AG2)

2. **An entity¹ that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for service concession arrangements.**
3. [Deleted]
4. [Deleted]
5. Arrangements within the scope of this Standard involve the operator providing public services related to the service concession asset on behalf of the grantor.
6. Arrangements outside the scope of this Standard are those that do not involve the delivery of public services and arrangements that involve service and management components where the asset is not controlled by the grantor (e.g., outsourcing, service contracts, or privatization).
7. This Standard does not specify the accounting by operators (guidance on accounting for service concession arrangements by the operator can be found in the relevant international or national accounting standard dealing with service concession arrangements).

Definitions (see paragraphs AG3–AG4)

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

A binding arrangement, for the purposes of this Standard, describes contracts and other arrangements that confer similar rights and obligations on the parties to it as if they were in the form of a contract.

A grantor, for the purposes of this Standard, is the entity that grants the right to use the service concession asset to the operator.

An operator, for the purposes of this Standard, is the entity that uses the service concession asset to provide public services subject to the grantor's control of the asset.

A service concession arrangement is a binding arrangement between a grantor and an operator in which:

¹ An entity for the purposes of this Standard is referred to as the grantor.

- (a) The operator uses the service concession asset to provide a public service on behalf of the grantor for a specified period of time; and
- (b) The operator is compensated for its services over the period of the service concession arrangement.

A service concession asset is an asset used to provide public services in a service concession arrangement that:

- (a) Is provided by the operator which:
 - (i) The operator constructs, develops, or acquires from a third party; or
 - (ii) Is an existing asset of the operator; or
- (b) Is provided by the grantor which:
 - (i) Is an existing asset of the grantor; or
 - (ii) Is an upgrade to an existing asset of the grantor.

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

Recognition and Measurement of a Service Concession Asset (see paragraphs AG5–AG35)

9. The grantor shall recognize an asset provided by the operator and an upgrade to an existing asset of the grantor as a service concession asset if:
 - (a) The grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price; and
 - (b) The grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the asset at the end of the term of the arrangement.
10. This Standard applies to an asset used in a service concession arrangement for its entire useful life (a “whole-of-life” asset) if the conditions in paragraph 9(a) are met.
11. The grantor shall initially measure the service concession asset recognized in accordance with paragraph 9 (or paragraph 10 for a whole-of-life asset) at its fair value, except as noted in paragraph 12.
12. Where an existing asset of the grantor meets the conditions specified in paragraph 9(a) and 9(b) (or paragraph 10 for a whole-of-life asset), the grantor shall reclassify the existing asset as a service concession

asset. The reclassified service concession asset shall be accounted for in accordance with IPSAS 17, *Property, Plant, and Equipment* or IPSAS 31, *Intangible Assets*, as appropriate.

13. **After initial recognition or reclassification, service concession assets shall be accounted for in accordance with IPSAS 17 or IPSAS 31, as appropriate.**

Recognition and Measurement of Liabilities (see paragraphs AG36–AG50)

14. **Where the grantor recognizes a service concession asset in accordance with paragraph 9 (or paragraph 10 for a whole-of-life asset), the grantor shall also recognize a liability. The grantor shall not recognize a liability when an existing asset of the grantor is reclassified as a service concession asset in accordance with paragraph 12, except in circumstances where additional consideration is provided by the operator, as noted in paragraph 15.**
15. **The liability recognized in accordance with paragraph 14 shall be initially measured at the same amount as the service concession asset measured in accordance with paragraph 11, adjusted by the amount of any other consideration (e.g., cash) from the grantor to the operator, or from the operator to the grantor.**
16. The nature of the liability recognized is based on the nature of the consideration exchanged between the grantor and the operator. The nature of the consideration given by the grantor to the operator is determined by reference to the terms of the binding arrangement and, when relevant, contract law.
17. In exchange for the service concession asset, the grantor may compensate the operator for the service concession asset by any combination of:
 - (a) Making payments to the operator (the “financial liability” model);
 - (b) Compensating the operator by other means (the “grant of a right to the operator” model) such as:
 - (i) Granting the operator the right to earn revenue from third-party users of the service concession asset; or
 - (ii) Granting the operator access to another revenue-generating asset for the operator’s use (e.g., a private wing of a hospital where the remainder of the hospital is used by the grantor to treat public patients or a private parking facility adjacent to a public facility).

Financial Liability Model (see paragraphs AG37–AG46)

18. **Where the grantor has an unconditional obligation to pay cash or another financial asset to the operator for the construction, development, acquisition, or upgrade of a service concession asset, the grantor shall account for the liability recognized in accordance with paragraph 14 as a financial liability.**
19. The grantor has an unconditional obligation to pay cash if it has guaranteed to pay the operator:
 - (a) Specified or determinable amounts; or
 - (b) The shortfall, if any, between amounts received by the operator from users of the public service and any specified or determinable amounts referred to in paragraph 19(a), even if the payment is contingent on the operator ensuring that the service concession asset meets specified quality or efficiency requirements.
20. IPSAS 28, *Financial Instruments: Presentation*, the derecognition requirements in IPSAS 29, *Financial Instruments: Recognition and Measurement*, and IPSAS 30, *Financial Instruments: Disclosures* apply to the financial liability recognized under paragraph 14, except where this Standard provides requirements and guidance.
21. **The grantor shall allocate the payments to the operator and account for them according to their substance as a reduction in the liability recognized in accordance with paragraph 14, a finance charge, and charges for services provided by the operator.**
22. **The finance charge and charges for services provided by the operator in a service concession arrangement determined in accordance with paragraph 21 shall be accounted for as expenses.**
23. **Where the asset and service components of a service concession arrangement are separately identifiable, the service components of payments from the grantor to the operator shall be allocated by reference to the relative fair values of the service concession asset and the services. Where the asset and service components are not separately identifiable, the service component of payments from the grantor to the operator is determined using estimation techniques.**

Grant of a Right to the Operator Model (see paragraphs AG47–AG49)

24. **Where the grantor does not have an unconditional obligation to pay cash or another financial asset to the operator for the construction, development, acquisition, or upgrade of a service concession asset, and grants the operator the right to earn revenue from third-party users or another revenue-generating asset, the grantor shall account for the**

liability recognized in accordance with paragraph 14 as the unearned portion of the revenue arising from the exchange of assets between the grantor and the operator.

25. **The grantor shall recognize revenue and reduce the liability recognized in accordance with paragraph 24 according to the economic substance of the service concession arrangement.**
26. Where the grantor compensates the operator for the service concession asset and the provision of services by granting the operator the right to earn revenue from third-party users of the service concession asset or another revenue-generating asset, the exchange is regarded as a transaction that generates revenue. As the right granted to the operator is effective for the period of the service concession arrangement, the grantor does not recognize revenue from the exchange immediately. Instead, a liability is recognized for any portion of the revenue that is not yet earned. The revenue is recognized according to the economic substance of the service concession arrangement, and the liability is reduced as revenue is recognized.

Dividing the Arrangement (see paragraph AG50)

27. **If the grantor pays for the construction, development, acquisition, or upgrade of a service concession asset partly by incurring a financial liability and partly by the grant of a right to the operator, it is necessary to account separately for each part of the total liability recognized in accordance with paragraph 14. The amount initially recognized for the total liability shall be the same amount as that specified in paragraph 15.**
28. **The grantor shall account for each part of the liability referred to in paragraph 27 in accordance with paragraphs 18–26.**

Other Liabilities, Commitments, Contingent Liabilities and Contingent Assets (see paragraphs AG51–AG54)

29. **The grantor shall account for other liabilities, commitments, contingent liabilities, and contingent assets arising from a service concession arrangement in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, IPSAS 28, IPSAS 29, and IPSAS 30.**

Other Revenues (see paragraphs AG55–AG64)

30. **The grantor shall account for revenues from a service concession arrangement, other than those specified in paragraphs 24–26, in accordance with IPSAS 9, *Revenue from Exchange Transactions*.**

Presentation and Disclosure (see paragraphs AG65–AG67)

31. **The grantor shall present information in accordance with IPSAS 1.**

32. **All aspects of a service concession arrangement shall be considered in determining the appropriate disclosures in the notes. A grantor shall disclose the following information in respect of service concession arrangements in each reporting period:**
- (a) **A description of the arrangement;**
 - (b) **Significant terms of the arrangement that may affect the amount, timing, and certainty of future cash flows (e.g., the period of the concession, re-pricing dates, and the basis upon which re-pricing or re-negotiation is determined);**
 - (c) **The nature and extent (e.g., quantity, time period, or amount, as appropriate) of:**
 - (i) **Rights to use specified assets;**
 - (ii) **Rights to expect the operator to provide specified services in relation to the service concession arrangement;**
 - (iii) **The carrying amount of service concession assets recognized at the end of the reporting period, including existing assets of the grantor reclassified as service concession assets;**
 - (iv) **Rights to receive specified assets at the end of the service concession arrangement;**
 - (v) **Renewal and termination options;**
 - (vi) **Other rights and obligations (e.g., major overhaul of service concession assets); and**
 - (vii) **Obligations to provide the operator with access to service concession assets or other revenue-generating assets; and**
 - (d) **Changes in the arrangement occurring during the reporting period.**
33. The disclosures required in accordance with paragraph 32 are provided individually for each material service concession arrangement or in aggregate for service concession arrangements involving services of a similar nature (e.g., toll collections, telecommunications or water treatment services). This disclosure is in addition to the disclosures required in IPSAS 17 and/or IPSAS 31 by class of assets. Service concession assets within service concession arrangements of a similar nature that are reported in aggregate may form a subset of a class of assets disclosed in accordance with IPSAS 17 and/or IPSAS 31 or may be included in more than one class of assets disclosed in accordance with IPSAS 17 and/or IPSAS 31. For example, for the purposes of IPSAS 17 a toll bridge may be included in the same class as other bridges. For the purposes of this paragraph, the toll bridge may be included with service concession arrangements reported in aggregate as toll roads.

Transitional

34. **A grantor that has previously recognized service concession assets and related liabilities, revenues, and expenses shall apply this Standard retrospectively in accordance with IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*.**
35. [Deleted]
- 35A. Paragraphs 13, 32, 33 and AG35 were amended by *Improvements to IPSASs 2015* issued in April 2016. An entity that has previously applied IPSAS 32 shall reassess the classification of service concession assets in accordance with paragraph 13. The entity shall present service concession assets in the revised classification retrospectively in accordance with IPSAS 3.
- 35B. Where service concessions assets are reclassified in accordance with paragraph 35A, an entity shall account for the service concession assets as follows:
- (a) If the service concession assets have previously been measured using the cost model, and the class of assets to which those service concession assets have been reclassified is measured using the cost model, the entity shall continue to apply the cost model. The entity shall carry forward the cost of the service concession assets, along with any accumulated depreciation or amortization and any accumulated impairment losses.
 - (b) If the service concession assets have previously been measured using the cost model, and the class of assets to which those service concession assets have been reclassified is measured using the revaluation model, the entity shall either:
 - (i) Revalue the service concession assets; or
 - (ii) Subject to the requirements in IPSAS 3 dealing with changes in accounting policies, retrospectively apply the cost model to the remaining assets in the class of asset to which those service concession assets have been reclassified. Where information regarding the cost of the assets is not available, the entity may use the carrying amount of the assets as the deemed cost.
 - (c) If the service concession assets have previously been measured using the revaluation model, and the class of assets to which those service concession assets have been reclassified is measured using the cost model, the entity shall either:
 - (i) Retrospectively apply the cost model to the service concession assets. Where information regarding the cost of the assets is not

available, the entity may use the carrying amount of the service concession assets as the deemed cost; or

- (ii) Subject to the requirements in IPSAS 3 dealing with changes in accounting policies, revalue the remaining assets in the class of asset to which those service concession assets have been reclassified.
- (d) If the service concession assets have previously been measured using the revaluation model, and the class of assets to which those service concession assets have been reclassified is measured using the revaluation model, the entity shall adjust the revaluation surplus in respect of each class of asset. Where previous revaluation decreases have been recognized in respect of either a service concession asset or one or more assets in the class to which the service concession asset is transferred, the entity shall consider whether transfers between revaluation surplus and accumulated surpluses or deficits are required.

Effective Date

- 36. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2014. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2014, it shall disclose that fact and apply IPSAS 5, *Borrowing Costs*, IPSAS 13, *Leases*, IPSAS 17, IPSAS 29, and IPSAS 31 at the same time.**
- 36A. **Paragraphs 35 and 37 were amended by IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* issued in January 2015. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is permitted. If an entity applies IPSAS 33 for a period beginning before January 1, 2017, the amendments shall also be applied for that earlier period.**
- 36B. **Paragraphs 13, 32, 33 and AG35 were amended and paragraphs 35A and 35B added by *Improvements to IPSASs 2015* issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2017 it shall disclose that fact.**
- 36C. **Paragraphs 3 and 4 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.**

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

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 32.

Scope (see paragraphs 2–7)

AG1. This Standard is intended to “mirror” Interpretation 12 of the International Financial Reporting Interpretations Committee, *Service Concession Arrangements* (IFRIC 12), which sets out the accounting requirements for the private sector operator in a service concession arrangement. To do so, the scope, principles for recognition of an asset, and terminology are consistent with the applicable guidance in IFRIC 12. However, because this Standard deals with the accounting issues of the grantor, this Standard addresses the issues identified in IFRIC 12 from the grantor’s point of view, as follows:

- (a) The grantor recognizes a financial liability when it is obliged to make a series of payments to the operator for provision of a service concession asset (i.e., constructed, developed, acquired, or upgraded). Using the measurement requirements specified in this Standard under paragraphs 12, 14, and 20 of IFRIC 12, the operator recognizes revenue for the construction, development, acquisition, upgrade, and operation services it provides. Under paragraph 8 of IFRIC 12, the operator derecognizes an asset that it held and recognized as property, plant, and equipment before entering the service concession arrangement.
- (b) The grantor recognizes a liability when it grants the operator the right to earn revenue from third-party users of the service concession asset or another revenue-generating asset. Under paragraph 26 of IFRIC 12, the operator recognizes an intangible asset.
- (c) The grantor derecognizes an asset it grants to the operator and over which it no longer has control. Under paragraph 27 of IFRIC 12, the operator recognizes the asset and a liability in respect of any obligations it has assumed in exchange for the asset.

AG2. Paragraph 9 of this Standard specifies the conditions under which an asset, other than a whole-of-life asset, is within the scope of the Standard. Paragraph 10 of the Standard specifies the condition under which whole-of-life assets are within the scope of the Standard.

Definitions (see paragraph 8)

AG3. Paragraph 8 defines a service concession arrangement. Common features of a service concession arrangement are:

- (a) The grantor is a public sector entity;
- (b) The operator is responsible for at least some of the management of the service concession asset and related services and does not merely act as an agent on behalf of the grantor;
- (c) The arrangement sets the initial prices to be levied by the operator and regulates price revisions over the period of the service concession arrangement;
- (d) The operator is obliged to hand over the service concession asset to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it; and
- (e) The arrangement is governed by a binding arrangement that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes.

AG4. Paragraph 8 defines a service concession asset. Examples of service concession assets are: roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks, permanent installations for military and other operations, and other non-current tangible or intangible assets used for administrative purposes in delivering public services.

Recognition and Initial Measurement of a Service Concession Asset (see paragraphs 9–13)

Recognition of a Service Concession Asset

- AG5. The assessment of whether a service concession asset should be recognized in accordance with paragraph 9 (or paragraph 10 for a whole-of-life asset) is made on the basis of all of the facts and circumstances of the arrangement.
- AG6. The control or regulation referred to in paragraph 9(a) could be by a binding arrangement, or otherwise (such as through a third party regulator that regulates other entities that operate in the same industry or sector as the grantor), and includes circumstances in which the grantor buys all of the output as well as those in which some or all of the output is bought by other users. The ability to exclude or regulate the access of others to the benefits of an asset is an essential element of control that distinguishes an entity's assets from those public goods that all entities have access to and benefit from. The binding arrangement sets the initial prices to be levied by the operator and regulates price revisions over the period of the service concession arrangement. When the binding arrangement conveys the right to control the use of the service concession asset to the grantor, the asset meets the condition specified in paragraph 9(a) regarding control in relation to those to whom the operator must provide services.

- AG7. For the purpose of paragraph 9(a), the grantor does not need to have complete control of the price: it is sufficient for the price to be regulated by the grantor, binding arrangement, or a third party regulator that regulates other entities that operate in the same industry or sector (e.g., hospitals, schools, or universities) as the grantor (e.g., by a capping mechanism). However, the condition is applied to the substance of the agreement. Non-substantive features, such as a cap that will apply only in remote circumstances, are ignored. Conversely, if, for example, an arrangement purports to give the operator freedom to set prices, but any excess profit is returned to the grantor, the operator's return is capped and the price element of the control test is met.
- AG8. Many governments have the power to regulate the behavior of entities operating in certain sectors of the economy, either directly, or through specifically created agencies. For the purpose of paragraph 9(a), the broad regulatory powers described above do not constitute control. In this Standard, the term "regulate" is intended to be applied only in the context of the specific terms and conditions of the service concession arrangement. For example, a regulator of rail services may determine rates that apply to the rail industry as a whole. Depending on the legal framework in a jurisdiction, such rates may be implicit in the binding arrangement governing a service concession arrangement involving the provision of railway transportation, or they may be specifically referred to therein. However, in both cases, the control of the service concession asset is derived from either the contract, or similar binding arrangement, or from the specific regulation applicable to rail services and not from the fact that the grantor is a public sector entity that is related to the regulator of rail service.
- AG9. For the purpose of paragraph 9(b), the grantor's control over any significant residual interest should both restrict the operator's practical ability to sell or pledge the asset and give the grantor a continuing right of use throughout the period of the service concession arrangement. The residual interest in the asset is the estimated current value of the asset as if it were already of the age and in the condition expected at the end of the period of the service concession arrangement.
- AG10. Control should be distinguished from management. If the grantor retains both the degree of control described in paragraph 9(a) and any significant residual interest in the asset, the operator is only managing the asset on the grantor's behalf—even though, in many cases, it may have wide managerial discretion.
- AG11. The conditions in paragraphs 9(a) and 9(b) together identify when the asset, including any replacements required, is controlled by the grantor for the whole of its economic life. For example, if the operator has to replace part of an asset during the period of the arrangement (e.g., the top layer of a road or

the roof of a building), the asset is considered as a whole. Thus the condition in paragraph 9(b) is met for the whole of the asset, including the part that is replaced, if the grantor controls any significant residual interest in the final replacement of that part.

AG12. Sometimes the use of a service concession asset is partly regulated in the manner described in paragraph 9(a) and partly unregulated. However, these arrangements take a variety of forms:

- (a) Any asset that is physically separable and capable of being operated independently and meets the definition of a cash-generating unit as defined in IPSAS 26, *Impairment of Cash-Generating Assets* is analyzed separately to determine whether the condition set out in paragraph 9(a) is met if it is used wholly for unregulated purposes (e.g., this might apply to a private wing of a hospital, where the remainder of the hospital is used by the grantor to treat public patients); and
- (b) When purely ancillary activities (such as a hospital shop) are unregulated, the control tests are applied as if those services did not exist, because in cases in which the grantor controls the services in the manner described in paragraph 9(a), the existence of ancillary activities does not detract from the grantor's control of the service concession asset.

AG13. The operator may have a right to use the separable asset described in paragraph AG12(a), or the facilities used to provide ancillary unregulated services described in paragraph AG12(b). In either case, there may in substance be a lease from the grantor to the operator; if so, it is accounted for in accordance with IPSAS 13.

Existing Asset of the Grantor

AG14. The arrangement may involve an existing asset of the grantor:

- (a) To which the grantor gives the operator access for the purpose of the service concession arrangement; or
- (b) To which the grantor gives the operator access for the purpose of generating revenues as compensation for the service concession asset.

AG15. The requirement in paragraph 11 is to measure assets recognized in accordance with paragraph 9 (or paragraph 10 for a whole-of-life asset) initially at fair value. Existing assets of the grantor used in the service concession arrangement are reclassified rather than recognized under this Standard. Only an upgrade to an existing asset of the grantor (e.g., that increases its capacity) is recognized as a service concession asset in accordance with paragraph 9, or paragraph 10 for a whole-of-life asset).

- AG16. In applying the impairment tests in IPSAS 17 or IPSAS 31, as appropriate, the grantor does not necessarily consider the granting of the service concession to the operator as a circumstance that causes impairment, unless there has been a change in use of the asset that affects its future economic benefits or service potential. The grantor refers to IPSAS 21, *Impairment of Non-Cash-Generating Assets* or IPSAS 26, as appropriate, to determine whether any of the indicators of impairment have been triggered under such circumstances.
- AG17. If the asset no longer meets the conditions for recognition in paragraph 9 (or paragraph 10 for a whole-of-life asset), the grantor follows the derecognition principles in IPSAS 17 or IPSAS 31, as appropriate. For example, if the asset is transferred to the operator on a permanent basis, it is derecognized. If the asset is transferred on a temporary basis, the grantor considers the substance of this term of the service concession arrangement in determining whether the asset should be derecognized. In such cases, the grantor also considers whether the arrangement is a lease transaction or a sale and leaseback transaction that should be accounted for in accordance with IPSAS 13.
- AG18. When the service concession arrangement involves upgrading an existing asset of the grantor such that the future economic benefits or service potential the asset will provide are increased, the upgrade is assessed to determine whether it meets the conditions for recognition in paragraph 9 (or paragraph 10 for a whole-of-life asset). If those conditions are met, the upgrade is recognized and measured in accordance with this Standard.

Existing Asset of the Operator

- AG19. The operator may provide an asset for use in the service concession arrangement that it has not constructed, developed, or acquired. If the arrangement involves an existing asset of the operator which the operator uses for the purpose of the service concession arrangement, the grantor determines whether the asset meets the conditions in paragraph 9 (or paragraph 10 for a whole-of-life asset). If the conditions for recognition are met, the grantor recognizes the asset as a service concession asset and accounts for it in accordance with this Standard.

Constructed or Developed Asset

- AG20. Where a constructed or developed asset meets the conditions in paragraph 9 (or paragraph 10 for a whole-of-life asset) the grantor recognizes and measures the asset in accordance with this Standard. IPSAS 17 or IPSAS 31, as appropriate, set out the criteria for when a service concession asset should be recognized. Both IPSAS 17 and IPSAS 31 require that an asset shall be recognized if, and only if:

- (a) It is probable that future economic benefits or service potential associated with the item will flow to the entity; and
- (b) The cost or fair value of the item can be measured reliably².

AG21. Those criteria, together with the specific terms and conditions of the binding arrangement, need to be considered in determining whether to recognize the service concession asset during the period in which the asset is constructed or developed. For both property, plant, and equipment and intangible assets, the recognition criteria may be met during the construction or development period, and, if so, the grantor will normally recognize the service concession asset during that period.

AG22. The first recognition criterion requires the flow of economic benefits or service potential to the grantor. From the grantor's point of view, the primary purpose of a service concession asset is to provide service potential on behalf of the public sector grantor. Similar to an asset the grantor constructs or develops for its own use, the grantor would assess, at the time the costs of construction or development are incurred, the terms of the binding arrangement to determine whether the service potential of the service concession asset would flow to the grantor at that time.

AG23. The second recognition criterion requires that the initial cost or fair value of the asset can be measured reliably. Accordingly, to meet the recognition criteria in IPSAS 17 or IPSAS 31, as appropriate, the grantor must have reliable information about the cost or fair value of the asset during its construction or development. For example, if the service concession arrangement requires the operator to provide the grantor with progress reports during the asset's construction or development, the costs incurred may be measurable, and would therefore meet the recognition principle in IPSAS 17 for constructed assets or in IPSAS 31 for developed assets. Also, where the grantor has little ability to avoid accepting an asset constructed or developed to meet the specifications of the contract, or a similar binding arrangement, the costs are recognized as progress is made towards completion of the asset. Thus, the grantor recognizes a service concession asset and an associated liability.

Measurement of Service Concession Assets

AG24. Paragraph 11 requires service concession assets recognized in accordance with paragraph 9 (or paragraph 10 for a whole-of-life asset) to be measured initially at fair value. In particular, fair value is used to determine the cost of a constructed or developed service concession asset or the cost of any upgrades to existing assets, on initial recognition. The requirement in paragraph 11 does not apply to existing assets of the grantor that are reclassified as service

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

concession assets in accordance with paragraph 12 of this Standard. The use of fair value on initial recognition does not constitute a revaluation under IPSAS 17 or IPSAS 31.

- AG25. The type of compensation exchanged between the grantor and the operator affects how the fair value of the service concession asset is determined on initial recognition. The paragraphs that follow outline how to determine the fair value of the asset on initial recognition based on the type of compensation exchanged:
- (a) Where payments are made by the grantor to the operator, the fair value on initial recognition of the asset represents the portion of the payments paid to the operator for the asset.
 - (b) Where the grantor does not make payments to the operator for the asset, the asset is accounted for in the same way as an exchange of non-monetary assets in IPSAS 17 and IPSAS 31.

Types of Compensation

- AG26. Service concession arrangements are rarely if ever the same; technical requirements vary by sector and by jurisdiction. Furthermore, the terms of the arrangement may also depend on the specific features of the overall legal framework of the particular jurisdiction. Contract laws, where they exist, may contain terms that do not have to be repeated in individual contracts.
- AG27. Depending on the terms of the service concession arrangement, the grantor may compensate the operator for the service concession asset and service provision by any combination of the following:
- (a) Making payments (e.g., cash) to the operator;
 - (b) Compensating the operator by other means, such as:
 - (i) Granting the operator the right to earn revenue from third-party users of the service concession asset; or
 - (ii) Granting the operator access to another revenue-generating asset for its use.
- AG28. Where the grantor compensates the operator for the service concession asset by making payments to the operator, the asset and service components of the payments may be separable (e.g., the binding arrangement specifies the amount of the predetermined series of payments to be allocated to the service concession asset) or inseparable.

Separable Payments

- AG29. A service concession arrangement may be separable in a variety of circumstances, including, but not limited to, the following:
- (a) Part of a payment stream that varies according to the availability of the service concession asset itself and another part that varies according to usage or performance of certain services are identified;
 - (b) Different components of the service concession arrangement run for different periods or can be terminated separately. For example, an individual service component can be terminated without affecting the continuation of the rest of the arrangement; or
 - (c) Different components of the service concession arrangement can be renegotiated separately. For example, a service component is market tested and some or all of the cost increases or reductions are passed on to the grantor in such a way that the part of the payment by the grantor that relates specifically to that service can be identified.
- AG30. IPSAS 17 and IPSAS 31 require initial measurement of an asset acquired in an exchange transaction at cost, which is the cash price equivalent of the asset. For exchange transactions, the transaction price is considered to be fair value, unless indicated otherwise. Where the asset and service components of payments are separable, the cash price equivalent of the service concession asset is the present value of the service concession asset component of the payments. However, if the present value of the asset portion of the payments is greater than fair value, the service concession asset is initially measured at its fair value.

Inseparable Payments

- AG31. Where the asset and service component of payments by the grantor to the operator are not separable, the fair value in paragraph 11 is determined using estimation techniques.
- AG32. For the purpose of applying the requirements of this Standard, payments and other consideration required by the arrangement are allocated at the inception of the arrangement or upon a reassessment of the arrangement into those for the service concession asset and those for other components of the service concession arrangement (e.g., maintenance and operation services) on the basis of their relative fair values. The fair value of the service concession asset includes only amounts related to the asset and excludes amounts for other components of the service concession arrangement. In some cases, allocating the payments for the asset from payments for other components of the service concession arrangement will require the grantor to use an estimation technique. For example, a grantor may estimate the payments related to the asset by reference to the fair value of a comparable asset in an

agreement that contains no other components, or by estimating the payments for the other components in the service concession arrangement by reference to comparable arrangements and then deducting these payments from the total payments under the arrangement.

Operator Receives Other Forms of Compensation

- AG33. The types of transactions referred to in paragraph 17(b) are non-monetary exchange transactions. Paragraph 38 of IPSAS 17 and paragraph 44 of IPSAS 31, as appropriate, provide guidance on these circumstances.
- AG34. When the operator is granted the right to earn revenue from third-party users of the service concession asset, or another revenue-generating asset, or receives non-cash compensation from the grantor, the grantor does not incur a cost directly for acquiring the service concession asset. These forms of compensation to the operator are intended to compensate the operator both for the cost of the service concession asset and for operating it during the term of the service concession arrangement. The grantor therefore needs to initially measure the asset component in a manner consistent with paragraph 11.

Subsequent Measurement

- AG35. After initial recognition, a grantor applies IPSAS 17 and IPSAS 31 to the subsequent measurement and derecognition of a service concession asset. IPSAS 21 and IPSAS 26 are also applied in considering whether there is any indication that a service concession asset is impaired. These requirements in these Standards are applied to all assets recognized or classified as service concession assets in accordance with this Standard.

Recognition and Measurement of Liabilities (see paragraphs 14–28)

- AG36. The grantor recognizes a liability in accordance with paragraph 14 only when a service concession asset is recognized in accordance with paragraph 9 (or paragraph 10 for a whole-of-life asset). The nature of the liability recognized in accordance with paragraph 14 differs in each of the circumstances described in paragraph AG25 according to its substance.

The Financial Liability Model (see paragraphs 18–23)

- AG37. When the grantor has an unconditional obligation to make a predetermined series of payments to the operator, the liability is a financial liability as defined in IPSAS 29. The grantor has an unconditional obligation if it has little, if any, discretion to avoid the obligation usually because of the binding arrangement with the operator being enforceable by law.
- AG38. When the grantor provides compensation to the operator for the cost of the service concession asset and service provision in the form of a predetermined series of payments, an amount reflecting the portion of the predetermined

series of payments that pertains to the asset is recognized as a liability in accordance with paragraph 14. This liability does not include the finance charge and service components of the payments specified in paragraph 21.

- AG39. Where the grantor makes any payments to the operator in advance of the service concession asset being recognized, the grantor accounts for those payments as prepayments.
- AG40. The finance charge specified in paragraph 21 is determined based on the operator's cost of capital specific to the service concession asset, if this is practicable to determine.
- AG41. If the operator's cost of capital specific to the service concession asset is not practicable to determine, the rate implicit in the arrangement specific to the service concession asset, the grantor's incremental borrowing rate, or another rate appropriate to the terms and conditions of the arrangement, is used.
- AG42. Where sufficient information is not available, the rate used to determine the finance charge may be estimated by reference to the rate that would be expected on acquiring a similar asset (e.g., a lease of a similar asset, in a similar location and for a similar term). The estimate of the rate should be reviewed together with:
- (a) The present value of the payments;
 - (b) The assumed fair value of the asset; and
 - (c) The assumed residual value, to ensure all figures are reasonable and mutually consistent.
- AG43. In cases when the grantor takes part in the financing (e.g., by lending the operator the funds to construct, develop, acquire, or upgrade a service concession asset, or through guarantees), it may be appropriate to use the grantor's incremental borrowing rate to determine the finance charge.
- AG44. The interest rate used to determine the finance charge may not be subsequently changed unless the asset component or the whole of the arrangement is renegotiated.
- AG45. The finance charge related to the liability in a service concession arrangement is presented consistently with other finance charges in accordance with IPSAS 28, IPSAS 29, and IPSAS 30.
- AG46. The service component of payments determined in accordance with paragraph 21 is ordinarily recognized evenly over the term of the service concession arrangement because this pattern of recognition best corresponds to the service provision. In cases when specific expenses are required to be separately compensated, and their timing is known, such expenses are recognized as incurred.

Grant of a Right to the Operator Model (see paragraphs 24–26)

- AG47. When the grantor compensates the operator for the service concession asset and service provision by granting the operator the right to earn revenue from third-party users of the service concession asset, the operator is granted the right to earn revenue over the period of the service concession arrangement. Likewise, the grantor earns the benefit associated with the assets received in the service concession arrangement in exchange for the right granted to the operator over the period of the arrangement. Accordingly, the revenue is not recognized immediately. Instead, a liability is recognized for any portion of the revenue that is not yet earned. Revenue is recognized and the liability reduced in accordance with paragraph 25 based on the economic substance of the service concession arrangement, usually as access to the service concession asset is provided to the operator over the term of the service concession arrangement. As described in paragraph AG27, the grantor may compensate the operator by a combination of payments and granting a right to earn revenue directly from third-party users. In such cases, if the operator's right to earn such third-party revenues significantly reduces or eliminates the grantor's predetermined series of payments to the operator, another basis may be more appropriate for reducing the liability (e.g., the term over which the grantor's future predetermined series of payments are reduced or eliminated).
- AG48. When the grantor compensates the operator for the service concession asset and service by the provision of a revenue-generating asset, other than the service concession asset, revenue is recognized and the liability recognized in accordance with paragraph 24 is reduced in a manner similar to that described in paragraph AG47. In such cases, the grantor also considers the derecognition requirements in IPSAS 17 or IPSAS 31, as appropriate.
- AG49. In some cases under the grant of a right to the operator model, there may be a "shadow toll". Some shadow tolls are paid for the construction, development, acquisition, or upgrade of the service concession asset, and its operation by the operator. In cases where the grantor pays the operator solely for the usage of the service concession asset by third-party users, such payment is compensation in exchange for the usage and not the acquisition of the service concession asset. Accordingly, such payments do not relate to the liability specified in paragraph AG48. The grantor compensates the operator only to the extent of the usage of the service concession asset, and accounts for such payments as expenses in accordance with IPSAS 1.

Dividing the Arrangement (see paragraphs 27–28)

- AG50. If the operator is compensated for the service concession asset partly by a predetermined series of payments and partly by receiving the right to earn revenue from third-party use of either the service concession asset or another

revenue-generating asset, it is necessary to account separately for each portion of the liability related to the grantor's consideration. In these circumstances, the consideration to the operator is divided into a financial liability portion for the predetermined series of payments and a liability portion for the right granted to the operator to earn revenue from third-party use of the service concession asset or another revenue-generating asset. Each portion of the liability is recognized initially at the fair value of the consideration paid or payable.

Other Liabilities, Commitments, Contingent Liabilities and Contingent Assets (see paragraph 29)

- AG51. Service concession arrangements may include various forms of financial guarantees (e.g., a guarantee, security, or indemnity related to the debt incurred by the operator to finance construction, development, acquisition, or upgrade of a service concession asset), or performance guarantees (e.g., guarantee of minimum revenue streams, including compensation for short-falls).
- AG52. Certain guarantees made by a grantor may meet the definition of a financial guarantee contract. The grantor determines whether guarantees made by the grantor as part of a service concession arrangement meet the definition of a financial guarantee contract and applies IPSAS 28, IPSAS 29, and IPSAS 30 in accounting for the guarantee. Where the guarantee is an insurance contract, the grantor can elect to apply the relevant international or national accounting standard dealing with insurance contracts. See IPSAS 28, paragraphs AG3–AG9 for further guidance.
- AG53. Guarantees and commitments that do not meet the requirements in IPSAS 28 and IPSAS 29 relating to financial guarantee contracts or are not insurance contracts are accounted for in accordance with IPSAS 19.
- AG54. Contingent assets or liabilities may arise from disputes over the terms of the service concession arrangement. Such contingencies are accounted for in accordance with IPSAS 19.

Other Revenues (see paragraph 30)

- AG55. The operator may compensate the grantor for access to the service concession asset by providing the grantor with a series of predetermined inflows of resources, including the following:
 - (a) An upfront payment or a stream of payments;
 - (b) Revenue-sharing provisions;
 - (c) A reduction in a predetermined series of payments the grantor is required to make to the operator; and

- (d) Rent payments for providing the operator access to a revenue-generating asset.
- AG56. When the operator provides an upfront payment, a stream of payments, or other consideration to the grantor for the right to use the service concession asset over the term of the service concession arrangement, the grantor accounts for these payments in accordance with IPSAS 9. The timing of the revenue recognition is determined by the terms and conditions of the service concession arrangement that specify the grantor's obligation to provide the operator with access to the service concession asset.
- AG57. Where the operator provides an upfront payment, a stream of payments, or other consideration to the grantor in addition to the service concession asset, for the right to earn the revenue from third-party use of the service concession asset, or another revenue-generating asset, any portion of the payments received from the operator not earned in the accounting period is recognized as a liability until the conditions for revenue recognition are met.
- AG58. When the conditions for revenue recognition are met, the liability is reduced as the revenue is recognized in accordance with paragraph 30.
- AG59. However, given the varying nature of the types of assets that may be used in service concession arrangements, and the number of years over which the arrangements operate, there may be more appropriate alternative methods for recognizing revenue associated with the inflows specified in the binding arrangement that better reflect the operator's economic consumption of their access to the service concession asset and/or the time value of money. For example, an annuity method that applies a compounding interest factor that more evenly recognizes revenue on a discounted basis, as opposed to on a nominal basis, may be more appropriate for a service concession arrangement with a term extending over several decades.
- AG60. When an upfront payment is received from the operator, the revenue is recognized in a way that best reflects the operator's economic consumption of its access to the service concession asset and/or the time value of money. For example, when the operator is required to pay annual installments over the term of the service concession arrangement, or predetermined sums for specific years, the revenue is recognized over the specified term.
- AG61. For service concession arrangements under which the operator is granted the right to earn revenue from third-party users of the service concession asset, revenue relates to the inflow of economic benefits received as the services are provided and is therefore recognized on the same basis as the liability is reduced. In these cases, the grantor will often negotiate to include a revenue-sharing provision in the arrangement with the operator. Revenue-sharing as part of a service concession arrangement may be based on all revenue earned by the operator, or on revenue above a certain threshold, or on revenue more than the operator needs to achieve a specified rate of return.

- AG62. The grantor recognizes revenue generated from revenue-sharing provisions in service concession arrangements as it is earned, in accordance with the substance of the relevant agreement, after any contingent event (e.g., the achievement of a revenue threshold) is deemed to have occurred. The grantor applies IPSAS 19 to determine when the contingent event has occurred.
- AG63. A reduction in the future predetermined series of payments the grantor would otherwise be required to make to the operator provides the grantor with upfront non-cash consideration. Such revenue is recognized as the liability is reduced.
- AG64. When the operator pays a nominal rent for access to a revenue-generating asset, the rental revenue is recognized in accordance with IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.

Presentation and Disclosure (see paragraphs 31–33)

- AG65. Disclosures relating to various aspects of service concession arrangements may be addressed in existing Standards. This Standard addresses only the additional disclosures relating to service concession arrangements. Where the accounting for a particular aspect of a service concession arrangement is addressed in another Standard, the grantor follows the disclosure requirements of that Standard in addition to those set out in paragraph 32.
- AG66. IPSAS 1 requires finance costs to be presented separately in the statement of financial performance. The finance charge determined in accordance with paragraph 21 is included in this item.
- AG67. In addition to the disclosures outlined in paragraphs 31–33, the grantor also applies the relevant presentation and disclosure requirements in other IPSASs as they pertain to assets, liabilities, revenues, and expenses recognized under this Standard.

Transition (see paragraphs 34–35)

- AG68. [Deleted]
- AG69. [Deleted]
- AG70. [Deleted]
- AG71. [Deleted]
- AG72. [Deleted]
- AG73. [Deleted]

Appendix B

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 32.

Objective

- BC1. In the absence of an International Public Sector Accounting Standard dealing with service concession arrangements, public sector entities are directed, in IPSAS 1, *Presentation of Financial Statements* to look to other international or national accounting standards. In the case of arrangements involving private sector participation, they would try to apply the principles in Interpretation 12 of the International Accounting Standards Board's International Financial Reporting Interpretations Committee (IFRIC 12), *Service Concession Arrangements*. However, IFRIC 12 addresses accounting by the operator, and does not, therefore, provide guidance for the grantor. The IPSASB believes this Standard will promote consistency and comparability in how service concession arrangements are reported by public sector entities.

Scope

- BC2. After considering the various types of arrangements involving public and private sector entities identified in the development of the March 2008 Consultation Paper, *Accounting and Financial Reporting for Service Concession Arrangements*, the IPSASB concluded that the scope of this Standard should be the mirror of IFRIC 12, in particular, the criteria under which the grantor recognizes a service concession asset (see paragraphs BC11–BC16). The rationale for this decision is that this approach would require both parties to the same arrangement to apply the same principles in determining which party should recognize the asset used in a service concession arrangement. Thus, arrangements in which the criteria for recognition of a service concession asset in paragraph 9 (or paragraph 10 for a whole-of-life asset) are not satisfied, are outside the scope of this IPSAS. The IPSASB considers that this approach minimizes the possibility for an asset to be accounted for by both of the parties, or by neither party.
- BC3. The IPSASB recognized that the Standard should provide Implementation Guidance on the relevant IPSASs that apply to arrangements outside the scope of the Standard. The Implementation Guidance contains a flowchart illustrating the application of this Standard as well as a table of references to relevant IPSASs for the other types of arrangements that are outside the scope of this Standard.
- BC4. The IPSASB concluded that it was important to provide guidance on accounting for the consideration given by the grantor to the operator for the service concession asset. The consideration may give the operator rights to a determinable series of payments of cash or cash equivalents or a right to earn revenue from third-party users of the service concession asset or

another revenue-generating asset for its use, or a combination of both types of consideration. Each type of consideration results in specific accounting issues on which the IPSASB has provided guidance to facilitate consistent application of the Standard.

- BC5. The IPSASB also concluded that guidance was necessary on applying the general revenue recognition principles in IPSAS 9, *Revenue from Exchange Transactions* to service concession arrangements because of the unique features of some service concession arrangements (e.g., revenue-sharing provisions).
- BC6. This Standard does not specify the accounting by operators, because it is addressed in IFRIC 12. In many cases the operator is a private sector entity, and IPSASs are not designed to apply to private sector entities. The operator or the grantor may also be a [Government Business Enterprise (GBE)] (the term in square brackets is no longer used following the issue of *The Applicability of IPSASs* in April 2016). When this Standard was issued, IPSASs were not designed to apply to GBES. International Financial Reporting Standards (IFRSs) were applied to private sector entities and GBES.
- BC7. Some respondents to ED 43 suggested that the scope of the proposed Standard should be extended to include public-to-public service concession arrangements. The IPSASB noted that addressing the accounting for such arrangements was not the primary purpose of the project which was to address the cases when the grantor is a public sector entity that follows accrual IPSASs. The IPSASB noted that application of this Standard by analogy would be appropriate under paragraphs 12–15 of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors* for the public sector grantor and that relevant international or national accounting standard dealing with service concession arrangements may be applied by the public sector operator

Definitions

- BC8. ED 43 did not provide definitions because IFRIC 12 did not do so. Accordingly, ED 43 provided guidance on certain terminology. Respondents to ED 43 proposed that, because this is a Standard and not an Interpretation, it was important to include definitions for consistency in application of the Standard. The IPSASB agreed that this Standard should include definitions.
- BC9. The IPSASB agreed not to use the term “infrastructure” to refer to the asset used in a service concession arrangement, even though IFRIC 12 uses the term. The IPSASB noted that the term is used in IPSASs in ways that may not be fully compatible with this Standard. Further, the term has a prescribed meaning in some jurisdictions that differs from that used in IFRIC 12. To ensure clarity that the asset referred to is the one recognized on the basis of the conditions for recognition in paragraph 9 of this Standard (or paragraph 10 for a whole-of-life asset), the asset in this Standard is referred to as the

“service concession asset”. This term is intended to cover the same types of assets as envisaged in IFRIC 12.

- BC10. The term “binding arrangement” had not been defined previously, but has been used in other IPSASs to describe arrangements that confer similar rights and obligations on the parties to it as if they were in the form of a contract. The IPSASB concluded that for the purposes of this Standard, this term should be defined to ensure consistent application of the Standard.

Recognition of a Service Concession Asset

- BC11. The main accounting issue in service concession arrangements is whether the grantor should recognize a service concession asset.
- BC12. The IPSASB considered the merits of the risks and rewards and the control-based approach to assess whether the grantor should recognize the asset. The risks and rewards approach focuses on the economic aspects of the terms and conditions in the arrangement. The IPSASB did not believe this focus to be appropriate for service concession arrangements because the primary purpose of a service concession asset, from the grantor’s point of view, is to provide specified public services on behalf of the grantor using a service concession asset, and not to provide economic benefits such as revenue generated by such assets (e.g., from user fees). Thus, the service potential of the asset accrues to the grantor. Economic benefits are only likely to arise from a service concession arrangement in circumstances where the operator is granted the right to earn revenue from third-party users, of either the service concession asset or another revenue-generating asset. A control-based approach focuses on control over the economic benefits and the service potential of the service concession asset.
- BC13. As it is often the case that service concession arrangements are entered into for the sharing of risks between the grantor and the operator, the IPSASB also questioned whether sufficiently objective criteria could be established for assessing risks and rewards to enable consistent results to be determined. In addition, weighting of various risks and rewards was seen to be problematic. The IPSASB concluded, therefore, that the risks and rewards approach is inappropriate.
- BC14. The IPSASB also considered whether a rights and obligations approach was appropriate. Although such an approach could have conceptual merit, the IPSASB believes that it would represent a significant change in the accounting and financial reporting of assets and liabilities for public sector entities that could have implications beyond service concession arrangements. Given the IPSASB’s decision to complement IFRIC 12, which uses a control-based approach, the IPSASB agreed that a rights and obligations approach was not appropriate for this Standard.

- BC15. The IPSASB concluded that a control-based approach was the most effective means to determine whether the grantor should recognize the asset. The IPSASB concluded that if a control-based approach is used, it should be consistent with IFRIC 12, for the same reasons cited in paragraph BC2. Accordingly, this Standard addresses only arrangements in which the grantor (a) controls or regulates the services provided by the operator, and (b) controls any significant residual interest in the service concession asset at the end of the term of the arrangement. Consistent with IFRIC 12, in the case of whole-of-life assets, only condition (a) must be met for recognition of a service concession asset. The IPSASB concluded that it was important to stress that a service concession arrangement is a binding arrangement. Accordingly, the assessment of whether a service concession asset should be recognized is made on the basis of all of the facts and circumstances of the arrangement.
- BC16. Paragraph 9(a) of this Standard is consistent with paragraph 5 of IFRIC 12. It is intended to apply only to the regulation that is specific to the service concession arrangement, and not to the broad understanding of public sector regulatory powers from the grantor's point of view. The regulation referred to in paragraph 9(a) of this Standard is either by contract or through a regulator. Guidance is provided in paragraph AG6 on applying the term "regulates" in paragraph 9(a) to determine whether the grantor should recognize a service concession asset. Some respondents to ED 43 asserted that providing such additional guidance creates an asymmetry with IFRIC 12, as there is no additional guidance on the meaning of this term. The IPSASB considers the additional guidance provided in paragraph AG6 is necessary to ensure symmetry exists between the public sector grantor's and the private sector operator's application of the "regulates" criterion in determining whether to recognize the service concession asset, as the public sector may have considered the term in the context of the broad regulatory powers of governments.

Recognition of a Liability

- BC17. ED 43 described two circumstances that may give rise to a liability when the grantor recognizes a service concession asset, based on the nature of the consideration due to the operator in exchange for the service concession asset.
- BC18. ED 43 proposed that when the grantor recognizes a service concession asset, a liability shall also be recognized. The ED noted that this liability may be any combination of a financial liability and a performance obligation. ED 43 proposed that a financial liability occurs when the grantor has a determinable series of cash payments of cash or cash equivalents to make to the operator and a performance obligation occurs when the grantor compensates the operator by granting the operator the right to charge users of the service concession asset or by granting the operator access to another revenue-generating asset for its use. ED 43 proposed that the grantor account for the performance

obligation in accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*.

- BC19. Respondents to ED 43 sought clarification on this issue, particularly with respect to the “performance obligation” identified in ED 43. Respondents’ concerns are summarized below.
- (a) The right to charge users of the service concession asset or by granting the operator access to another revenue-generating asset was seen by some respondents as independent of the compensation for the asset. These respondents highlighted that the requirement to provide access is a feature of most service concession arrangements, and if this is to be recognized, such recognition should not be dependent on the non-occurrence of a payment stream from the grantor to the operator.
 - (b) While being described as a performance obligation, there is no obligation for an outflow of economic resources from the grantor in future periods. These respondents therefore question whether a liability as defined in IPSAS 1, or a provision as defined in IPSAS 19 could be fairly represented to exist.
- BC20. In addition, a number of other respondents, possibly as a result of the above concerns, requested clarification of the meaning of “performance obligation” in the ED. A few of these respondents queried whether the substance of the nature of this “balancing item” was deferred revenue.
- BC21. The IPSASB agreed that clarification of this issue was required. The IPSASB noted that using the term “performance obligation” could give rise to confusion because it is used in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* in relation to non-exchange transactions. The IPSASB noted that a service concession arrangement is an exchange transaction rather than a non-exchange transaction and therefore it would be preferable not to use the term performance obligation in relation to exchange transactions.
- BC22. In IFRIC 12, when the operator does not control the service concession asset, the operator recognizes either a financial asset, or an intangible asset, depending on which party bears the demand risk. The IPSASB agreed that, to maintain symmetry with IFRIC 12, the same approach should be adopted for the grantor. Thus, two models are identified for accounting for the credit when the grantor recognizes a service concession asset in accordance with this Standard: the financial liability model, and the grant of a right to the operator model (which replaces the “performance obligation”).
- BC23. The IPSASB’s decision to amend the terminology used in ED 43 from “performance obligation” to the Standard’s use of “liability” does not change the grantor’s accounting treatment of a service concession arrangement from that proposed in ED 43.

The Financial Liability Model

- BC24. Where the grantor compensates the operator by the delivery of cash or another financial asset in exchange for its control of a service concession asset, IFRIC 12 classifies this type of arrangement as the “financial asset model” because the operator receives a financial asset. This Standard refers to this type of arrangement as the “financial liability model” because the grantor has a financial liability.
- BC25. A financial liability arises in cases when the grantor is obligated to make a determinable series of payments to the operator because the grantor has an obligation as a result of the binding arrangement to deliver cash or another financial asset to another entity (the operator). The IPSASB concluded further that when there is a determinable series of payments of cash or cash equivalents, the payments should be allocated as a reduction of the liability, an imputed finance charge, and charges for services provided by the operator under the service concession arrangement.
- BC26. Service concession arrangements are concluded by way of a binding arrangement, which may include contracts or similar arrangements that confer similar rights and obligations on the parties as if they were in the form of a contract. The IPSASB concluded that, if similar arrangements exist that confer the same rights and obligations on either party as if they were in the form of a contract, IPSAS 28, *Financial Instruments: Presentation*, IPSAS 29, *Financial Instruments: Recognition and Measurement*, and IPSAS 30, *Financial Instruments: Disclosures* should be applied by analogy to such arrangements.
- BC27. In considering a departure from this aspect of IFRIC 12, the IPSASB noted that the main features of IFRIC 12 that were the subject of the “mirror” approach to developing this Standard were limited to the scope of the arrangements to be included and the recognition and disclosure requirements.
- BC28. IFRIC 12 requires the financial asset to be accounted for in accordance with the IFRS on financial instruments. This Standard provides guidance for determining the interest rate to be used to determine the finance charge under the financial liability model. The IPSASB considered the grantor ordinarily would not have sufficient information to determine a market rate. Accordingly, the guidance requires the operator’s cost of capital to be used, if that is practicable to determine. It also permits other rates to be used appropriate to the specific terms and conditions of the service concession arrangement.

Grant of a Right to the Operator Model

- BC29. In responding to the issues raised by respondents to ED 43, the IPSASB reconsidered the nature of the consideration given by the grantor for the service concession asset where the operator recoups the price of the asset

from earning revenue from third-party users of the service concession asset or another revenue-generating asset. The IPSASB noted that in this situation, the cash consideration for the service concession asset is not being met by the grantor but by users of the service concession asset or other revenue-generating asset. The economic substance of this arrangement provides an increase in net assets to the grantor, and therefore revenue accrues and should be recognized. As the service concession arrangement is an exchange transaction, the Board referred to IPSAS 9 when considering the nature of the revenue and the timing of the recognition of that revenue.

- BC30. Where the operator bears the demand risk, the grantor compensates the operator by the grant of a right (e.g., a license) to charge users of the public service related to the service concession asset or of another revenue-generating asset. The grantor provides the operator access to the asset in order for the operator to be compensated for construction, development, acquisition, or upgrade of the service concession asset. IFRIC 12 classifies this type of arrangement as the “intangible asset model.” This Standard refers to this type of arrangement as the “grant of a right to the operator model.”
- BC31. The IPSASB therefore considered whether the credit should be accounted for as a liability, as a direct increase to net assets/equity, or as revenue.
- BC32. It was agreed that, in this circumstance, the grantor does not have a liability because the service concession arrangement is an exchange of assets, with the service concession asset being obtained by the grantor in exchange for a transfer of rights to the operator to earn revenue from third-party users of the asset over the period of the service concession arrangement.
- BC33. Some respondents to ED 43 indicated that the credit should be treated as net assets/equity, consistent with IPSAS 1, which defines net assets/equity as the residual interest in the assets of the entity after deducting all its liabilities. IPSAS 1 envisages four components of net assets/equity. Those components include:
- (a) Contributed capital, being the cumulative total at the reporting date of contributions from owners, less distributions to owners;
 - (b) Accumulated surpluses or deficits;
 - (c) Reserves, including a description of the nature and purpose of each reserve within net assets/equity; and
 - (d) Non-controlling interests.
- BC34. The IPSASB concluded that the credit did not represent a direct increase in the grantor’s net assets/equity because the credit is not one of the components of net assets/equity identified in paragraph BC33 for the reasons noted below:
- (a) Contributions from owners are defined as “future economic benefits or service potential that has been contributed to the entity by parties

external to the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets/equity of the entity, which: (a) Conveys entitlement both to (i) distributions of future economic benefits or service potential by the entity during its life, such distributions being at the discretion of the owners or their representatives, and to (ii) distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or (b) Can be sold, exchanged, transferred, or redeemed.” The credit related to the recognition of a service concession asset does not meet this definition because the operator has not made a contribution to the grantor that results in a financial interest in the entity by the operator as envisaged by IPSAS 1.

- (b) Accumulated surplus/deficit is an accumulation of an entity’s surpluses and deficits. The credit related to recognition of a service concession asset represents an individual transaction and not an accumulation.
- (c) Reserves generally arise from items recognized directly in net assets/equity from specific requirements in IPSASs, and may include, for example, gains and losses on revaluation of assets (e.g., property, plant, and equipment, investments). The credit related to the recognition or reclassification of a service concession asset does not represent a gain or loss specified to be directly recognized in net/assets equity because it involves an exchange transaction and not a revaluation of an existing asset of the grantor. Existing assets of the grantor, when used in a service concession arrangement and continue to meet the control criteria in this Standard, are reclassified, thus no revaluation is done.
- (d) A non-controlling interest is defined as “that portion of the surplus or deficit and net assets/equity of a controlled entity attributable to net assets/equity interests that are not owned, directly or indirectly, through controlled entities, by the controlling entity.” A non-controlling interest may arise, for example, when at the whole-of-government level, the economic entity includes a commercial public sector entity that has been partly privatized. Accordingly, there may be private shareholders who have a financial interest in the net assets/equity of the entity. The credit related to the recognition of a service concession asset does not meet this definition because operator does not have such a financial interest in the grantor.

BC35. The IPSASB agreed that the credit represents revenue. As a service concession arrangement is an exchange transaction, the IPSASB referred to IPSAS 9 when considering the nature of the revenue and the timing of the recognition of that revenue. In accordance with IPSAS 9, when goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction that generates revenue as it results in an increase in the net assets of the grantor. In this situation, the grantor has received a

service concession asset in exchange for granting a right (a license) to the operator to charge the third party users of the public service that it provides on the grantor's behalf. The service concession asset recognized by the grantor and the right (intangible asset) recognized by the operator are dissimilar. However, until the criteria for recognition of revenue have been satisfied, the credit is recognized as a liability.

- BC36. The IPSASB noted that, in this situation, there is no cash inflow to equal the revenue recognized. This result is consistent with IPSAS 9 in which an entity provides goods or services in exchange for another dissimilar asset that is subsequently used to generate cash revenues.
- BC37. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.
- BC38. IPSAS 9 identifies three types of transaction that give rise to revenue: the rendering of services, the sale of goods (or other assets) and revenue arising from the use by others of the entity's assets, yielding interest, royalties, and dividends. In considering the nature of the revenue, the IPSASB considered these types of transactions separately.
- BC39. The IPSASB considered the approaches to revenue recognition set out in IPSAS 9 in relation to the "grant of a right to the operator" model and concluded that none of those scenarios fully met the circumstances of this model. Nevertheless, the IPSASB noted that the timing of revenue recognition under each of them is over the term of the arrangement, rather than immediately. The IPSASB determined that, by analogy, such a pattern of revenue recognition was also appropriate for recognizing the revenue arising from the liability related to this model. As a result, until the criteria for recognition of revenue have been satisfied, the credit is recognized as a liability.
- BC40. The IPSASB considered whether the grantor should recognize the operating expenses in the circumstances described in paragraph BC30 relating to the grant of a right to the operator model. The IPSASB noted that the grantor's liability recognized relates solely to the service concession asset received by the grantor. If the service expenses were recognized, the grantor would also have to recognize annually imputed revenue equal to the annual expense. The IPSASB did not believe this accounting would provide useful information, because revenue and an expense of equal amounts would be recognized annually. The IPSASB noted further that reliable information about the operator's expenses may not be available in any case. The IPSASB therefore concluded that the grantor should not recognize operating expenses

associated with the service concession arrangement in the circumstances described in paragraph BC30.

Accounting Issues Addressed in Other IPSASs

BC41. Because of the complexity of many service concession arrangements, there may be additional accounting issues related to certain terms in the contract, or a similar binding arrangement (e.g., revenues, expenses, guarantees, and contingencies). The IPSASB agreed that it was not necessary to repeat such existing guidance in this Standard. Accordingly, when an existing IPSAS specifies the accounting and reporting for a component of a service concession arrangement, that IPSAS is referred to in this Standard and no additional guidance is provided. However, the IPSASB noted some cases (e.g., revenue recognition), when the application of such IPSASs would be difficult given certain unique features in service concession arrangements. To ensure consistent implementation of this Standard, the IPSASB provided specific guidance on how the principles in the other IPSAS would be applied.

Transition

BC42. This Standard requires an entity that has previously recognized service concession assets and related liabilities, revenues, and expenses to apply this Standard retrospectively in accordance with IPSAS 3. The Standard also requires an entity that has not previously recognized service concession assets and related liabilities, revenues, and expenses and uses the accrual basis of accounting to apply this Standard either retrospectively or prospectively using deemed cost from the beginning of the earliest period for which comparative information is presented in the financial statements.

BC43. The general requirement in IPSAS 3 is that the changes should be accounted for retrospectively, except to the extent that retrospective application would be impracticable. The IPSASB noted that there are two aspects to retrospective determination: reclassification and remeasurement. The IPSASB took the view that it will usually be practicable to determine retrospectively the appropriate classification of all amounts previously included in a grantor's statement of financial position, but that retrospective remeasurement of service concession assets might not always be practicable, particularly if an entity has not previously recognized service concession assets and related liabilities, revenues, and expenses.

BC44. The IPSASB noted that, when retrospective restatement is not practicable, IPSAS 3 requires prospective application from the earliest practicable date, which could be the start of the current reporting period.

BC45. The transitional provisions in this Standard for entities that have not previously recognized service concession assets were amended from ED 43 because some respondents to ED 43 questioned why the general requirement in IPSAS 3 is not also appropriate for an entity that has not previously

recognized service concession arrangements. ED 43 required prospective application in such cases, but permitted retrospective application.

- BC46. When developing ED 43 the IPSASB had concerns relating to the practicality of determining the measurement of a service concession asset, and considered that this could result in inconsistent treatment of arrangements entered into in the past. This was a similar issue to that which arose in finalizing IPSAS 31, *Intangible Assets*. On that basis, the IPSASB considered it appropriate to propose transitional provisions in ED 43 that were consistent with those in IPSAS 31.
- BC47. However, the IPSASB noted that the circumstances surrounding intangible assets differ from those in service concession arrangements. Notably, service concession arrangements generally involve long-term binding arrangements for which information required to develop fair value and cost information would likely be more readily available than it is for intangible assets acquired or developed in the past, even in cases where an entity had not previously recognized service concession assets.
- BC48. The IPSASB did however acknowledge that because many of these arrangements may have been entered into some time ago, it may be difficult to apply full retrospective application. As a result, the IPSASB considered that a “deemed cost” could be used to recognize and measure service concession assets.

Revision of IPSAS 32 as a result of Part II of *Improvements to IPSASs 2015*: issues raised by stakeholders

- BC49. The IPSASB had its attention drawn to a possible inconsistency between the requirements in IPSAS 32 and the requirements in IPSAS 17 and IPSAS 31. The requirements in IPSAS 32 could be seen as requiring service concession assets to be presented as a single class of assets, even if they were of a dissimilar nature and function. As it is not the intention of the IPSASB to require that dissimilar assets be reported as if they were similar, the IPSASB decided to propose clarifications to IPSAS 32 to make its intentions clear. The IPSASB considered whether these changes would reduce the information available to users, but is satisfied that the current disclosure requirements, in particular those in paragraph 32, ensure high quality disclosures about assets subject to service concession arrangements.
- BC50. The IPSASB noted that the reclassification of service concessions assets could require a change in measurement basis for some entities. For example, some service concession assets measured using the revaluation model, might be reclassified into a class of assets measured using the cost model. Equally, some service concession assets measured using the cost model, might be reclassified into a class of assets measured using the revaluation model. Because the balance between the service concession assets and the other assets in a class will vary from entity to entity, the IPSASB agreed to permit entities

to select the measurement basis to be applied at the point of reclassification. The IPSASB also noted that the information required to retrospectively apply the cost model might not be readily available. Consequently, the IPSASB agreed to permit entities to use the carrying amounts determined under the revaluation model as deemed cost at the point of reclassification where an entity elects to measure a class of assets using the cost model.

Revision of IPSAS 32 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

BC51. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

- (a) Removes the standard paragraphs about the applicability of IPSASs to “public sector entities other than GBEs” from the scope section of each Standard;
- (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and
- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

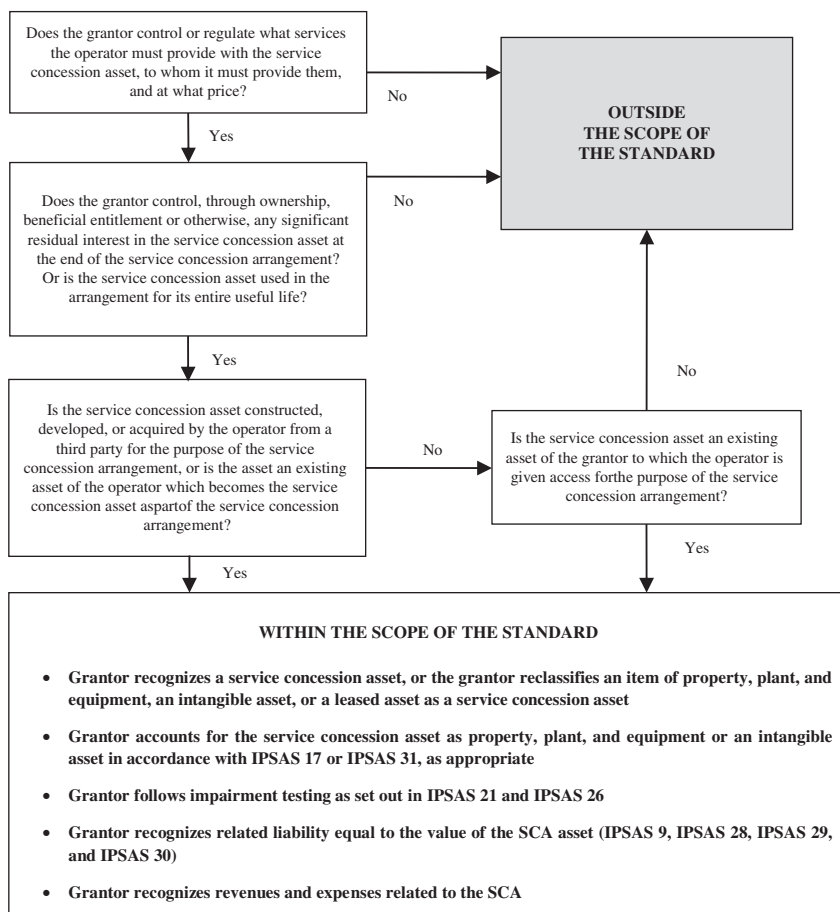
Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 32.

IG1. The purpose of this Implementation Guidance is to illustrate certain aspects of the requirements of IPSAS 32.

Accounting Framework for Service Concession Arrangements

IG2. The diagram below summarizes the accounting for service concession arrangements established by IPSAS 32.



References to IPSASs that Apply to Typical Types of Arrangements Involving an Asset Combined with Provision of a Service

IG3. The table sets out the typical types of arrangements for private sector participation in the provision of public sector services and provides references to IPSASs that apply to those arrangements. The list of arrangements types is not exhaustive. The purpose of the table is to highlight the continuum of arrangements. It is not the IPSASB's intention to convey the impression that bright lines exist between the accounting requirements for various types of arrangements.

IG4. Shaded text shows arrangements within the scope of IPSAS 32.

Category	Lessee	Service provider			Owner	
Typical arrangement types	Lease (e.g., operator leases asset from grantor)	Service and/or maintenance contract (specific tasks e.g., debt collection, facility management)	Rehabilitate-operate-transfer	Build-operate-transfer	Build-own-operate	100% Divestment/Privatization/Corporation
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Grantor and/or Operator		Operator	
Typical duration	8–20 years	1–5 years	25–30 years			Indefinite (or may be limited by binding arrangement or license)
Residual interest	Grantor				Operator	
Relevant IPSASs	IPSAS 13	IPSAS 1	This IPSAS/IPSAS 17/IPSAS 31		IPSAS 17/IPSAS 31 (derecognition) IPSAS 9 (revenue recognition)	

Illustrative Examples

These examples accompany, but are not part of, IPSAS 32.

IE1. These examples deal with only three of many possible types of service concession arrangements. Their purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustrations as clear as possible, it has been assumed that the term of the service concession arrangement is only ten years and that the operator's annual receipts are constant over that period. In practice, terms may be much longer and annual revenues may increase with time.

Arrangement Terms (Common to All Three Examples)

- IE2. In these examples, monetary amounts are denominated in "currency units" (CU).
- IE3. These terms are common to the three examples that follow:
- IE4. The terms of the arrangement require an operator to construct a road—completing construction within two years—and maintain and operate the road to a specified standard for eight years (i.e., years 3–10). The arrangement is within the scope of this Standard and the road meets the conditions for recognition of a service concession asset in paragraph 9 (or paragraph 10 for a whole-of-life asset).
- IE5. The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8 at a fair value of CU110. The compensation to the operator for this service is included in the predetermined series of payments and/or the revenue the operator has the right to earn from the service concession asset or another revenue-generating asset granted to the operator by the grantor.
- IE6. It is assumed that the original road surface is a separate component of the service concession asset and meets the criteria for recognition specified in IPSAS 17 when the service concession asset is initially recognized. It is further assumed that there is sufficient certainty regarding the timing and amount of the resurfacing work for it to be recognized as a separate component when the resurfacing occurs.³ It is assumed that the expected cost of the resurfacing can be used to estimate the initial cost of the surface layers recognized as a separate component of the service concession asset. The road surface is therefore recognized as a separate component of the initial fair value of the service concession asset and measured at

³ If this was not the case (e.g., where the operator might resurface in future, or might incur additional maintenance over the period of the service concession arrangement), it might not be appropriate to recognize a component.

the estimated fair value of the resurfacing and depreciated over years 3–8. This depreciation period is shorter than that for the road base, and takes into account that resurfacing would ordinarily occur over six years, rather than 25 years. During the construction phase, it is assumed that only the road base is constructed in year 1, and that the road only becomes ready to use at the end of year 2.

- IE7. Recognition of the replacement component of the road surface as a separate component of the service concession asset in year 8 also results in an increase in the liability recognized by the grantor. Where the liability relates to the grant of a right to the operator model, additional revenue in respect of this increase is recognized evenly over the term of the arrangement. However, if the expenditure represented an improvement in service potential such as a new traffic lane rather than restoration to original service capability then it would be appropriate to instead recognize revenue relevant to that improvement only once it has occurred.

- IE8. At the beginning of year 3, the total fair value of the road is CU1,050, comprised of CU940 related to the construction of the base layers and CU110 related to construction of the surface layers. The fair value of the surface layers is used to estimate the fair value of the resurfacing (which is treated as a replacement component in accordance with IPSAS 17). The estimated life of surface layers (i.e., six years) is also used to estimate the depreciation of the replacement component in years 9 and 10. The total initial fair value of the road is lower than the present value of the series of predetermined payments pertaining to the asset, where applicable.

- IE9. The road base has an economic life of 25 years. Annual depreciation is taken by the grantor on a straight-line basis. It is therefore CU38 (940/25) for the base layers. The surface layers are depreciated over 6 years (years 3–8 for the original component, and starting in year 9 for the replacement component). Annual depreciation related to the surface layers is CU18 (CU110/6). There is no impairment in the value of the road over the term of the service concession arrangement.

- IE10. The operator's cost of capital is not practicable to determine. The rate implicit in the service concession arrangement specific to the asset is 6.18%.

- IE11. It is assumed that all cash flows take place at the end of the year.

- IE12. It is assumed that the time value of money is not significant. Paragraph AG59 provides guidance on methods that may be appropriate where the time value of money is significant.

- IE13. At the end of year 10, the arrangement will end. At the end of the arrangement, the operator will transfer the operation of the road to the grantor.
- IE14. The total compensation to the operator under each of the three examples is inclusive of each of the components of the service concession arrangement and reflects the fair values for each of the services, which are set out in Exhibit 1.
- IE15. The grantor's accounting policy for property, plant, and equipment is to recognize such assets using the cost model specified in IPSAS 17.

**Exhibit 1: Fair Values of the Components of the Arrangement
(Currency Units)**

Contact Component	Fair Value
Road – base layers	940
Road – original surface layers	110
Total FV of road	1,050
Annual service component	12
Effective interest rate	6.18%

Example 1: The Grantor makes a Predetermined Series of Payments to the Operator

Additional Terms

- IE16. The terms of the arrangement require the grantor to pay the operator CU200 per year in years 3–10 for making the road available to the public. The total consideration (payment of CU200 in each of years 3–10) reflects the fair values for each of the services indicated in Exhibit 1. These payments are intended to cover the cost of constructing the road, annual operating costs of CU12 and reimbursement to the operator for the cost of resurfacing the road in year 8 of CU110.

Financial Statement Impact

- IE17. The grantor initially recognizes the service concession asset as property, plant, and equipment at its fair value (total CU1,050, comprised of CU940 related to construction of the base layers and CU110 related to construction of the original surface layers). The asset is recognized as it is constructed (CU525 in year 1 and CU525 in year 2). Depreciation is taken annually (CU56, comprised of CU38 for the base layers and CU18 for the surface layers), starting from year 3.
- IE18. The grantor initially recognizes a financial liability at fair value equal to the fair value of the asset under construction at the end of year 1 (CU525). The

liability is increased at the end of year 2 to reflect both the fair value of the additional construction (CU525) and the finance charge on the outstanding financial liability. Because the amount of the predetermined payment related to the service component of the service concession arrangement is known, the grantor is able to determine the amount of the payment that reduces the liability. A finance charge at the implicit rate of 6.18% is recognized annually. The liability is subsequently measured at amortized cost, i.e., the amount initially recognized plus the finance charge on that amount calculated using the effective interest method minus repayments.

- IE19. The compensation for the road resurfacing is included in the predetermined series of payments. There is no direct cash flow impact related to the road resurfacing; however, the grantor recognizes the resurfacing as an asset when the work is undertaken and recognizes depreciation expense of CU110/6 = CU18, beginning in year 9.
- IE20. The compensation for maintenance and operating the road (CU12) is included in the predetermined series of payments. There is no cash flow impact related to this service expense; however, the grantor recognizes an expense annually.
- IE21. The costs of services are accounted for in accordance with IPSAS 1.

Overview of Cash Flows, Statement of Financial Performance, and Statement of Financial Position

- IE22. The grantor's cash flows, statement of financial performance, and statement of financial position over the duration of the arrangement will be as illustrated in Tables 1.1 to 1.3. In addition, Table 1.4 shows the changes in the financial liability.

Table 1.1 Cash Flows (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Predetermined series of payments	–	–	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(1,600)
Net inflow/ (outflow)	–	–	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(200)	(1,600)

Table 1.2 Statement of Financial Performance (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Service expense	–	–	(12)	(12)	(12)	(12)	(12)	(12)	(12)	(12)	(96)
Finance charge	–	(32)	(67)	(59)	(51)	(43)	(34)	(25)	(22)	(11)	(344)
Depreciation – base layers	–	–	(38)	(38)	(38)	(38)	(38)	(38)	(38)	(38)	(304)
Depreciation – original surface layer	–	–	(18)	(19)	(18)	(18)	(19)	(18)	–	–	(110)
Depreciation – replacement surface layer	–	–	–	–	–	–	–	–	(18)	(19)	(37)
Total depreciation	–	–	(56)	(57)	(56)	(56)	(57)	(56)	(56)	(57)	(451)
Annual surplus/ (deficit)	–	(32)	(135)	(128)	(119)	(111)	(103)	(93)	(90)	(80)	(891)

NOTES:

1. Depreciation in years 3–8 reflects the depreciation on the initially-constructed road surface. It is fully depreciated over that period. Depreciation in years 9–10 reflects the depreciation on the new service concession asset component (surface) recognized in year 8.
2. Although these Illustrative Examples use a straight-line depreciation method, it is not intended that this method be used in all cases. Paragraph 76 of IPSAS 17 requires that, “The depreciation method shall reflect the pattern in which the asset’s future economic benefits or service potential is expected to be consumed by the entity.” Likewise, for intangible assets, paragraph 96 of IPSAS 31 requires that, “The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life.”

Table 1.3 Statement of Financial Position (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10
Service concession asset – base layers	525	940	902	864	826	788	750	712	674	636
Service concession asset – original surface layer	–	110	92	73	55	37	18	–	–	–
Service concession asset – replacement surface layer	–	–	–	–	–	–	–	110	92	73
Total Service concession asset	525	1,050	994	937	881	825	768	822	766	709
Cash	–	–	(200)	(400)	(600)	(800)	(1,000)	(1,200)	(1,400)	(1,600)
Financial liability	(525)	(1,082)	(961)	(832)	(695)	(550)	(396)	(343)	(177)	–
Cumulative surplus/deficit	–	32	167	295	414	525	628	721	811	891
NOTES: <ol style="list-style-type: none"> In this example, the resurfacing occurs as expected in year 8, when the initially-constructed road surface is fully depreciated. If the resurfacing occurred earlier, the initially-constructed road surface would not be fully depreciated, and would need to be derecognized in accordance with IPSAS 17 before the new component of the service concession asset related to the resurfacing is recognized. The new component of the service concession asset related to the resurfacing is recognized in year 8. Years 9–10 reflect depreciation on this additional component (Table 1.2). The financial liability is increased in year 8 for the recognition of the new component of the service concession asset. 										

Table 1.4 Changes in Financial Liability (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10
Balance brought forward	–	525	1,082	961	832	695	550	396	343	177
Liability recognized along with initial service concession asset	525	525	–	–	–	–	–	–	–	–
Finance charge added to liability prior to payments being made	–	32	–	–	–	–	–	–	–	–
Portion of predetermined series of payments that reduces the liability	–	–	(121)	(129)	(137)	(145)	(154)	(163)	(166)	(177)
Liability recognized along with replacement surface layers	–	–	–	–	–	–	–	110	–	–
Balance carried forward	525	1,082	961	832	695	550	396	343	177	–

Example 2: The Grantor Gives the Operator the Right to Charge Users a Toll for Use of the Road

Additional Arrangement Terms

IE23. The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the arrangement and that it will receive tolls of CU200 in each of years 3–10. The total consideration (tolls of CU200 in each of years 3–10) reflects the fair values for each of the services indicated in Exhibit 1, and is intended to cover the cost of constructing the road, annual operating costs of CU12 and reimbursement to the operator for the cost of resurfacing the road in year 8 of CU110.

Financial Statement Impact

IE24. The grantor initially recognizes the service concession asset as property, plant, and equipment at its fair value (total CU1,050, comprised of CU940 related to construction of the base layers and CU110 related to construction of the original surface layers). The asset is recognized as it is constructed (CU525 in year 1 and CU525 in year 2). Depreciation is taken annually

(CU56, comprised of CU38 for the base layers and CU18 for the surface layers, starting in year 3).

- IE25. As consideration for the service concession asset, the grantor recognizes a liability under the grant of a right to the operator model for granting the operator the right to collect tolls of CU200 in years 3–10. The liability is recognized as the asset is recognized.
- IE26. The liability is reduced over years 3–10, and the grantor recognizes revenue on that basis because access to the service concession asset is expected to be provided evenly over the term of the service concession arrangement from the point at which the asset is capable of providing economic benefits.
- IE27. The compensation for the road resurfacing is included in the tolls the operator expects to earn over the term of the service concession arrangement. There is no direct cash flow impact related to the road resurfacing; however, the grantor recognizes the resurfacing as an asset when the work is undertaken and recognizes depreciation expense of $CU110/6 = CU18$, beginning in year 9.
- IE28. The compensation for maintenance and operating the road (CU12) is included in the tolls the operator expects to earn over the term of the service concession arrangement. There is no financial statement impact related to this service expense. It does not affect cash flow because the grantor has no cash outflow. It is not recognized as an operating expense because the fair value of the asset and liability initially recognized do not include any service costs the operator may incur.

Overview of Cash Flows, Statement of Financial Performance, and Statement of Financial Position

- IE29. The grantor's cash flows, statement of financial performance, and statement of financial position over the duration of the arrangement will be as illustrated in Tables 2.1 to 2.3. In addition, Table 2.4 shows the changes in the liability.

Cash Flows

- IE30. Because there are no payments made to the operator, there are no cash flow impacts for this example.

Table 2.2 Statement of Financial Performance (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue (reduction of liability)	–	–	145	145	145	145	145	145	145	145	1160
Depreciation – base layers	–	–	(38)	(38)	(38)	(38)	(38)	(38)	(38)	(38)	(304)
Depreciation – original surface layer	–	–	(18)	(19)	(18)	(18)	(19)	(18)	–	–	(110)
Depreciation – replacement surface layer	–	–	–	–	–	–	–	–	(18)	(19)	(37)
Total depreciation	–	–	(56)	(57)	(56)	(56)	(57)	(56)	(56)	(57)	(451)
Annual surplus/(deficit)	–	–	89	88	89	89	88	89	89	88	709

NOTES:

1. Depreciation in years 3–8 reflects the depreciation on the initially-constructed road surface. It is fully depreciated over that period.
2. Depreciation in years 9–10 reflects the depreciation on the new service concession asset component (surface) recognized in year 8.
3. The revenue (reduction of the liability) includes revenue from the additional liability (Table 2.3).
4. All revenue is recognized evenly over the term of the arrangement.

Table 2.3 Statement of Financial Position (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10
Service concession asset – base layers	525	940	902	864	826	788	750	712	674	636
Service concession asset – original surface layer	–	110	92	73	55	37	18	–	–	–
Service concession asset – replacement surface layer	–	–	–	–	–	–	–	110	92	73
Total Service concession asset	525	1,050	994	937	881	825	768	822	766	709
Cash	–	–	–	–	–	–	–	–	–	–
Liability	(525)	(1,050)	(905)	(760)	(615)	(470)	(325)	(290)	(145)	–
Cumulative surplus/deficit	–	–	(89)	(177)	(266)	(355)	(443)	(532)	(621)	(709)

NOTES:

1. In this example, the resurfacing occurs as expected in year 8, when the initially-constructed road surface is fully depreciated. If the resurfacing occurred earlier, the initially-constructed road surface would not be fully depreciated, and would need to be derecognized in accordance with IPSAS 17 before the new component of the service concession asset related to the resurfacing is recognized.
2. The new component of the service concession asset related to the resurfacing is recognized in year 8. Years 9–10 reflect depreciation on this additional component (Table 2.2).
3. The liability is increased in year 8 for the recognition of the new component of the service concession asset.

Table 2.4 Changes in Liability (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10
Balance brought forward	–	525	1,050	905	760	615	470	325	290	145
Liability recognized along with initial service concession asset	525	525	–	–	–	–	–	–	–	–
Revenue (reduction of liability)	–	–	(145)	(145)	(145)	(145)	(145)	(145)	(145)	(145)
Liability recognized along with replacement surface layers	–	–	–	–	–	–	–	110	–	–
Balance carried forward	525	1,050	905	760	615	470	325	290	145	–

Example 3: The Grantor Makes a Predetermined Series of Payments to the Operator and Also Grants the Operator the Right to Charge Users a Toll for Use of the Road

Additional Arrangement Terms

- IE31. The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the arrangement and that it will receive tolls of CU100 in each of years 3–10. The arrangement also requires the grantor to make a predetermined series of payments to the operator of CU100 annually. The fair value of the right to collect tolls and the predetermined series of payments are considered to compensate the operator equally (i.e., 50% from each form of compensation to the operator).

Financial Statement Impact

- IE32. The grantor initially recognizes the service concession asset as property, plant, and equipment at its fair value (total CU1,050, comprised of CU940 related to construction of the base layers and CU110 related to construction of the original surface layers). The asset is recognized as it is constructed (CU525 in year 1 and CU525 in year 2). Depreciation is taken annually (CU56, comprised of CU38 for the base layers and CU18 for the surface layers).
- IE33. As consideration for the service concession asset, the grantor recognizes both a liability under the grant of a right to the operator model by granting the operator the right to collect tolls of CU100 in years 3–10, and a financial liability to make payments of CU100 in years 3–10. A liability and a financial liability are recognized as the asset is recognized at the end of year 1 (CU525). The liability and financial liability are increased at the end of year 2 to reflect

both the fair value of the additional construction (CU525) and the finance charge on the outstanding financial liability.

- IE34. The grantor's obligation related to the right granted to the operator to charge tolls and the predetermined payments are regarded as two separate items. Therefore in this arrangement it is necessary to divide the grantor's consideration to the operator into two parts—a liability and a financial liability.
- IE35. The liability of CU525 (recognized evenly at the end of years 1 and 2) is reduced over years 3–10, and the grantor recognizes revenue on the same basis because the tolls are expected to be earned evenly over the term of the service concession arrangement from the point at which the asset is capable of providing service benefits.
- IE36. The grantor initially recognizes a financial liability at fair value equal to half of the fair value of the asset (CU525), recognized evenly at the end of years 1 and 2; a liability under the grant of a right to the operator model is recognized in an amount equal to the other half of the fair value of the asset. The financial liability is also increased at the end of year 2 by the finance charge on the outstanding financial liability. Because the amount of the predetermined payments related to the service component of the service concession arrangement is known, the grantor is able to determine the amount of the payments that reduces the liability. A finance charge at the implicit rate of 6.18% is recognized annually. The liability is subsequently measured at amortized cost, i.e., the amount initially recognized plus the finance charge on that amount calculated using the effective interest method minus repayments.
- IE37. The operator is compensated for the road resurfacing (CU110) equally through the tolls the operator expects to earn over the term of the service concession arrangement and the series of predetermined payments (i.e., 50% from each). There is no direct cash flow impact related to the road resurfacing; however, the grantor recognizes the resurfacing as an asset when the work is undertaken and recognizes depreciation expense of $CU110/6 = CU18$, beginning in year 9.
- IE38. The operator is compensated for maintenance and operating the road (CU12) equally through the tolls the operator expects to earn over the term of the service concession arrangement and the predetermined payment (i.e., 50% from each). There is no direct cash flow impact related to this service expense because the grantor has no cash outflow. However, the grantor recognizes an expense annually for the portion of the compensation related to the series of predetermined payments (CU6). There is no financial statement impact for the remaining CU6 of this service expense. It is not recognized as an operating expense because the fair value of the asset and liability initially recognized do not include any service costs the operator may incur.

IE39. The grantor’s cash flows, statement of financial performance, and statement of financial position over the duration of the arrangement will be as illustrated in Tables 3.1 to 3.3. In addition, Table 3.4 shows the changes in the liability and Table 3.5 shows the changes in the financial liability.

Overview of Cash Flows, Statement of Financial Performance, and Statement of Financial Position

Table 3.1 Cash Flows (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Predetermined series of payments	–	–	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(800)
Net inflow/ (outflow)	–	–	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(800)

Table 3.2 Statement of Financial Performance (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue (reduction of liability)	–	–	73	72	73	72	73	72	73	72	580
Service expense	–	–	(6)	(6)	(6)	(6)	(6)	(6)	(6)	(6)	(48)
Finance charge	–	(16)	(33)	(30)	(26)	(22)	(17)	(12)	(11)	(5)	(172)
Depreciation – base layers	–	–	(38)	(38)	(38)	(38)	(38)	(38)	(38)	(38)	(304)
Depreciation – original surface layer	–	–	(18)	(19)	(18)	(18)	(19)	(18)	–	–	(110)
Depreciation – replacement surface layer	–	–	–	–	–	–	–	–	(18)	(19)	(37)
Total depreciation	–	–	(56)	(57)	(56)	(56)	(57)	(56)	(56)	(57)	(451)
Annual surplus/ (deficit)	–	(16)	(22)	(21)	(15)	(12)	(7)	(2)	–	4	(91)

NOTES:

1. Depreciation in years 3–8 reflects the depreciation on the initially-constructed road surface. It is fully depreciated over that period.
2. Depreciation in years 9–10 reflects the depreciation on the new service concession asset component (surface) recognized in year 8.
3. The revenue (reduction of the liability) includes revenue from the additional liability (Table 3.3).
4. All revenue is recognized evenly over the term of the arrangement.

Table 3.3 Statement of Financial Position (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10
Service concession asset – base layers	525	940	902	864	826	788	750	712	674	636
Service concession asset – surface layer	–	110	92	73	55	37	18	–	–	–
Service concession asset – replacement surface layer	–	–	–	–	–	–	–	110	92	73
Total service concession asset	525	1,050	994	937	881	825	768	822	766	709
Cash	–	–	(100)	(200)	(300)	(400)	(500)	(600)	(700)	(800)
Liability	(262)	(525)	(452)	(380)	(307)	(235)	(162)	(145)	(72)	–
Financial liability	(263)	(541)	(480)	(416)	(348)	(276)	(199)	(172)	(89)	–
Cumulative surplus/deficit	–	16	38	59	74	86	93	95	95	91

NOTES:

1. In this example, the resurfacing occurs as expected in year 8, when the initially-constructed road surface is fully depreciated. If the resurfacing occurred earlier, the initially-constructed road surface would not be fully depreciated, and would need to be derecognized in accordance with IPSAS 17 before the new component of the service concession asset related to the resurfacing is recognized.
2. The new component of the service concession asset related to the resurfacing is recognized in year 8. Years 9–10 reflect depreciation on this additional component (Table 3.2).
3. The liability is increased in year 8 for the recognition of 50% of the new component of the service concession asset.
4. The financial liability is increased in year 8 for the recognition of 50% of the new component of the service concession asset.

Table 3.4 Changes in Liability (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10
Balance brought forward	–	262	525	452	380	307	235	162	145	72
Liability recognized along with initial service concession asset	262	263	–	–	–	–	–	–	–	–
Revenue (reduction of liability)	–	–	(73)	(72)	(73)	(72)	(73)	(72)	(73)	(72)
Liability recognized along with replacement surface layers	–	–	–	–	–	–	–	55	–	–
Balance carried forward	262	525	452	380	307	235	162	145	72	–

Table 3.5 Changes in Financial Liability (Currency Units)

Year	1	2	3	4	5	6	7	8	9	10
Balance brought forward	–	263	541	480	416	348	276	199	172	89
Liability recognized along with initial service concession asset	263	262	–	–	–	–	–	–	–	–
Finance charge added to liability prior to payments being made	–	16	–	–	–	–	–	–	–	–
Portion of predetermined series of payments that reduces the liability	–	–	(61)	(64)	(68)	(72)	(77)	(82)	(83)	(89)
Liability recognized along with replacement surface layers	–	–	–	–	–	–	–	55	–	–
Balance carried forward	263	541	480	416	348	276	199	172	89	–

IPSAS 33—FIRST-TIME ADOPTION OF ACCRUAL BASIS INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS (IPSASS)

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* was issued in January 2015.

Since then, IPSAS 33 has been amended by the following IPSASs:

- IPSAS 40, *Public Sector Combinations* (issued January 2017)
- IPSAS 39, *Employee Benefits* (issued July 2016)
- *The Applicability of IPSASs* (issued April 2016)
- *Improvements to IPSASs 2015* (issued April 2016)

Table of Amended Paragraphs in IPSAS 33

Paragraph Affected	How Affected	Affected By
7	Deleted	The Applicability of IPSASs April 2016
8	Deleted	The Applicability of IPSASs April 2016
36	Amended	IPSAS 39 July 2016
39	Amended	Improvements to IPSASs April 2016
62A	New	IPSAS 40 January 2017
62B	New	IPSAS 40 January 2017
62C	New	IPSAS 40 January 2017
86	Amended	IPSAS 40 January 2017
102	Amended	IPSAS 39 July 2016
104	Amended	IPSAS 39 July 2016
105	Amended	IPSAS 39 July 2016
106	Deleted	IPSAS 39 July 2016

Paragraph Affected	How Affected	Affected By
107	Deleted	IPSAS 39 July 2016
129	Amended	IPSAS 40 January 2017
130	Amended	IPSAS 40 January 2017
132	Amended	IPSAS 40 January 2017
154A	New	The Applicability of IPSASs April 2016
154B	New	IPSAS 39 July 2016
154C	New	IPSAS 40 January 2017

**IPSAS 33—FIRST-TIME ADOPTION OF ACCRUAL BASIS
INTERNATIONAL PUBLIC SECTOR ACCOUNTING
STANDARDS (IPSASs)**

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International Public Sector Accounting Standard 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* is set out in paragraphs 1–154. All the paragraphs have equal authority. IPSAS 33 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to provide guidance to a first-time adopter that prepares and presents financial statements following the adoption of accrual basis IPSASs, in order to present high quality information:
 - (a) That provides transparent reporting about a first-time adopter's transition to accrual basis IPSASs;
 - (b) That provides a suitable starting point for accounting in accordance with accrual basis IPSASs irrespective of the basis of accounting the first-time adopter has used prior to the date of adoption; and
 - (c) Where the benefits are expected to exceed the costs.

Scope

2. **An entity shall apply this IPSAS when it prepares and presents its annual financial statements on the adoption of, and during the transition to, accrual basis IPSASs.**
3. This IPSAS applies when an entity first adopts accrual basis IPSASs and during the transitional period allowed in this IPSAS. It does not apply when, for example, a first-time adopter:
 - (a) Stops presenting financial statements in accordance with prescribed requirements, having previously presented them as well as another set of financial statements that contained an explicit and unreserved statement of compliance with accrual basis IPSASs;
 - (b) Presented financial statements in the previous reporting period in accordance with prescribed requirements and those financial statements contained an explicit and unreserved statement of compliance with accrual basis IPSASs; or
 - (c) Presented financial statements in the previous reporting period that contained an explicit and unreserved statement of compliance with accrual basis IPSASs, even if the auditors modified their audit report on those financial statements.
4. This Standard shall be applied from the date on which a first-time adopter adopts accrual basis IPSASs and during the period of transition. This Standard permits a first-time adopter to apply transitional exemptions and provisions that may impact fair presentation. Where these transitional exemptions and provisions are applied, a first-time adopter is required to disclose information about the transitional exemptions and provisions adopted, and progress towards fair presentation and compliance with accrual basis IPSASs.
5. At the end of the transitional period a first-time adopter must comply with the recognition, measurement, presentation and disclosure requirements in the

other accrual basis IPSAS in order to assert compliance with accrual basis IPSASs as required in IPSAS 1, *Presentation of Financial Statements*.

6. This IPSAS does not apply to changes in accounting policies made by an entity that already applies IPSASs. Such changes are the subject of:
 - (a) Requirements on changes in accounting policies in IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*; and
 - (b) Specific transitional requirements in other IPSASs. The transitional provisions in other IPSASs apply only to changes in accounting policies made by an entity that already applies accrual basis IPSASs; they do not apply to a first-time adopter's transition to IPSASs, except as specified in this IPSAS.
7. [Deleted]
8. [Deleted]

Definitions

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

Date of adoption of IPSASs is the date an entity adopts accrual basis IPSASs for the first time, and is the start of the reporting period in which the first-time adopter adopts accrual basis IPSASs and for which the entity presents its first transitional IPSAS financial statements or its first IPSAS financial statements.

Deemed cost is an amount used as a surrogate for acquisition cost or depreciated cost at a given date.

First IPSAS financial statements are the first annual financial statements in which an entity complies with the accrual basis IPSASs and can make an explicit and unreserved statement of compliance with those IPSASs because it adopted one or more of the transitional exemptions in this IPSAS that do not affect the fair presentation of the financial statements and its ability to assert compliance with accrual basis IPSASs.

First-time adopter is an entity that adopts accrual basis IPSASs for the first time and presents its first transitional IPSAS financial statements or its first IPSAS financial statements.

Opening statement of financial position is a first-time adopter's statement of financial position at the date of adoption of IPSASs.

Period of transition is the period during which a first-time adopter applies one or more of the exemptions in this IPSAS before it complies

with the accrual basis IPSASs, and before it is able to make an explicit and unreserved statement of such compliance with IPSASs.

Previous basis of accounting is the basis of accounting that a first-time adopter used immediately before adopting accrual basis IPSASs.

Transitional IPSAS financial statements are the financial statements prepared in accordance with this IPSAS where a first-time adopter cannot make an explicit and unreserved statement of compliance with other IPSASs because it adopted one or more of the transitional exemptions in this IPSAS that affect the fair presentation of the financial statements and its ability to assert compliance with accrual basis IPSASs.

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

Date of Adoption of IPSASs

10. The date of adoption of IPSASs is the date that an entity adopts accrual basis IPSASs for the first time. It is the start of the reporting period in which the first-time adopter adopts accrual basis IPSASs and for which it presents its first transitional IPSAS financial statements or its first IPSAS financial statements. If a first-time adopter takes advantage of the exemptions in this IPSASs that affect fair presentation and compliance with accrual basis IPSASs (see paragraphs 36–62) in producing its first transitional IPSAS financial statements, it can only make an explicit and unreserved statement of compliance with accrual basis IPSASs when the exemptions that provided the relief have expired, and/or when the relevant items are recognized, measured and/or the relevant information is presented and/or disclosed in the financial statements in accordance with the applicable IPSASs (whichever is earlier). Financial statements shall not be described as complying with IPSASs unless they comply with all the requirements of all the applicable IPSASs.

First IPSAS Financial Statements

11. An entity's first IPSAS financial statements are the first annual financial statements in which the first-time adopter can make an explicit and unreserved statement in those financial statements of compliance with accrual basis IPSASs. If a first-time adopter does not adopt the exemptions in this IPSAS that affect fair presentation and compliance with accrual basis IPSASs (see paragraphs 36–62), its first financial statements following the adoption of accrual basis IPSASs will also be its first IPSAS financial statements.

Previous Basis of Accounting

12. The previous basis of accounting is the basis of accounting that a first-time adopter used immediately before adopting accrual basis IPSASs. This might be a cash basis of accounting, an accrual basis of accounting, a modified

version of either a cash basis or an accrual basis of accounting, or another prescribed basis.

Transitional IPSAS Financial Statements

13. An entity's transitional IPSAS financial statements are the annual financial statements in which an entity transitions to accrual basis IPSASs and adopts certain exemptions in this IPSAS that affect the fair presentation of the financial statements and its ability to assert compliance with accrual basis IPSASs. If a first-time adopter adopts the exemptions in this IPSASs that affect fair presentation and compliance with accrual basis IPSASs (see paragraphs 36–62), it will not be able to make an explicit and unreserved statement of compliance with other accrual basis IPSASs until the exemptions that provided the relief in this IPSAS have expired and/or when the relevant items are recognized, measured and/or the relevant information has been presented and/or disclosed in accordance with the applicable IPSASs (whichever is earlier). Financial statements shall not be described as complying with IPSASs unless they comply with all the requirements of all the applicable IPSASs.
14. An entity's transitional IPSAS financial statements are those financial statements, where the entity transitions from another accounting basis such as when it:
 - (a) Prepared its most recent previous financial statements in accordance with the IPSAS, *Financial Reporting Under the Cash Basis of Accounting*;
 - (b) Presented its most recent previous financial statements:
 - (i) In accordance with prescribed requirements that are not consistent with IPSASs in all respects;
 - (ii) In conformity with IPSASs in all respects, except that the financial statements did not contain an explicit and unreserved statement that they complied with IPSASs;
 - (iii) Containing an explicit statement of compliance with some, but not all, IPSASs, including the adoption of the exemptions provided in this IPSAS that affect fair presentation and compliance with accrual basis IPSASs (see paragraphs 36–62);
 - (iv) In accordance with prescribed requirements inconsistent with IPSASs, using some individual IPSASs to account for items for which prescribed requirements did not exist; or
 - (v) In accordance with prescribed requirements, with a reconciliation of some amounts to the amounts determined in accordance with IPSASs;
 - (c) Prepared financial statements in accordance with IPSASs for internal use only, without making them available to external users;

- (d) Prepared a reporting package in accordance with IPSASs for consolidation purposes without preparing a complete set of financial statements as defined in IPSAS 1; or
- (e) Did not present financial statements for previous periods.

Recognition and Measurement

Opening Statement of Financial Position on Adoption of IPSASs

- 15. **A first-time adopter shall prepare and present an opening statement of financial position at the date of adoption of IPSASs. This is the starting point for its accounting in accordance with accrual basis IPSASs.**

Accounting Policies

- 16. **On the date of adoption of accrual basis IPSASs, a first-time adopter shall apply the requirements of the IPSASs retrospectively except if required, or otherwise permitted, in this IPSAS.**
- 17. **A first-time adopter shall use the same accounting policies in its opening statement of financial position and throughout all periods presented, except as specified in paragraphs 36–134. The accounting policies shall comply with each IPSAS effective at the date of adoption of IPSASs, except as specified in paragraphs 36–134.**
- 18. A first-time adopter that takes advantage of the exemptions in paragraph 36–134 will be required to amend its accounting policies after the exemptions that provided the relief have expired and/or when the relevant items are recognized, measured and/or the relevant information is presented and/or disclosed in the financial statements in accordance with the applicable IPSASs (whichever is earlier).
- 19. A first-time adopter shall apply the versions of accrual basis IPSASs effective at the date of adoption of IPSASs. A first-time adopter may apply a new IPSAS that is not yet mandatory if that IPSAS permits early application. Any new IPSASs that become effective during the period of transition shall be applied by the first-time adopter from the date it becomes effective.
- 20. Except as described in paragraphs 36–134, a first-time adopter shall, in its opening statement of financial position:
 - (a) Recognize all assets and liabilities whose recognition is required by IPSASs;
 - (b) Not recognize items as assets or liabilities if IPSASs do not permit such recognition;
 - (c) Reclassify items that it recognized in accordance with the previous basis of accounting as one type of asset, liability or component of net

assets/equity, but are a different type of asset, liability or component of net assets/equity in accordance with IPSASs; and

(d) Apply IPSASs in measuring all recognized assets and liabilities.

21. The accounting policies that a first-time adopter uses in financial statements may differ from those that it used at the end of its comparative period under its previous basis of accounting. The resulting adjustments arise from transactions, other events or conditions before the date of adoption of IPSASs. Therefore, a first-time adopter shall recognize those adjustments to the opening balance of accumulated surplus or deficit in the period in which the items are recognized and/or measured (or, if appropriate, another category of net assets/equity). The first-time adopter shall recognize these adjustments in the earliest period presented.
22. The transitional exemptions and provisions in other IPSAS apply to changes in accounting policies made by an entity that already applies accrual basis IPSASs. The transitional exemptions and provisions in this IPSAS applies to a first-time adopter that prepares and presents its annual financial statements on the adoption of, and during the transition to accrual basis IPSASs.

Exceptions to the Retrospective Application of IPSASs

23. **A first-time adopter's estimates in accordance with IPSASs at the date of adoption of IPSASs, shall be consistent with estimates made in accordance with the previous basis of accounting (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were inconsistent with the requirements in IPSASs.**
24. This IPSAS prohibits retrospective application of some aspects of accrual basis IPSASs. A first-time adopter may receive information after the date of adoption of IPSASs about estimates that it had made under its previous basis of accounting. In accordance with paragraph 23, a first-time adopter shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with IPSAS 14, *Events after the Reporting Period*.
25. A first-time adopter may need to make estimates in accordance with IPSASs at the date of adoption of IPSASs or during the period of transition that were not required at that date under the previous basis of accounting. To achieve consistency with IPSAS 14, those estimates in accordance with IPSASs shall reflect conditions that existed at the date of adoption of IPSASs or at the date during the period of transition. In particular, estimates determined at the date of adoption of IPSASs or during the period of transition of market prices, interest rates or foreign exchange rates shall reflect market conditions at that date. For non-financial assets, such as property, plant and equipment, estimates about the asset's useful life, residual value or condition reflect management's expectations and judgment at the date of adoption of IPSASs or the date during the period of transition.

26. Paragraphs 23–25 apply to the opening statement of financial position. They also apply to a comparative period where an entity elects to present comparative information in accordance with paragraph 78, in which case the references to the date of adoption of IPSASs are replaced by references to the end of that comparative period.

Fair Presentation and Compliance with IPSASs

27. **A first-time adopter's first IPSAS financial statements shall fairly present the financial position, financial performance, and cash flows of the entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, revenue, and expenses set out in IPSASs. If a first-time adopter takes advantage of the exemptions in paragraphs 36–62, these exemptions will affect the fair presentation of the financial statements and the first-time adopter's ability to assert compliance with accrual basis IPSASs, until the exemptions that provided the relief have expired and/or when the relevant items are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier).**
28. **A first-time adopter shall claim full compliance with IPSASs only when it has complied with all the requirements of the applicable IPSASs effective at that date, subject to paragraph 11. If a first-time adopter adopts one or more of the exemptions in paragraph 36–62, the fair presentation of the financial statements and its ability to assert compliance with accrual basis IPSASs will be affected. An entity's whose financial statements comply with IPSASs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IPSASs unless they comply with all the requirements of IPSASs, and shall be qualified as accrual basis IPSAS complaint financial statements.**
29. In accordance with paragraph 29 of IPSAS 1 fair presentation is achieved in virtually all circumstances by compliance with applicable IPSASs. For a first-time adopter to claim full compliance with IPSASs, all the requirements of the applicable IPSASs needs to be complied with to ensure that information is presented in a manner that meets the qualitative characteristics, subject to paragraph 11.
30. The exemptions in paragraphs 36–62 provide relief from the recognition, measurement, presentation and/or disclosure requirements in IPSASs on the date of adoption of IPSASs and during the period of transition. A first-time adopter may elect to adopt these exemptions, but shall consider that applying these exemptions will affect the fair presentation of its financial statements and its ability to assert compliance with accrual basis IPSASs in accordance with paragraphs 27 and 28 until the exemptions that provided the relief have expired and/or when the relevant items are recognized, measured, and/or the

relevant information is presented and/or disclosed in the financial statements in accordance with the applicable IPSASs (whichever is earlier). Before making use of such exemptions, a first-time adopter shall consider all the relevant facts and circumstances and the potential effect on its financial statements.

31. **A first-time adopter shall assess whether the transitional exemptions adopted affect the fair presentation of the financial statements and the first-time adopter's ability to assert compliance with accrual basis IPSASs.**
32. For example, a first-time adopter adopts the three year transitional relief period for the recognition and measurement of traffic fines because insufficient data is available about the value of fines issued, fines written off, the compromises reached with offenders etc. The relief period is not applied to any other class of non-exchange revenue. The revenue received from fines is not material in relation to the financial statements as a whole. The entity concludes that, by adopting the transitional exemption and provisions, fair presentation and compliance with IPSASs will not be affected. As a result, the first-time adopter will still be able to achieve fair presentation and assert compliance with accrual basis IPSASs at the date of adoption of accrual basis IPSASs or during the period of transition.

Exemptions that Affect Fair Presentation and Compliance with Accrual Basis IPSASs during the Period of Transition

33. **A first-time adopter may adopt the exemptions in paragraphs 36–62. These exemptions will affect the fair presentation of a first-time adopter's financial statements and its ability to assert compliance with accrual basis IPSASs during the period of transition in accordance with paragraphs 27 and 28 while they are applied. A first-time adopter shall not apply these exemptions by analogy to other items.**
34. **Notwithstanding the exemptions provided in paragraphs 36–62 a first-time adopter is encouraged to comply in full with all the requirements of the applicable IPSASs as soon as possible.**
35. **To the extent that a first-time adopter applies the exemptions in paragraph 36–62, it is not required to apply any associated presentation and/or disclosure requirements in the applicable IPSASs until the exemptions that provided the relief have expired or the relevant items are recognized and/or measured in the financial statements in accordance with the applicable IPSASs (whichever is earlier).**

Three Year Transitional Relief Period for the Recognition and/or Measurement of Assets and/or Liabilities

Recognition and/or Measurement of Assets and/or Liabilities

36. **Where a first-time adopter has not recognized assets and/or liabilities under its previous basis of accounting, it is not required to recognize and/**

or measure the following assets and/or liabilities for reporting periods beginning on a date within three years following the date of adoption of IPSASs:

- (a) **Inventories (see IPSAS 12, *Inventories*);**
 - (b) **Investment property (see IPSAS 16, *Investment Property*);**
 - (c) **Property, plant and equipment (see IPSAS 17, *Property, Plant and Equipment*);**
 - (d) **Defined benefit plans and other long-term employee benefits (see IPSAS 39, *Employee Benefits*);**
 - (e) **Biological assets and agricultural produce (see IPSAS 27, *Agriculture*);**
 - (f) **Intangible assets (see IPSAS 31, *Intangible Assets*);**
 - (g) **Service concession assets and the related liabilities, either under the financial liability model or the grant of a right to the operator model (see IPSAS 32, *Service Concession Arrangements: Grantor*); and**
 - (h) **Financial instruments (see IPSAS 29, *Financial Instruments: Recognition and Measurement*).**
37. **Where a first-time adopter applies the exemption in paragraph 36(d), it shall recognize the obligation and any related plan assets at the same time.**
38. **Where a first-time adopter has recognized the assets and/or liabilities included in paragraph 36 under its previous basis of accounting, it is not required to change its accounting policy(ies) in respect of the measurement of these assets and/or liabilities for reporting periods beginning on a date within three years following the date of adoption of IPSASs.**
39. Subject to paragraphs 36 and 38, a first-time adopter is not required to change its accounting policy(ies) in respect of the recognition and/or measurement of assets and/or liabilities for reporting periods beginning on a date within three years following the date of adoption of IPSASs. The transitional exemptions in paragraphs 36 and 38 are intended to allow a first-time adopter a period to develop reliable¹ models for recognizing and/or measuring its assets and/or liabilities during the period of transition. The first-time adopter may apply accounting policies for the recognition and/or measurement of such assets and/or liabilities that do not comply with the provisions of other IPSASs.
40. **Subject to the provisions of paragraphs 36 and 38, a first-time adopter shall only change its accounting policies during the period of transition to better conform to the accounting policies in accrual basis IPSASs, and may retain**

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

its existing accounting policies until the exemptions that provided the relief have expired or when the relevant items are recognized and/or measured in the financial statements in accordance with the applicable IPSASs (whichever is earlier). A first-time adopter may change its accounting policy in respect of the recognition and/or measurement of assets and/or liabilities on a class-by-class or category-by-category basis where the use of classes or categories is permitted in the applicable IPSAS.

41. To the extent that a first-time adopter applies the exemptions in paragraphs 36 and 38 which allows a three year transitional relief period to not recognize and/or measure financial assets, it is not required to recognize and/or measure any related revenue in terms of IPSAS 9, *Revenue from Exchange Transactions*, or other receivables settled in cash or another financial asset in terms of IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.

Recognition and/or Measurement of Non-Exchange Revenue

42. A first-time adopter is not required to change its accounting policy in respect of the recognition and measurement of non-exchange revenue for reporting periods beginning on a date within three years following the date of adoption of IPSASs. A first-time adopter may change its accounting policy in respect of revenue from non-exchange transactions on a class-by-class basis.
43. The transitional provision in paragraph 42 is intended to allow a first-time adopter a period to develop reliable models for recognizing and measuring revenue from non-exchange transactions in accordance with IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* during the period of transition. The first-time adopter may apply accounting policies for the recognition and/or measurement of revenue from non-exchange transactions that do not comply with the provisions of IPSAS 23. The transitional provision in paragraph 42 allows a first-time adopter to apply IPSAS 23 incrementally to different classes of revenue from non-exchange transactions. For example, a first-time adopter may be able to recognize and measure property taxes and some other classes of transfers in accordance with IPSAS 23 from the date of adoption of IPSASs, but may require three years to fully develop a reliable model for recognizing and measuring income tax revenue.

Other Exemptions

IPSAS 5, Borrowing Costs

44. Where a first-time adopter applies the exemption in paragraph 36 which allows a three year transitional relief period to not recognize and/or measure assets, and elects to account for borrowing costs in terms of the allowed alternative treatment, it is not required to capitalize any borrowing costs on qualifying assets for which the commencement date

for capitalization is prior to the date of adoption of accrual basis IPSASs, until the exemption that provided the relief has expired and/or when the relevant assets are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).

45. Paragraph 36 allows a first-time adopter to not, recognize and/or measure assets in accordance with IPSASs 16, 17, 27, 31 and 32 for a period of up to three years from the date of adoption of IPSASs. During this period, a first-time adopter may need to consider the requirements of those IPSASs at the same time as the capitalization of borrowing costs where it applies the allowed alternative method. Where a first-time adopter takes advantage of the transitional exemption period for the recognition and/or measurement of assets in accordance with IPSASs 16, 17, 27, 31 and 32 it is not required to capitalize borrowing costs incurred on qualifying assets prior, or during the period of transition. Only when the exemptions that provided the relief have expired, and/or when the relevant assets are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier) will a first-time adopter be allowed to capitalize borrowing costs incurred on the qualifying assets in accordance with the allowed alternative treatment.

IPSAS 13, Leases

46. **Where a first-time adopter takes advantage of the exemption in paragraph 36 which allows a three year transitional relief period to not recognize assets, it is not required to apply the requirements related to finance leases until the exemption that provided the relief has expired, and/or when the relevant assets are recognized in accordance with the applicable IPSASs (whichever is earlier).**
47. This IPSAS allows a first-time adopter a period of up to three years from the date of adoption of IPSASs to not recognize assets in accordance with IPSASs 16, 17, 27, 31 and 32. During this period, a first-time adopter may need to consider the recognition requirements of those IPSASs at the same time as considering the recognition of finance leases in this IPSAS. Where a first-time adopter takes advantage of the exemption in accordance with IPSASs 16, 17, 27, 31 and 32 it is not required to recognize finance lease assets and/or liabilities until the exemptions that provided the relief have expired, and/or when the relevant assets are recognized in accordance with the applicable IPSASs (whichever is earlier).

IPSAS 19, Provisions, Contingent Liabilities and Contingent Assets

48. **Where a first-time adopter takes advantage of the exemption in paragraph 36 which allows a three year transitional relief period to not recognize and/or measure property, plant and equipment, it is not required to recognize and/or measure the liability relating to the initial estimate of costs of dismantling and removing the item and restoring the site on which it is located until the exemption for IPSAS 17 has expired, and/or the relevant asset is recognized and/or measured in accordance with IPSAS 17 (whichever is earlier).**

49. This IPSAS allows a first-time adopter a period of up to three years from the date of adoption of IPSASs to not recognize and/or measure property, plant and equipment. IPSAS 17 requires an entity to include as part of the cost of an item of property, plant and equipment, the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located. Where a first-time adopter takes advantage of the exemption that allows a three year transitional relief period for the recognition and/or measurement of property, plant and equipment, a first-time adopter is not required to apply the requirements related to the initial estimate of costs of dismantling and removing the item and restoring the site on which it is located until the exemption that provided the relief has expired, and/or when the relevant asset is recognized and/or measured in accordance with IPSAS 17 (whichever is earlier). The liability shall be measured as at the date of adoption of IPSASs, or where a first-time adopter has taken advantage of the exemption that allows a three year transitional relief period for the recognition and/or measurement of an asset, the date on which the exemption that provides the relief has expired and/or the asset has been recognized and/or measured in accordance with the applicable IPSASs.
50. **Where a first-time adopter takes advantage of the exemption in paragraph 48, it shall recognize and/or measure the obligation and any related asset at the same time.**

IPSAS 20, Related Party Disclosures

51. **A first-time adopter is not required to disclose related party relationships, related party transactions and information about key management personnel for reporting periods beginning on a date within three years following the date of adoption of IPSASs.**
52. **Notwithstanding the transitional provision in paragraph 51, a first-time adopter is encouraged to disclose information about related party relationships, related party transactions and information about key management personnel that is known at the date of adoption of IPSAS.**

IPSAS 34, Separate Financial Statements, IPSAS 35, Consolidated Financial Statements and IPSAS 36, Investments in Associates and Joint Ventures

53. **Where a first-time adopter has not recognized its interests in controlled entities, associates or joint ventures under its previous basis of accounting, it is not required to recognize and/or measure its interests in other entities as a controlled entity, associate or joint venture for reporting periods beginning on a date within three years following the date of adoption of accrual basis IPSAS.**
54. Subject to paragraph 53, a first-time adopter is not required to change its accounting policy in respect of the recognition and/or measurement of its interests in controlled entities, associates or joint ventures for reporting periods beginning on a date within three years following the date of adoption of IPSASs. The

transitional exemption in paragraph 53 is intended to allow a first-time adopter a period to identify and appropriately classify its interests in other entities as either controlled entities, associates or joint ventures during the period of transition. The first-time adopter may apply accounting policies for the recognition and/or measurement of its interests in controlled entities, associates or joint ventures that do not comply with the provisions of other IPSASs.

IPSAS 35, Consolidated Financial Statements

55. **Subject to paragraph 53, a first-time adopter shall present consolidated financial statements following the adoption of accrual basis IPSASs. A first-time adopter presenting consolidated financial statements is, however, not required to eliminate all balances, transactions, revenue and expenses between entities within the economic entity for reporting periods beginning on a date within three years following the date of adoption of IPSASs.**
56. On adoption of IPSASs, an entity may have controlled entities with a significant number of transactions between controlled entities. Accordingly, it may be difficult to identify some transactions and balances that need to be eliminated for the purpose of preparing the consolidated financial statements of the economic entity. For this reason, paragraph 55 provides relief for a period of up to three years to fully eliminate balances, transactions, revenue and expenses between entities within the economic entity.
57. **Notwithstanding the transitional exemption in paragraph 55, a first-time adopter is encouraged to eliminate those balances, transactions, revenue and expenses that are known on the date of adoption of IPSASs to comply in full with the provisions of IPSAS 35 6 as soon as possible.**
58. **Where a first-time adopter has taken advantage of the transitional exemption in paragraph 53 and/or paragraph 55, it shall not present financial statements as consolidated financial statements until:**
 - (a) **The exemptions that provided the relief have expired; and**
 - (b) **Its interests in other entities have been appropriately recognized and/or measured as controlled entities, associates or joint ventures; or**
 - (c) **Inter-entity balances, transactions, revenue and expenses between entities within the economic entity are eliminated (whichever is earlier).**

IPSAS 36, Investments in Associates and Joint Ventures

59. **When a first-time adopter applies the equity method on adoption of IPSAS 36, the investor is not required to eliminate its share in the surplus and deficit resulting from upstream and downstream transactions between the investor and its associate or joint venture for reporting periods beginning on a date within three years following the date of adoption of IPSASs.**

60. On adoption of IPSASs, a first-time adopter may be an investor in one or more associates or joint ventures with a significant number of upstream and downstream transactions between the investor and the investee. Accordingly, it may be difficult to identify some upstream and/or downstream transactions in which the investor's share in the associate's or joint venture's surplus or deficit needs to be eliminated in applying the equity method. For this reason, paragraph 59 provides the investor relief with a period of up to three years to fully eliminate its share in the associate's or joint venture's surplus or deficit resulting from upstream and/or downstream transactions.
61. **Notwithstanding the transitional exemption in paragraph 59, a first-time adopter is encouraged to eliminate its share in the associate's and joint venture's surplus and deficit resulting from upstream and downstream transactions that are known on the date of adoption of IPSASs, to comply in full with the provisions of IPSAS 36 as soon as possible.**
62. **Where a first-time adopter has taken advantage of the transitional exemption in paragraph 53 and/or paragraph 59, it shall not present financial statements in which investments in associates or joint ventures are accounted for using the equity method until:**
- (a) **The exemptions that provided the relief have expired; and**
 - (b) **The interest in other entities have been appropriately recognized and/or measured as an associate or joint venture; or**
 - (c) **Its share in the associate's surplus and deficit resulting from upstream and downstream transactions between the investor and the investee are eliminated (whichever is earlier).**

IPSAS 40, Public Sector Combinations

- 62A. **Where a first-time adopter applies the exemption in paragraph 36 which allows a three year transitional relief period to not recognize and/or measure assets and/or liabilities, the first-time adopter may be a party to a public sector combination during that three year transitional relief period. The first-time adopter is not required to recognize and/or measure the assets and/or liabilities associated with the public sector combination, until the exemption that provided the relief has expired and/or when the relevant assets and/or liabilities are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).**
- 62B. **Where a first-time adopter applies the exemption in paragraph 62A it shall not recognize goodwill in respect of an acquisition. The first-time adopter shall recognize the difference between (a) and (b) below in net assets/equity:**
- (a) **The aggregate of:**
 - (i) **Any consideration transferred;**

- (ii) **Any non-controlling interests in an acquired operation; and**
 - (iii) **Any previously held equity interests in an acquired operation.**
 - (b) **The net amounts of any identifiable assets acquired and the liabilities assumed.**
- 62C. IPSAS 40 is applied prospectively. Consequently, a first-time adopter does not adjust any amounts of goodwill recognized as a result of a public sector combination that occurred prior to the application of IPSAS 40.

Exemptions that Do Not Affect Fair Presentation and Compliance with Accrual Basis IPSASs During the Period of Adoption

63. **A first-time adopter is required, or may elect, to adopt the exemptions in paragraphs 64–134. These exemptions will not affect the fair presentation of a first-time adopter’s financial statements and its ability to assert compliance with accrual basis IPSASs during the period of transition in accordance with paragraphs 27 and 28 while they are applied. A first-time adopter shall not apply these exemptions by analogy to other items.**

Using Deemed Cost to Measure Assets and/or Liabilities

64. **A first-time adopter may elect to measure the following assets and/or liabilities at their fair value when reliable cost information about the assets and liabilities is not available, and use that fair value as the deemed cost for:**
- (a) **Inventory (see IPSAS 12);**
 - (b) **Investment property, if the first-time adopter elects to use the cost model in IPSAS 16;**
 - (c) **Property, plant and equipment (see IPSAS 17);**
 - (d) **Intangible assets, other than internally generated intangible assets (see IPSAS 31) that meets:**
 - (i) **The recognition criteria in IPSAS 31 (excluding the reliable measurement criterion); and**
 - (ii) **The criteria in IPSAS 31 for revaluation (including the existence of an active market);**
 - (e) **Financial Instruments (see IPSAS 29); or**
 - (f) **Service concession assets (see IPSAS 32).**
65. Deemed cost can only be determined where the acquisition cost of the asset and/or the liability is not available. Deemed cost assumes that the entity had initially recognized the asset and/or the liability at the given date. Subsequent depreciation or amortization is based on that deemed cost on the premise that the acquisition

cost is equal to the deemed cost. For example, a first-time adopter may elect to measure property, plant and equipment at deemed cost at the date of adoption of IPSASs because cost information about the item of property, plant and equipment was not available on that date, and use fair value as its deemed cost at that date. Any subsequent depreciation is based on the fair value determined at that date and starts from the date that the deemed cost has been determined.

66. The use of deemed cost is not considered a revaluation or the application of the fair value model for subsequent measurement in accordance with other IPSASs.
67. **A first-time adopter may elect to use the revaluation amount of property, plant and equipment under its previous basis of accounting as deemed cost if the revaluation was, at the date of the revaluation, broadly comparable to:**
 - (a) **Fair value; or**
 - (b) **Cost or depreciated cost, where appropriate, in accordance with IPSASs adjusted to reflect, for example, changes in a general or specific price index.**
68. A first-time adopter may have established a deemed cost in accordance with its previous basis of accounting for property, plant and equipment by measuring it at fair value at one particular date because of a specific event:
 - (a) If the measurement date is at or before the date of adoption of IPSASs, a first-time adopter may use such event-driven fair value measurements as deemed cost for IPSASs at the date of that measurement.
 - (b) If the measurement date is after the date of adoption of IPSASs, but during the period of transition where the first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets, the event-driven fair value measurements may be used as deemed cost when the event occurs. A first-time adopter shall recognize the resulting adjustments directly in accumulated surplus or deficit when the asset is recognized and/or measured.
69. In determining the fair value in accordance with paragraph 67, the first-time adopter shall apply the definition of fair value and guidance in other applicable IPSASs in determining the fair value of the asset in question. The fair value shall reflect conditions that existed at the date on which it was determined.
70. **If reliable market-based evidence of fair value is not available for inventory, or investment property that is of a specialized nature, a first-time adopter may consider the following measurement alternatives in determining a deemed cost:**
 - (a) **For inventory, current replacement cost; and**
 - (b) **For investment property of a specialized nature, depreciated replacement cost.**

Using Deemed Cost to Measure Assets Acquired Through a Non-Exchange Transaction

71. A first-time adopter may elect to measure an asset acquired through a non-exchange transaction at its fair value when reliable cost information about the asset is not available, and use that fair value as its deemed cost.

Using Deemed Cost for Investments in Controlled Entities, Joint Ventures and Associates (IPSAS 34)

72. Where a first-time adopter measures an investment in a controlled entity, joint venture or associate at cost in its separate financial statements, it may, on the date of adoption of IPSASs, elect to measure that investment at one of the following amounts in its separate opening statement of financial position:
- (a) Cost; or
 - (b) Deemed cost. The deemed cost of such an investment shall be its fair value (determined in accordance with IPSAS 29) at the first-time adopter's date of adoption of IPSASs in its separate financial statements.
73. A first-time adopter may have established a deemed cost in accordance with its previous basis of accounting for an investment in a controlled entity, joint venture or associate by measuring it at its fair value at one particular date because of a specific event. In such instances, a first-time adopter applies paragraph 72(a) and (b).

Date at which Deemed Cost can be Determined

74. The date at which deemed cost is determined may vary depending on whether the first-time adopter takes advantage of the exemptions that provides a three year transitional relief period to not recognize and/or measure certain assets and/or liabilities. When the first-time adopter takes advantage of the exemption, deemed cost can be determined at any date during this period, or on the date that the exemption expires (whichever is earlier), and shall be recognized in accordance with paragraph 76. If a first-time adopter does not adopt the exemption, deemed cost shall be determined at the beginning of the earliest period for which the first-time adopter presents IPSAS financial statements.
75. Where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets and/or liabilities, it may determine a deemed cost for that asset and/or liability at any point of time within the three year transitional relief period.
76. When a deemed cost is determined during the period in which a first-time adopter takes advantage of the exemption that provides a three year transitional exemption not to recognize and/or measure an asset and/or

liability, a first-time adopter shall recognize the adjustment against the opening accumulated surplus or deficit in the year in which the deemed cost of the asset and/or liability is recognized and/or measured.

IPSAS 1, Presentation of Financial Statements

Comparative Information

77. **A first-time adopter is encouraged, but not required, to present comparative information in its first transitional IPSAS financial statements or its first IPSAS financial statements presented in accordance with this IPSAS. When a first-time adopter presents comparative information, it shall be presented in accordance with the requirements of IPSAS 1.**
78. **Where a first-time adopter elects to present comparative information, the transitional IPSAS financial statements or the first IPSAS financial statements presented in accordance with this IPSAS shall include:**
- (a) **One statement of financial position with comparative information for the preceding period, and an opening statement of financial position as at the beginning of the reporting period prior to the date of adoption of accrual basis IPSAS;**
 - (b) **One statement of financial performance with comparative information for the preceding period;**
 - (c) **One statement of changes in net assets/equity with comparative information for the preceding period;**
 - (d) **One cash flow statement with comparative information for the preceding period;**
 - (e) **A comparison of budget and actual amounts for the current year as a separate additional financial statement or as a budget column in the financial statements if the first-time adopter makes its approved budget publicly available; and**
 - (f) **Related notes including comparative information, and the disclosure of narrative information about material adjustments as required by paragraph 142.**
79. **Where a first-time adopter elects to not present comparative information, its transitional IPSAS financial statements following the adoption of accrual basis IPSASs or its first IPSAS financial statements presented in accordance with this IPSASs shall include:**
- (a) **One statement of financial position, and an opening statement of financial position at the date of adoption of accrual basis IPSAS;**
 - (b) **One statement of financial performance;**
 - (c) **One statement of changes in net assets/equity;**

- (d) **One cash flow statement;**
 - (e) **A comparison of budget and actual amounts for the current year as a separate additional financial statement or as a budget column in the financial statements if the first-time adopter makes its approved budget publicly available; and**
 - (f) **Related notes and the disclosure of narrative information about material adjustments as required by paragraph 142.**
80. **Where a first-time adopter takes advantage of the exemptions in paragraphs 36–62 which allow a three year transitional relief period to not recognize and/or measure an item, comparative information for the year following the date of adoption of IPSASs shall be adjusted only when information is available about the items following their recognition and/or measurement during the relief period.**
81. IPSAS 1 requires an entity to present comparative information in respect of the previous period for all amounts reported in the financial statements. Where a first-time adopter takes advantage of the exemption that provides a three year transitional exemption to not recognize and/or measure an item, it shall, during the period of transition present comparative information for an item recognized and/or measured during that period only, if information is available about the item for the comparative period. The first-time adopter shall apply the requirements in IPSAS 1 after it has adjusted its first IPSAS financial statements.

Non-IPSAS Comparative Information

82. A first-time adopter may present comparative information in accordance with its previous basis of accounting. In any financial statements containing comparative information in accordance with the previous basis of accounting, the first-time adopter shall label the information prepared using the previous basis of accounting information as not being prepared in accordance with IPSASs, and disclose the nature of the main adjustments that would be required to comply with IPSASs.
83. Where a first-time adopter presents non-IPSAS comparative information in its first IPSAS or first transitional IPSAS financial statements following its adoption of accrual basis IPSASs, the transitional exemptions and provisions provided in this Standard shall not be applied to the non-IPSAS comparative information presented in the first IPSAS financial statements or first transitional IPSAS financial statements.

Non-IPSAS Historical Summaries

84. A first-time adopter may elect to present historical summaries of selected data for periods before the first period for which it presents financial statements in accordance with IPSASs. This IPSAS does not require such summaries to comply with the recognition and measurement requirements of IPSASs.

In any financial statements containing historical summaries in accordance with the previous basis of accounting, the first-time adopter shall label the previous basis of accounting information prominently as not being prepared in accordance with IPSASs, and disclose the nature of the main adjustments that would be required to comply with IPSASs. The first-time adopter need not quantify those adjustments.

IPSAS 4, The Effects of Changes in Foreign Exchange Rates

85. **On the date of adoption of IPSASs a first-time adopter need not comply with the requirements for cumulative translation differences that exist at that date. If a first-time adopter uses this exemption:**
 - (a) **The cumulative translation differences for all foreign operations are deemed to be zero at the date of adoption of IPSASs; and**
 - (b) **The gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of adoption of IPSASs and shall include later translation differences.**
86. **A first-time adopter shall apply the requirement to treat any goodwill (see IPSAS 40) arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation, as assets and liabilities of the foreign operation, prospectively on the date of adoption of IPSASs.**
87. In applying the transitional exemption in paragraph 85, a first-time adopter shall not restate prior years for the acquisition of a foreign operation acquired prior to the date of adoption of IPSASs, and accordingly shall, where appropriate, treat goodwill and fair value adjustments arising on acquisition as assets and liabilities of the entity rather than as assets and liabilities of the foreign operation. Therefore, those goodwill and fair value adjustments either are already expressed in the entity's functional currency or are non-monetary foreign currency items, which are reported using the exchange rate at the date of the acquisition.

IPSAS 5, Borrowing Costs

88. **A first-time adopter is encouraged, but not required, to apply the requirements of IPSAS 5 retrospectively where it adopts or changes its accounting policy to the benchmark treatment.**
89. **Where a first-time adopter adopts or changes its accounting policy to the benchmark treatment it is allowed to designate any date before the date of adoption of IPSASs and apply IPSAS 5 prospectively on or after that designated date.**
90. **Where a first-time adopter changes its accounting policy to the allowed alternative treatment, any borrowing costs incurred both before and after date of adoption of IPSASs on qualifying assets for which the**

commencement date for the capitalization is prior to the date of adoption of IPSASs, shall be recognized retrospectively in accordance with the allowed alternative treatment.

IPSAS 10, Financial Reporting in Hyperinflationary Economies

Severe Hyperinflation

91. **If a first-time adopter has a functional currency that was, or is, the currency of a hyperinflationary economy, it shall determine whether it was subject to severe hyperinflation before the date of adoption of IPSASs.**
92. The currency of a hyperinflationary economy is subject to severe hyperinflation if it has both of the following characteristics:
 - (a) A reliable general price index is not available to all entities with transactions and balances in the currency; and
 - (b) Exchangeability between the currency and a relatively stable foreign currency does not exist.
93. The functional currency of a first-time adopter ceases to be subject to severe hyperinflation on the functional currency normalization date. That is the date when the functional currency no longer has either, or both, of the characteristics in paragraph 94 or when there is a change in the first-time adopter's functional currency to a currency that is not subject to severe hyperinflation.
94. **When a first-time adopter's date of adoption of IPSASs is on, or after, the functional currency normalization date, the first-time adopter may elect to measure all assets and liabilities held before the functional currency normalization date at fair value on the date of adoption to IPSASs. The first-time adopter may use that fair value as the deemed cost of those assets and liabilities in the opening statement of financial position.**

IPSAS 13, Leases

95. **A first-time adopter shall on the date of adoption of IPSAS, classify all existing leases as operating or finance leases on the basis of circumstances existing at the inception of the lease, to the extent that these are known on the date of adoption of IPSASs.**
96. **If, however, the lessee and the lessor have agreed to change the provisions of the lease between the date of inception of the lease and the date of adoption of accrual basis IPSASs in a manner that would have resulted in a different classification of the lease at the date of adoption, the revised agreement shall be regarded as a new agreement. A first-time adopter shall consider the provisions of the new agreement at the date of adoption of accrual basis IPSASs in classifying the lease as an operating or finance lease.**

IPSAS 18, Segment Reporting

97. **A first-time adopter is not required to present segment information for reporting periods beginning on a date within three years following the date of adoption of IPSASs.**

IPSAS 21, Impairment of Non-Cash-Generating Assets

98. **A first-time adopter shall apply the requirements in IPSAS 21 prospectively from the date of adoption of IPSASs, except in relation to those assets where a first-time adopter takes advantage of the exemption in paragraph 36 which allows a three year transitional relief period to not recognize and/or measure assets. When a first-time adopter takes advantage of the exemption that provides a three year transitional relief period in IPSAS 16, 17, 27, 31 and 32, it applies IPSAS 21 when the exemption that provided the relief has expired, and/or the relevant assets are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).**
99. **On the date that the transitional exemption that provided the relief has expired, and/or when the relevant assets are recognized and/or measured in the financial statements (whichever is earlier), a first-time adopter shall assess whether there is any indication that the non-cash-generating assets recognized and/or measured are impaired. Any impairment loss shall be recognized in opening accumulated surplus or deficit on the date of adoption of IPSASs, or in opening accumulated surplus or deficit in the reporting period in which the transitional exemption expires, and/or the relevant assets are recognized and/or measured (whichever is earlier).**
100. **A first-time adopter shall apply the requirements of IPSAS 21 prospectively. This means that on the date of adoption of accrual basis IPSASs, or if the first-time adopter has adopted transitional relief relating to the recognition and/or measurement of assets, only when the three year transitional exemption expires, and/or when the relevant assets are recognized and/or measured in the financial statements (whichever is earlier), will a first-time adopter be required to assess whether there is an indication that any non-cash-generating assets included in the opening statement of financial position, are impaired.**

IPSAS 39, Employee Benefits

101. **A first-time adopter shall recognize and/or measure all employee benefits on the date of adoption of IPSASs, except for defined benefit plans and other long-term employee benefits where it takes advantage of the exemption in paragraph 36.**

Defined Benefit Plans and Other Long-Term Employee Benefits

102. **On the date of adoption of IPSASs, or where a first-time adopter takes advantage of the three year transitional exemption, the date on which the**

exemption expires, or when the relevant liabilities are recognized and/or measured in the financial statements (whichever is earlier), a first-time adopter shall determine its initial liability for defined benefit plans and other long-term employee benefits at that date as:

- (a) **The present value of the obligation at the date of adoption of IPSASs, or where a first-time adopter takes advantage of the three year transitional relief period, the date on which the exemption expires, or when the relevant liabilities are recognized and/or measured in the financial statements (whichever is earlier), by using the Projected Unit Credit Method; and**
- (b) **Minus the fair value, at the date of adoption of IPSASs, or where a first-time adopter takes advantage of the three year transitional relief period, the date on which the exemption expires, or when the relevant liabilities are recognized and/or measured in the financial statements (whichever is earlier) of plan assets (if any) out of which the obligations are to be settled directly.**
- (c) [Deleted]

103. If the initial liability in accordance with paragraph 102 is more or less than the liability that was recognized and/or measured at the end of the comparative period under the first-time adopter's previous basis of accounting, the first-time adopter shall recognize that increase/decrease in opening accumulated surplus or deficit in the period in which the items are recognized and/or measured.

104. The effect of the change in the accounting policy to IPSAS 39 includes any remeasurements that arose, if any, in earlier periods. Under its previous basis of accounting, a first-time adopter may not have recognized and/or measured any liability, in which case the increase in the liability will represent the full amount of the liability minus the fair value, at the date of adoption of IPSASs or where a first-time adopter takes advantage of the three year transitional relief period, the date on which the exemption expires, or when the relevant liabilities are recognized and/or measured in the financial statements (whichever is earlier), of any plan assets in accordance with paragraph 102(b). This increased liability is recognized in opening accumulated surplus or deficit in the period in which the items are recognized and/or measured.

105. A first-time adopter shall recognize all cumulative remeasurements in opening accumulated surplus or deficit in the period in which the items are recognized and/or measured.

106. [Deleted]

107. [Deleted]

IPSAS 26, Impairment of Cash-Generating Assets

108. **A first-time adopter shall apply the requirements in IPSAS 26 prospectively from the date of adoption of IPSASs, except in relation to those assets where a first-time adopter takes advantage of the exemption in paragraph 36 which allows a three year transitional relief period to not recognize and/or measure assets. When a first-time adopter takes advantage of the exemption that provides a three year transitional relief period in IPSASs 16, 17, 27, 31 and 32, it applies IPSAS 26 when the exemption that provided the relief has expired, and/or the relevant assets are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).**
109. **On the date that the transitional exemption that provided the relief has expired, and/or when the relevant assets are recognized and/or measured in the financial statements (whichever is earlier), a first-time adopter shall assess whether there is any indication that the cash-generating assets recognized and/or measured are impaired. Any impairment loss shall be recognized in opening accumulated surplus or deficit on the date of adoption of IPSASs, or in opening accumulated surplus or deficit in the reporting period in which the transitional exemption expires, and/or the relevant assets are recognized and/or measured (whichever is earlier).**
110. A first-time adopter shall apply the requirements of IPSAS 26 prospectively. This means that on the date of adoption of accrual basis IPSASs, or if the first-time adopter has adopted the transitional relief relating to the recognition and/or measurement of assets, only when the three year transitional exemption expires, and/or when the relevant assets are recognized and/or measured in the financial statements (whichever is earlier), will a first-time adopter be required to assess whether there is an indication that any cash-generating assets included in the opening statement of financial position, are impaired.

IPSAS 28, Financial Instruments: Presentation

111. **On the date of adoption of IPSASs, a first-time adopter shall evaluate the terms of the financial instrument to determine whether it contains both a liability component and a net asset/equity component. If the liability component is no longer outstanding on the date of adoption of IPSASs, the first-time adopter need not separate the compound financial instrument into a liability component and a net asset/equity component.**
112. IPSAS 28 requires an entity to split a compound financial instrument at inception into separate liability and net asset/equity components. If the liability component is no longer outstanding, retrospective application of IPSAS 28 involves separating two portions of net assets/equity. The first portion is in accumulated surplus and deficit and represents the cumulative interest accreted on the liability component. The other portion represents the original net asset/equity component. However, this IPSASs allows a first-

time adopter to not separate these two portions if the liability component is no longer outstanding at the date of adoption of IPSASs.

IPSAS 29, Financial Instruments: Recognition and Measurement

Designation of Financial Instruments on the Date of Adoption of IPSAS or During the Period of Transition

113. **A first-time adopter may designate a financial asset or financial liability as a financial asset or financial liability at fair value through surplus or deficit that meet the criteria for designation in IPSAS 29, in accordance with paragraph 114. A first-time adopter shall disclose the fair value of financial assets and financial liabilities designated into each category at the date of designation, their classification and carrying amount.**
114. **IPSAS 29 permits a financial asset to be designated on initial recognition as available for sale or a financial instrument (provide it meets certain criteria) to be designated as a financial asset or financial liability at fair value through surplus or deficit. Despite this requirement, exceptions apply in the following circumstances:**
 - (a) **A first-time adopter is permitted to make an available-for-sale designation at the date of adoption of IPSASs.**
 - (b) **A first-time adopter is permitted to designate, at the date of adoption of IPSASs, any financial asset or financial liability as at fair value through surplus or deficit provided the asset or liability meets the criteria in paragraph 10(b)(i), 10(b)(ii) or 13 of IPSAS 29 at that date.**

Derecognition of Financial Assets and Financial Liabilities

115. **Except as permitted by paragraph 116 a first-time adopter shall apply the derecognition requirements in IPSAS 29 prospectively for transactions occurring on or after the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemptions not to recognize financial instruments, the date on which the exemptions that provided the relief have expired and/or the financial instruments are recognized (whichever is earlier). For example, if a first-time adopter derecognized non-derivative financial assets or non-derivative financial liabilities in accordance with its previous basis of accounting as a result of a transaction that occurred before the date of adoption of IPSASs, it shall not recognize those assets and liabilities in accordance with IPSAS 29, unless they qualify for recognition as a result of a later transaction or event.**
116. **Notwithstanding the provision in paragraph 115, a first-time adopter may apply the derecognition requirements in IPSAS 29 retrospectively from a date of the first-time adopter choosing, provided that the information needed to apply IPSAS 29 to financial assets and financial liabilities**

derecognized as a result of past transactions was obtained at the time of initially accounting for these transactions.

Hedge Accounting

117. As required by IPSAS 29, a first-time adopter shall at the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial instruments, the date when the exemption that provided the relief has expired and/or the relevant financial instruments are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier):
- (a) Measure all derivatives at fair value; and
 - (b) Eliminate all deferred losses and gains arising on derivatives that were reported in accordance with its previous basis of accounting as if they were assets or liabilities.
118. A first-time adopter shall not reflect in its opening statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with IPSAS 29 (for example, many hedging relationships where the hedging instrument is a cash instrument or written option; or where the hedged item is a net position). However, if a first-time adopter designated a net position as a hedged item in accordance with its previous basis of accounting, it may designate an individual item within that net position as a hedged item in accordance with IPSASs, provided that it does so no later than the date of adoption of IPSASs or where it takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial instruments, the date when the exemption that provided the relief has expired, and/or the relevant financial instruments are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).
119. If, before the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial instruments the date on which the exemption that provided the relief has expired, and/or the relevant financial instruments are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier), a first-time adopter had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in IPSAS 29, the first-time adopter shall apply paragraphs 102 and 112 of IPSAS 29 to discontinue hedge accounting. Transactions entered into before the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial instruments, the date when the

transitional exemption expires and/or the relevant financial instruments are recognized and/or measured in accordance with IPSAS 29 (whichever is earlier), shall not be retrospectively designated as hedges.

Impairment of Financial Assets

120. **A first-time adopter shall apply the impairment requirements prospectively from the date of adoption of IPSASs, except in relation to those financial assets where it takes advantage of the exemptions in paragraphs 36, 38 and 42 which allow a three year transitional relief period to not recognize and/or measure financial instruments. When a first-time adopter adopts the three year transitional relief period provided, it applies the impairment provisions when exemption that provided the relief has expired, and/or the relevant financial instruments are recognized and/or measured in accordance with IPSAS 29 (whichever is earlier).**
121. **A first-time adopter shall on the date of adoption of IPSASs, or when the exemptions that provided the relief have expired, and/or when the relevant financial instruments are recognized and/or measured and relevant information has been presented and/or disclosed in the financial statements in accordance with the applicable IPSAS (whichever is earlier), assess at that date whether there is any indication that the financial instrument recognized and/or measured in the statement of financial position, is impaired. Any impairment loss incurred shall be recognized in opening accumulated surplus or deficit in the period in which the financial instrument is recognized and/or measured.**
122. **A first-time adopter shall apply the impairment requirements prospectively. This means that on the date of adoption of IPSAS 29, when the exemptions that provided the relief have expired, and/ or when the relevant financial instruments are recognized and/or measured, a first-time adopter shall be required to assess whether there is an indication that the financial instrument is impaired. Any impairment loss shall be recognized in opening accumulated surplus or deficit on the date of adoption of IPSASs, or in the opening accumulated surplus or deficit of the reporting period in which the exemptions that provided the relief have expired, and/or the relevant financial instruments are recognized and/or measured (whichever is earlier).**

IPSAS 30, Financial Instruments: Disclosures

123. **Where the first-time adopter elects to present comparative information in accordance with paragraph 78, it is not required to present information about the nature and extent of risks arising from financial instruments for the comparative period in its transitional IPSAS financial statements or its first IPSAS financial statements.**
124. **A first-time adopter shall apply the requirements in IPSAS 30 prospectively from the date of adoption of IPSASs, or when the exemptions**

that provided the relief have expired, and/or when the relevant financial instrument is recognized and/or measured in accordance with IPSAS 29 (whichever is earlier).

IPSAS 31, Intangible Assets

125. **A first-time adopter shall recognize and/or measure an internally generated intangible asset if it meets the definition of an intangible asset and the recognition criteria in IPSAS 31, even if the first-time adopter has, under its previous basis of accounting, expensed such costs. A deemed cost may not be determined for internally generated intangible assets.**
126. As required by paragraph 20, a first-time adopter is required to recognize all assets for which recognition is required by IPSASs. A first-time adopter shall therefore recognize any internally generated intangible asset if it meets the definition of an intangible asset and the recognition criteria in IPSAS 31, irrespective of whether such costs were expensed under its previous basis of accounting.

IPSAS 32, Service Concession Arrangements

Initial Measurement of Related Liability

127. **Where a first-time adopter elects to measure service concession assets using deemed cost, the related liabilities shall be measured as follows:**
- (a) **For the liability under the financial liability model, the remaining contractual cash flows specified in the binding arrangement and the rate prescribed in IPSAS 32; or**
 - (b) **For the liability under the grant of a right to the operator model, the fair value of the asset less any financial liabilities, adjusted to reflect the remaining period of the service concession arrangement.**
128. **A first-time adopter shall recognize and/or measure any difference between the value of the service concession asset and the financial liability under the financial liability model in paragraph 127 in opening accumulated surplus or deficit in the period in which the items are recognized and/or measured.**

IPSAS 34, Separate Financial Statements, IPSAS 35, Consolidated Financial Statements and IPSAS 36, Investments in Associates and Joint Ventures

129. **If a controlled entity becomes a first-time adopter later than its controlling entity, except for the controlled entity of an investment entity, the controlled entity shall, in its financial statements, measure its assets and liabilities at either:**
- (a) **The carrying amounts determined in accordance with this IPSAS that would be included in the controlling entity's consolidated financial statements, based on the controlled entity's date of**

adoption of IPSASs, if no adjustments were made for consolidation procedures and for the effects of the public sector combination in which the controlling entity acquired the controlled entity; or

- (b) The carrying amounts required by the rest of this IPSAS, based on the controlled entity's date of adoption of IPSASs. These carrying amounts could differ from those described in (a):**
 - (i) When the exemptions in this IPSAS result in measurements that depend on the date of adoption of IPSASs.**
 - (ii) When the accounting policies used in the controlled entity's financial statements differ from those in the consolidated financial statements. For example, the controlled entity may use as its accounting policy the cost model in IPSAS 17, whereas the economic entity may use the revaluation model.**

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

- 130. However, if a controlling entity becomes a first-time adopter later than its controlled entity (or associate or joint venture) the controlling entity shall, in its consolidated financial statements, measure the assets and liabilities of the controlled entity (or associate or joint venture) at the same carrying amounts as in the financial statements of the controlled entity (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the public sector combination in which the controlling entity acquired the controlled entity (or associate or joint venture), subject to the exemptions that may be adopted in terms of this IPSAS. Similarly, if a controlled entity becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, subject to the exemptions that may be adopted in this IPSAS, except for consolidation adjustments.**

IPSAS 35, Consolidated Financial Statements

- 131. A first-time adopter that is a controlled entity shall assess whether it is an investment entity on the basis of the facts and circumstances that exist at the date of adoption of accrual basis IPSASs, and measure its investment in each controlled entity at fair value through surplus or deficit at the date of adoption of accrual basis IPSASs.**

IPSAS 37, Joint Arrangements

- 132. Where a first-time adopter accounted for its investment in a joint venture under its previous basis of accounting basis using proportionate consolidation, the investment in the joint venture shall be measured on**

the date of adoption as the aggregate of the carrying amount of the assets and liabilities that the entity previously proportionately consolidated, including any purchased goodwill arising from acquisition transactions (see IPSAS 40).

133. The opening balance of the investment determined in accordance with paragraph 132 is regarded as the deemed cost of the investment at initial recognition. A first-time adopter shall test the investment for impairment as at the date of adoption, regardless of whether there is any indication that the investment may be impaired. Any impairment loss shall be adjusted to the accumulated surplus or deficit at the date of adoption.
134. If aggregating all previously proportionately consolidated assets and liabilities results in negative net assets, the first-time adopter shall assess whether it has legal or constructive obligations in relation to the negative net assets and, if so, the first-time adopter shall recognize a corresponding liability. If the first-time adopter concludes that it does not have legal or constructive obligations in relation to the negative net assets, it shall not recognize the corresponding liability but it shall adjust accumulated surplus or deficit at the date of adoption. The first-time adopter shall disclose this fact, along with its cumulative unrecognized share of losses of its joint ventures as at the date of adoption of accrual basis IPSASs.

Disclosures

135. A first-time adopter with financial statements that comply with the requirements of this IPSAS while taking advantage of the transitional exemptions and provisions that affect fair presentation and its ability to assert compliance with accrual basis IPSASs, shall make an explicit and unreserved statement of compliance with this IPSAS in the notes to the financial statements. This statement shall be accompanied by a statement that the financial statements do not fully comply with accrual basis IPSASs.
136. Where a first-time adopter takes advantage of the transitional exemptions in this IPSAS, the first-time adopter shall disclose:
 - (a) The extent to which it has taken advantage of the transitional exemptions that affect the fair presentation of the financial statements and its ability to assert compliance with accrual basis IPSASs; and/or
 - (b) The extent to which it has taken advantage of the transitional exemptions that do not affect the fair presentation of the financial statements and its ability to assert compliance with accrual basis IPSASs.
137. To the extent that a first-time adopter has taken advantage of the transitional exemptions and provisions in this IPSAS that affect fair presentation and compliance with accrual basis IPSASs in relation to assets, liabilities, revenue and/or expenses, it shall disclose:

- (a) **Progress made towards recognizing, measuring, presenting and/or disclosing assets, liabilities revenue and/or expenses in accordance with the requirements of the applicable IPSAS;**
 - (b) **The assets, liabilities, revenue and/or expenses that have been recognized and measured under an accounting policy that is not consistent with the requirements of applicable IPSAS;**
 - (c) **The assets, liabilities, revenue and/or expenses that have not been measured, presented and/or disclosed in the previous reporting period, but which are now recognized and/or measured, and/or presented and/or disclosed;**
 - (d) **The nature and amount of any adjustments recognized during the reporting period; and**
 - (e) **An indication of how and by when it intends to comply in full with the requirements of the applicable IPSAS.**
138. **Where a first-time adopter takes advantage of the transitional exemption to not eliminate some balances, transactions, revenue and expenses, and/or where it applies the three year transitional relief for the recognition and/or measurement of its interest in controlled entities, associates or joint ventures in paragraph 55, it shall disclose the nature of the balances, transactions, revenue and expenses and/or upstream or downstream transactions that have been eliminated during the reporting period.**
139. **Where a first-time adopter is not able to present consolidated financial statements because of the transitional exemptions and provisions adopted in paragraphs 58 or 62, it shall disclose:**
- (a) **The reason why the financial statements, investments in associates or interests in joint ventures could not be presented as consolidated financial statements; and**
 - (b) **An indication by when the first-time adopter will be able to present consolidated financial statements.**
140. **The disclosure requirements of paragraphs 135 and 139 will assist users to track the progress of the first-time adopter in conforming its accounting policies to the requirements in the applicable IPSASs during the period of transition.**

Explanation of Transition to IPSASs

141. **A first-time adopter shall disclose:**
- (a) **The date of adoption of IPSASs; and**
 - (b) **Information and explanations about how the transition from the previous basis of accounting to IPSASs affected its reported**

financial position, and, where appropriate, its reported financial performance and cash flows.

Reconciliations

142. A first-time adopter shall present in the notes to its transitional IPSAS financial statements or its first IPSAS financial statements:

- (a) A reconciliation of its net assets/equity reported in accordance with its previous basis of accounting to its opening balance of net assets/equity at the date of adoption of IPSASs; and**
- (b) A reconciliation of its surplus or deficit in accordance with its previous basis of accounting to its opening balance of surplus or deficit at the date of adoption of IPSASs.**

A first-time adopter that has applied a cash basis of accounting in its previous financial statements is not required to present such reconciliations.

143. The reconciliation presented in accordance with paragraph 142 shall provide sufficient detail, both quantitative and qualitative, to enable users to understand the material adjustments to the opening statement of financial position and, where applicable, the restated comparative statement of financial performance presented in accordance with accrual basis IPSAS. Where narrative explanations are included in other public documents issued in conjunction with the financial statements, a cross reference to those documents shall be included in the notes.

144. If an entity becomes aware of errors made under its previous basis of accounting, the reconciliations required by paragraph 142 shall distinguish the correction of those errors from changes in accounting policies.

145. If an entity did not present financial statements for previous periods, its transitional IPSAS financial statements or its first IPSAS financial statements shall disclose that fact.

146. Where a first-time adopter takes advantage of the exemptions in paragraph 36–43 which allow a three year transitional relief period to not recognize and/or measure items, it shall present as part of the notes, a reconciliation of items that have been recognized and/or measured during the reporting period when these items were not included in the previous reported financial statements. The reconciliation shall be presented in each period when new items are recognized and/or measured in accordance with this IPSAS.

147. The reconciliation presented in accordance with paragraph 146 provides sufficient detail to enable users to understand which items have been recognized and/or measured during the reporting period where the first-time adopter adopts one of more of the exemptions that provide a three year transitional relief period to not recognize and/or measure an item. The

reconciliation explains the adjustments to the previously reported statement of financial position and, where applicable, the previously reported statement of financial performance in each period when new items are recognized and/or measured in accordance with this IPSAS.

Disclosures where Deemed Cost is Used for Inventory, Investment Property, Property, Plant and Equipment, Intangible Assets, Financial Instruments or Service Concession Assets

148. If a first-time adopter uses fair value, or the alternative in paragraphs 64, 67 or 70, as deemed cost for inventory, investment property, property, plant and equipment, intangible assets, financial instruments, or service concession assets, its financial statements shall disclose:
- (a) The aggregate of those fair values or other measurement alternatives that were considered in determining deemed cost;
 - (b) The aggregate adjustment to the carrying amounts recognized under the previous basis of accounting; and
 - (c) Whether the deemed cost was determined on the date of adoption of IPSASs or during the period of transition.

Disclosures Where Deemed Cost is Used for Investments in Controlled Entities, Joint Ventures or Associates

149. If a first-time adopter uses fair value as deemed cost in its opening statement of financial position for an investment in a controlled entity, joint venture or associate in its separate financial statements, its separate financial statements shall disclose:
- (a) The aggregate deemed cost of those investments for which deemed cost is fair value; and
 - (b) The aggregate adjustment to the carrying amounts reported under the previous basis of accounting.
150. The disclosure requirements required in paragraph 148 and 149 shall be disclosed in each period when new items are recognized and/or measured until the exemptions that provided the relief have expired and/or when the relevant assets are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).

Exemptions from Disclosure Requirements in IPSASs During the Period of Transition

151. To the extent that a first-time adopter takes advantage of the exemption that provides a three year relief period to not recognize and/or measure items, it is not required to apply any associated presentation and/or disclosure requirements related to such items as required in IPSAS 1,

IPSAS 18 and/or the applicable IPSASs until such time as the exemptions that provided the relief have expired and/or when the relevant items have been recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).

152. Notwithstanding the transitional provision in paragraph 151, a first-time adopter is encouraged to disclose the information required by IPSAS 1, IPSAS 18 and/or the applicable IPSAS as soon as possible.

Transitional Provisions

153. Where a first-time adopter has adopted the existing transitional provisions in other accrual basis IPSASs, it shall continue to apply those transitional provisions until they expire and/or the relevant items are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier). If the first-time adopter elects to adopt the transitional exemptions in this IPSAS, the relief period applied in adopting accrual basis IPSASs, may not be longer than the relief period provided in this IPSAS.

Effective Date

154. A first-time adopter shall apply this Standard if its first IPSAS financial statements are for a period beginning on or after January 1, 2017. Earlier application is permitted.
- 154A. Paragraphs 7 and 8 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.
- 154B. Paragraphs 36, 102, 104 and 105 were amended and paragraphs 106 and 107 were deleted by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies these amendments for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.
- 154C. Paragraphs 86, 129, 130 and 132 were amended and paragraphs 62A–62C were added by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2019. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2019 it shall disclose that fact and apply IPSAS 40 at the same time.

Appendix A

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 33.

Background

- BC1. Prior to the development of IPSAS 33, there was no Standard that addresses issues arising from the first-time adoption of IPSASs. As a result, the IPSASB approved a project in June 2011 to develop a comprehensive set of principles to be used by entities on the adoption of accrual basis International Public Sector Accounting Standards (IPSASs).
- BC2. While this IPSAS has Implementation Guidance, it is not within the scope of this project to develop more detailed practical guidance on the first-time adoption of IPSASs. The IPSASB is of the view that because specific issues relating to first-time adoption are likely to vary from one jurisdiction to the next, and because the starting point for first-time adopters varies depending on their previous basis of accounting, individual jurisdictions need to play a role in the development of additional implementation guidance to assist first-time adopters in their transition to accrual basis IPSASs.
- BC3. This IPSAS addresses the transition from either a cash basis, or an accrual basis under another reporting framework, or a modified version of either the cash or accrual basis of accounting. Consequently, the IPSASB agreed that the project is not an IFRS convergence project.
- BC4. The IPSASB did, however, consider the transitional exemptions included in IFRS 1 *First-time Adoption of International Financial Reporting Standards*, as well as the transitional provisions included in the existing suite of IPSASs, in developing this IPSAS.
- BC5. In developing this IPSAS, the IPSASB agreed that, because this IPSAS is not a convergence project, all the transitional provisions and exemptions should be included in a single pronouncement. In comparison with IFRS 1, the IPSASB agreed that no transitional provisions and exemptions should be included as appendices, as this could be confusing to the preparers of the financial statements if the provisions and exemptions are dispersed all over the Standard.
- BC6. The transitional exemptions provided in this IPSAS will replace many of the transitional provisions in IPSASs once they are applied.
- BC7. When the IPSASB issues new pronouncements, it will consider specific transitional provisions to be included in this IPSAS that will provide relief to a first-time adopter. Transitional provisions for entities already applying accrual basis IPSASs will be included in the new pronouncements that are developed.

Scope

- BC8. This IPSAS applies when an entity first adopts accrual basis IPSASs for the first time and during the period that it transitions to accrual basis IPSASs to the extent that it has adopted one or more of the transitional exemptions and provisions in this IPSASs. This IPSAS provides relief to a first-time adopter in presenting its financial statements, and allows a first-time adopter certain voluntary exemptions during the period of transition.
- BC9. This IPSAS requires an entity to comply with each effective IPSAS on the date of adoption, but grants limited exemptions from requirements in certain areas where the benefits to users of financial statements are less than the cost of complying with those requirements. Retrospective application of some IPSASs is prohibited, particularly where they require judgment by management about past conditions.
- BC10. The exemptions provided in this IPSAS may override some of the requirements in existing accrual basis IPSASs during the transition to accrual basis IPSASs.
- BC11. The date of adoption of accrual basis IPSASs is the start of the reporting period in which the first-time adopter elects to adopt accrual basis IPSASs. If, on the date of adoption of accrual basis IPSASs the first-time adopter elects to apply one or more of the voluntary exemptions or provisions that affect fair presentation and the first-time adopter's ability to assert compliance with accrual basis IPSASs, the first-time adopter will present transitional IPSAS financial statements during the period of transition. At the end of the transitional period the first-time adopter must comply with the recognition, measurement, presentation and disclosure requirements in the other accrual basis IPSASs in order to assert compliance with accrual basis IPSASs as required in IPSAS 1, *Presentation of Financial Statements*, even though the date of adoption of accrual basis IPSAS may have been at an earlier point.
- BC12. If, however, on the date of adoption of accrual basis IPSASs the first-time adopter elects not to apply one or more of the exemptions or provisions that affect fair presentation and the ability to assert compliance with accrual basis IPSASs, the first-time adopter can present IPSAS financial statements during the period of transition. IPSAS financial statements are financial statements in which the first-time adopter can make an explicit and unreserved statement in those financial statements of compliance with accrual basis IPSASs. If a first-time adopter does not adopt the exemptions in this IPSAS that affect fair presentation and compliance with accrual basis IPSASs, its first financial statements following the adoption of accrual basis IPSASs may also be its first IPSAS financial statements.

Developing Criteria to Develop and Assess Transitional Exemptions

- BC13. In developing the transitional exemptions in this IPSAS, the IPSASB developed a set of criteria based on what user information needs are likely to be on the adoption of and transition to accrual basis IPSASs as set out in Chapter 2 of the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the Conceptual Framework)*. These criteria were used to evaluate these transitional provisions, along with an assessment of the qualitative characteristics, and constraints on, information included in GPFRs as outlined in Chapter 3 of the *Conceptual Framework*. The results of these evaluations are included in paragraphs BC14 to BC19.
- BC14. In developing requirements for the first-time adopter's opening statement of financial position and in considering the transitional exemptions, the IPSASB referred to the objective of financial statements, as set out in Chapter 2 of the *Conceptual Framework*.
- BC15. Chapter 2 of the *Conceptual Framework* states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in providing information for accountability and decision-making purposes.
- BC16. Chapter 3 of the *Conceptual Framework* also identifies qualitative characteristics of information included in the general purpose financial reports (GPFRs) of public sector entities. These qualitative characteristics are relevance, faithful representation, understandability, timeliness, comparability and verifiability. The constraints on information included in GPFRs are materiality and cost-benefit.

Criteria Used to Develop the Transitional Exemptions

Fair Presentation and Compliance with IPSASs

- BC17. IPSAS 1 requires that an entity whose financial statements comply with IPSASs shall make an explicit and unreserved statement of such compliance in the notes to the financial statements. Financial statements shall not be described as complying with IPSASs unless they comply with all the requirements of IPSASs. Due to the complexity of issues relating to the first-time adoption of IPSASs, the IPSASB agreed that relief should be provided in certain instances. The IPSASB however agreed that some relief will affect the fair presentation of a first-time adopter's financial statements and the ability to assert compliance with accrual basis IPSASs.
- BC18. The IPSASB agreed that there should be a differentiation between those transitional exemptions which do not affect fair presentation of a first-time adopter's financial statements and those that do. The IPSASB also agreed that, structuring the Standard in this way will give preparers a better understanding of the affect that the various transitional provisions and exemptions will have

on their financial statements during the period of transition. Following the differentiation the IPSASB agreed that first-time adopters should be alerted to the fact that they will not be able to assert compliance with accrual basis IPSASs as required by IPSAS 1 if they adopt certain exemptions provided in this IPSAS.

- BC19. The IPSASB agreed that where a first-time adopter takes advantage of the exemptions that affect fair presentation and compliance with accrual basis IPSASs, it will not be able to make an unreserved statement of compliance with accrual basis IPSASs until such time as the exemptions that provided the relief have expired, or when the relevant items are recognized, measured and/or the relevant information has been presented and/or disclosed in the financial statements in accordance with the applicable IPSASs (whichever is earlier).
- BC20. Following comment received on the proposed IPSAS on *First-time Adoption of Accrual Basis IPSAS*, the IPSASB agreed to clarify that a first-time adopter should apply judgment in assessing to what extent the transitional exemptions and provisions adopted affect fair presentation of the financial statements and the first-time adopter's ability to assert compliance with accrual basis IPSAS. Where a first-time adopter elects to apply one or more of the transitional exemptions and provisions that affect the fair presentation of the financial statements and its ability to assert compliance with accrual basis IPSAS, the first-time adopter may still conclude that fair presentation is achieved because the recognition and/or measurement of the item, transaction or event that are exempted is not significant in relation to the financial statements as a whole. Applying judgment to assess the significance of the transitional exemption and provision adopted in relation to the financial statements as a whole needs to be assessed based on the first-time adopter's specific circumstances.
- BC21. The IPSASB agreed that the financial statements presented at the end of the first reporting period where a first-time adopter takes advantage of one of more of the transitional exemptions that affect fair presentation and compliance with accrual basis IPSASs, should be referred to as the transitional IPSAS financial statements. This is because the first-time adopter will not be able to make an explicit and unreserved statement of compliance with IPSASs while applying the exemptions in this IPSAS that affect the fair presentation of the financial statements and a first-time adopter's ability to assert compliance with accrual basis IPSASs.
- BC22. To provide relevant information during the transition to accrual basis IPSASs disclosures to inform users about the transitional exemptions adopted by a first-time adopter, and how it transitions from its previous basis of accounting to accrual basis IPSASs.

- BC23. The IPSASB noted that, as part of a first-time adopter's transition to accrual accounting, an implementation plan should be developed so as to assess the first-time adopter's progress reporting under accrual basis IPSASs. Disclosures on the progress towards recognizing, measuring, presenting and/or disclosing assets, liabilities, revenue and/or expenses in accordance with this plan will provide useful information to the users of financial statements in understanding how and by when the first-time adopter intends to comply in full with the requirements of all the applicable IPSASs.

Presentation of Information on First-Time Adoption

Presenting Comparative Information Following the Adoption of Accrual Basis IPSASs

- BC24. The IPSASB considered whether comparative information should be required on the adoption of IPSASs, as the existing transitional provisions in IPSAS 1, *Presentation of Financial Statements* do not require comparative information in respect of the financial statements in which accrual accounting is first adopted in accordance with IPSASs.
- BC25. In considering the cost-benefit criterion, the IPSASB confirmed that the current approach in IPSAS 1 for the presentation of comparative information should be retained to promote the adoption of accrual IPSASs. This IPSAS therefore only encourages the provision of comparative information, with no requirement that a first-time adopter should provide comparative information in its transitional IPSAS financial statements, or first IPSAS financial statements.
- BC26. Where a first-time adopter elects to not present comparative information, the IPSASB agreed that, as a minimum, a first-time adopter's transitional IPSAS financial statements, should include one statement of financial position and an opening statement of financial position at the date of adoption of accrual basis IPSASs.
- BC27. Where an entity elects to present comparative information, the IPSASB agreed that a first-time adopter should present one statement of financial position with comparative information for the preceding period and an opening statement of financial position as at the beginning of the reporting period prior to the date of adoption of accrual basis IPSASs.
- BC28. As the adoption of the three year transitional relief period also affects the presentation of comparative information, the IPSASB agreed that where the first-time adopter takes advantage of any of the transitional relief periods permitted, it should only adjust comparative information for the year following the date of adoption of accrual basis IPSASs when information is available about the items that were recognized and/or measured during that period. Comparative information will thus only be adjusted retrospectively to the extent that the information is available.

- BC29. A first-time adopter shall apply the requirements in IPSAS 1 relating to the disclosure of comparative information after it has presented its first IPSAS financial statements.

Presenting a Reconciliation Following the Adoption of Accrual Basis IPSASs

- BC30. In considering what information would be useful to users of the financial statements in relation to the first-time adoption of IPSASs, the IPSASB agreed that a reconciliation should be presented in the notes to the transitional IPSAS financial statements, or first IPSAS financial statements. The presentation of a reconciliation provides an important link between the information previously presented under the first-time adopter's previous basis of accounting, and the information prepared using IPSASs. The purpose of the reconciliation is to illustrate the adjustments that are necessary to conform with the requirements of accrual basis IPSASs, and how the transition from the previous basis of accounting to IPSASs affected the first-time adopter's reported financial position, financial performance and cash flows. This information will be useful to the users of financial statements.
- BC31. The IPSASB considered two types of reconciliations that could be presented – the first one reconciling opening balances as at the date of adoption of IPSASs, and the second a reconciliation reconciling the end of the latest period presented in the first-time adopter's most recent annual financial statements in accordance with its previous basis of accounting.
- BC32. The IPSASB concluded that the latter option will be too onerous and that the cost of presenting the reconciliation, outweighs the benefit. It was also concluded that users will not likely make use of such reconciliations and that the information will not have predictive value.
- BC33. As a result, it was agreed that a first-time adopter should only present a reconciliation of its closing balances reported under its previous basis of accounting, to its net assets/equity in accordance with IPSASs for the opening statement of financial position. The information should be presented in the notes to the transitional IPSAS financial statements, or the first IPSAS financial statements.
- BC34. If a first-time adopter previously applied a cash basis of accounting it would not have presented net assets/equity. The IPSASB therefore agreed that if a first-time adopter's previous basis of accounting is cash, it is not required to present a reconciliation.
- BC35. To meet the qualitative characteristics of relevance, understandability and comparability during the period of transition where a first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of assets and/or liabilities, the IPSASB considered whether a first-time adopter should be required to present a reconciliation at different points during its transition to accrual basis IPSASs.

- BC36. The IPSASB agreed that where a first-time adopter takes advantage of any of the transitional relief periods permitted, it should present a reconciliation of items that have been recognized and/or measured during the reporting period when these items have not been recognized and/or measured in the previous reported financial statements. This reconciliation should be presented in addition to the reconciliation that is presented to explain differences between the first-time adopter's previous basis of accounting and those items that are recognized and/or measured in accordance with IPSASs in the opening statement of financial position.

Presenting a Comparison of Budget and Actual Information in a First-time Adopter's Financial Statements

- BC37. The IPSASB debated whether a first-time adopter should be required to present a comparison of budget and actual information following the adoption of accrual basis IPSASs, and whether such information is useful to the users of the financial statements.
- BC38. The IPSASB considered that if a first-time adopter prepares its budget on the cash-basis of accounting after the adoption of IPSASs, presenting this comparison in its transitional IPSAS financial statements, or its first IPSAS financial statements could be onerous. The IPSASB, however, agreed that such a comparison should be included in a first-time adopter's financial statements, as the comparison is a unique feature of IPSASs and promotes accountability and decision-making.

Presenting a Cash Flow Statement in a First-time Adopter's Financial Statements

- BC39. During the comment period, respondents requested the IPSASB to consider providing transitional exemptions and provisions for the preparation of the cash flow statement where a first-time adopter elects to adopt a three year relief period for the recognition and/or measurement of certain assets and/or liabilities. Respondents noted that it did not seem appropriate to present a cash flow statement when the statement of financial position is incomplete.
- BC40. The IPSASB confirmed its previous decision to not provide any transitional relief as, during the transitional period, users still need cash flow information on: (a) the sources of cash inflows; (b) the items on which cash was expensed during the reporting period; and (c) the cash balance as at the end of the reporting period.

Alignment of Accrual IPSASs and Government Finance Statistics Reporting

- BC41. As the objective of this Standard is to provide a suitable starting point for accounting in accordance with accrual basis IPSAS it does not provide specific guidance to a first-time adopter on alignment of GFS reporting and accrual basis IPSASs. In its Consultation Paper, *Alignment of IPSASs and Government Finance Statistics Reporting Guidelines: Resolution of*

Differences through Convergence and Management, the IPSASB discusses where guidance on GFS alignment options within the suite of IPSASB's pronouncements will be best addressed. By choosing Government Finance Statistics (GFS) aligned policy options on the first-time adoption of accrual IPSASs, a first-time adopter may facilitate production of high quality and timely data for inclusion in their GFS reports.

Exemptions that Affect Fair Presentation and Compliance with Accrual Basis IPSAS

Transitional Exemptions Relating to the Recognition, Measurement and Classification of Non-Financial Assets

- BC42. When an entity first adopts IPSASs, it may not have comprehensive information about the existence of all the assets under its control, and may require a period of time to obtain and compile appropriate records to account for such assets. As this is relevant to entities that previously did not apply the accrual basis of accounting, it is likely that these entities will require considerable effort to recognize, measure and/or classify their assets in accordance with IPSASs.
- BC43. In considering the relief that should be provided to a first-time adopter for the recognition of its assets, the IPSASB considered the existing five year relief period in IPSAS 17. To encourage entities to prepare for the adoption of IPSASs in advance of the preparation of their transitional IPSAS financial statements, or their first IPSAS financial statements, the IPSASB agreed that a grace period not exceeding three years should be allowed. As entities should prepare well in advance for their transition to accrual basis IPSASs and not solely rely on the relief period provided in this IPSAS, the IPSASB is of the view that the three year transitional period is more manageable, and reduces the period over which entities will not be able to assert compliance with IPSASs.
- BC44. The IPSASB agreed that prescribing a relief period in this IPSAS, rather than allowing each jurisdiction to prescribe their own transitional period, reduces inconsistencies between jurisdictions. The credibility and comparability of financial statements during the period of transition will also be enhanced.
- BC45. The IPSASB confirmed that the relief provided in this IPSAS should not be seen as a complete roadmap for the adoption of accrual basis IPSASs, but rather the end stage of their adoption process. The relief period of three years provided in this IPSAS is aimed at providing relief to a first-time adopter to assist with the final conversion to accrual basis IPSASs. Prior to the adoption of this IPSAS, a first-time adopter should adequately prepare for its transition to accrual basis IPSASs. The complexity and length of the transition will depend on its previous basis of accounting. The three year relief period should not be seen as the entire adoption phase.

- BC46. The guidance in Study 14, *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities* issued by the IPSASB may assist a first-time adopter in planning their conversion to accrual basis IPSASs, prior to adoption of this IPSAS.
- BC47. The IPSASB proposed that a relief period of three years should be provided for the following assets:
- (a) Investment property;
 - (b) Property, plant and equipment;
 - (c) Biological assets and agricultural produce;
 - (d) Intangible assets; and
 - (e) Service concession assets.
- BC48. Following comment received on this proposed IPSAS, the IPSASB agreed to also allow a relief period for the recognition and/or measurement of inventory. The IPSASB agreed that, even though inventory is a current asset which is realised, consumed, sold or used in an entity's operating cycle, a first-time adopter may need time to identify and classify its assets appropriately between inventory, investment property or property, plant and equipment, particularly in respect of land. Inventory may also comprise specialized assets or high volumes of items, e.g. medical supplies, for which additional time may be required for appropriate classification.
- BC49. In considering whether a relief period should be allowed for the recognition of biological assets and agricultural produce, the IPSASB noted that these assets and activities may be limited in some jurisdictions while they may be more significant in other jurisdictions, for example, developing countries. On balance, the IPSASB agreed that a three year relief period should be provided for the recognition of biological assets and agricultural produce to assist those jurisdictions where this is a significant issue.
- BC50. IPSAS 5 allows a first-time adopter to either adopt the benchmark treatment or the allowed alternative treatment in accounting for borrowing costs incurred on qualifying assets. When a first-time adopter elects to apply the allowed alternative treatment, there may a timing difference between the capitalization of borrowing costs on qualifying assets where the first-time adopter takes advantage of the three year transitional relief period to not recognize certain assets. To address this timing difference, and because it might not be practical to obtain information on borrowing costs incurred prior to the recognition of the asset where the first-time adopter takes advantage of the three year transitional exemption period, the IPSASB agreed that a first-time adopter should not be required to capitalize any borrowing costs on qualifying assets for which the commencement date for capitalization is prior to the date of adoption of accrual basis IPSASs. Based on comment

received from respondents on the proposed Exposure Draft, the IPSASB also agreed that any borrowing costs incurred during the period of transition should also not be capitalized until the exemptions that provided the relief have expired and/or when the relevant assets are recognized in accordance with the applicable IPSASs (whichever is earlier).

- BC51. After comment received on the proposed IPSAS, the IPSASB also agreed that a first-time adopter may change its accounting policy in respect of the recognition and/or measurement of assets and/or liabilities on a class-by-class or category-by-category basis where the use of classes or categories are permitted in the applicable IPSAS.

Transitional Exemptions relating to the Measurement of Non-Financial Assets

- BC52. The IPSASB acknowledged that some entities may have recognized non-financial assets under their previous basis of accounting. The IPSASB therefore agreed that a three year transitional relief period should be allowed for the measurement of all non-financial assets that were recognized by a first-time adopter under its previous basis of accounting. During this transitional period, a first-time adopter will be able to develop reliable models for applying the principles in the IPSASs. During the transitional period the first-time adopter will not be required to change its accounting policy in respect of the measurement of these assets.

Transitional Exemptions Relating to the Recognition of Liabilities

Interaction Between the Asset Standards and Other IPSASs

- BC53. Where a first-time adopter takes advantage of one or more of the transitional exemptions relating to the recognition of assets, it would, as part of this process, analyze title deeds, contracts and other similar arrangements, including lease arrangements, in determining what assets should be accounted for and their measurement. As a result, a first-time adopter may not be in a position to account for finance lease liabilities related to finance lease assets until such time as the transitional relief period provided has expired and/or the relevant assets are recognized in accordance with the applicable IPSASs (whichever is earlier).
- BC54. Likewise, where a first-time adopter has elected to adopt the transitional relief provided for the recognition of service concession assets in accordance with IPSAS 32, it will not be in a position to account for the related liability under either the financial liability model or the grant of a right to the operator model until such time as the transitional relief period provided has expired and/or the relevant assets are recognized and/or measured in accordance with IPSAS 32 (whichever is earlier).

- BC55. The IPSASB agreed that the recognition of finance lease liabilities and the recognition and/or measurement of liabilities related to service concession assets should also be delayed until the relief period related to the relevant assets have expired and/or the applicable assets have been recognized and/or measured.

Recognition of Provisions Included in the Initial Cost of Property, Plant and Equipment

- BC56. The IPSASB concluded that no transitional relief period should be provided for provisions in IPSAS 19 and that a first-time adopter should account for all its liabilities on the date of adoption of IPSASs. The IPSASB, however, acknowledges that the delay in the recognition and/or measurement of property, plant and equipment affects the recognition and/or measurement of certain provisions which are included in the cost of such assets.
- BC57. IPSAS 17 requires an entity to include, as part of the cost of an item of property, plant and equipment, the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation which an entity incurs either when the item is acquired, or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. IPSAS 17 requires that the obligation for costs accounted for in accordance with IPSAS 17 is recognized and measured in accordance with IPSAS 19.
- BC58. The IPSASB agreed that it would not be possible to recognize and/or measure provisions for the initial estimate of costs to dismantle and remove the item and restore the site on which it is located until such time as the relevant item of property, plant and equipment is recognized and/or measured in accordance with IPSAS 17. A transitional relief period was therefore also provided for the recognition and/or measurement of the provision to address the timing difference.

IPSAS 39, Employee Benefits

- BC59. The IPSASB acknowledged that the recognition and/or measurement of specific liabilities in IPSAS 39, will be challenging for many public sector entities as new systems may be required and/or existing systems may need to be upgraded. The IPSASB therefore agreed that a first-time adopter should be given a three year relief period for the recognition and/or measurement of assets and liabilities related to defined benefit plans and other long-term employee benefits. To avoid a skewed statement of financial position, the IPSASB further agreed that any plan assets should be recognized and/or measured at the same time as the liabilities. All other employee benefits should be recognized and/or measured on the date of adoption of IPSASs.

BC60. [Deleted]

Transitional Exemptions Relating to the Recognition and Measurement of Monetary Assets and/or Liabilities

IPSAS 29, Financial Instruments: Recognition and Measurement

- BC61. The existing transitional provisions in IPSAS 29 do not provide any relief to a first-time adopter for the recognition and/or measurement of financial instruments. Because many public sector entities will need some time to identify and appropriately classify their financial instruments, the IPSASB agreed that a transitional relief period should be provided to a first-time adopter for the recognition and/or measurement of financial instruments. A transitional relief period of three years was granted in line with the relief period provided for the recognition and/or measurement of other items.
- BC62. The IPSASB, however, agreed that a distinction should be made between those entities that previously recognized financial instruments and those that did not. The IPSASB was of the view that many basic financial instruments such as cash, debtors and creditors are already recognized by public sector entities. A three year relief period for the recognition of financial instruments that have not been recognized under a first-time adopter's previous basis of accounting, is therefore provided.
- BC63. As with non-monetary assets, the IPSASB agreed that the same principle should be applied to the recognition and/or measurement of monetary assets and/or liabilities, i.e. to the extent that a first-time adopter has recognized financial instruments under its previous basis of accounting, the IPSASB agreed that a three year relief period should be granted for the measurement and classification of financial instruments following the date of adoption of IPSASs. During this transitional period, a first-time adopter will be able to develop reliable models for applying the principles in IPSAS 29. It would also be allowed to apply accounting policies for the measurement of financial instruments that differs from the requirements in IPSAS 29 during the period of transition.

Transitional Exemptions Relating to the Recognition and Measurement of Non-Exchange Revenue

IPSAS 23, Revenue from Non-Exchange Transactions (Taxes and Transfers)

- BC64. The existing transitional provisions in IPSAS 23 allow a first-time adopter to not change its accounting policy in respect of the recognition and measurement of taxation revenue for a period of five years. IPSAS 23 also allows a first-time adopter to not change its accounting policy in respect of recognition and measurement of revenue from non-exchange transactions, other than taxation revenue, for a period of three years. It also requires that

changes in accounting policies should only be made to better conform to IPSAS 23.

- BC65. The IPSASB concluded that it will be challenging for many public sector entities to implement IPSAS 23 as new systems may be required and/or existing systems may need to be upgraded. Because of these practical challenges, the IPSASB agreed that a transitional relief period should be provided. The IPSASB, however, acknowledged that a first-time adopter should build up models to assist with the transition to accrual accounting prior to the adoption of the accrual basis. In line with the relief period of three years provided for the recognition of assets and/or liabilities in other IPSASs, and in line with the existing three year transitional relief period provided for other non-exchange revenue in IPSAS 23, it was agreed that a first-time adopter should be granted a relief period of three years to develop reliable models for recognizing and measuring revenue from non-exchange transactions. The IPSASB agreed that a transitional period of three years is manageable, and reduces the period over which an entity will not be able to assert compliance with accrual basis IPSASs. During the period of transition, a first-time adopter will be allowed to apply accounting policies for the recognition of non-exchange revenue transactions that do not comply with the provisions in IPSAS 23.

Exemptions from Presentation and/or Disclosure Requirements Where a First-time Adopter Takes Advantage of the Exemptions that Provide a Three Year Transitional Relief Period

- BC66. The IPSASB acknowledged and agreed that the three year exemption provided for the recognition and/or measurement of assets and/or liabilities also implies that the associated presentation and/or disclosure requirements in the applicable IPSASs do not need to be complied with as the information will not be available. The IPSASB agreed that the information need not be provided until the exemptions that provided the relief have expired or when the relevant assets and/or liabilities are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).
- BC67. For the same reason, the IPSASB agreed that a first-time adopter should not be required to provide any related disclosure requirements in IPSAS 1, *Presentation of Financial Statements* and IPSAS 18, *Segment Reporting*.

IPSAS 5, Borrowing Costs

- BC68. The existing transitional provisions in IPSAS 5 encouraged a first-time adopter to adjust its financial statements retrospectively if it did not recognize borrowing costs under its previous basis of accounting. The IPSASB agreed that it does not want to provide more relief to a first-time adopter than to those entities that already apply IPSASs, particularly where the first-time adopter elects to adopt the allowed alternative treatment under which borrowing costs

that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalized as a part of the cost of an asset.

- BC69. As a result, the IPSASB agreed that a first-time adopter should only be encouraged to apply the requirements of IPSAS 5 retrospectively where it adopts or changes its accounting policy to the benchmark treatment. Providing this relief was seen a necessary because obtaining information retrospectively may be costly and considerable effort may be needed to obtain such information.
- BC70. The IPSASB, however acknowledged that some information may be available to a first-time adopter depending on its previous basis of accounting. It was therefore agreed that a first-time adopter who adopted or changed its accounting policy to the benchmark treatment, should apply the principles in IPSAS 5 prospectively, but it may designate a date before the date of adoption of IPSASs in applying IPSAS 5. This relief can only be adopted to the extent that the information is available.
- BC71. The IPSASB does not want to encourage first-time adopters to adopt the allowed alternative treatment. Therefore it was agreed that where a first-time adopter changes its accounting policy to the allowed alternative treatment, any borrowing costs incurred on qualifying assets both before and after the date of adoption of IPSASs, for which the commencement date for capitalization is prior to the date of adoption of IPSASs, should be recognized retrospectively where the first-time adopter has not taken advantage of the transitional relief to not recognise and/or measure assets for a period of three years.

IPSAS 34, Separate Financial Statements, IPSAS 35, Consolidated Financial Statements and IPSAS 36, Investments in Associates and Joint Ventures

- BC72. The IPSASB considered whether it should provide transitional relief that allows a first-time adopter to not present consolidated financial statements on adoption of IPSASs. In considering this proposal, it was argued that providing such an exemption would contradict the concept of a reporting entity and would not result in fair presentation.
- BC73. The IPSASB therefore agreed that providing a relief period to not present consolidated financial statements should not be provided, but instead, a first-time adopter should be given a three year relief period from eliminating balances, transactions, revenues and expenses between entities within the economic entity.
- BC74. As some balances, transactions revenues and expenses may be known on adoption of IPSASs, a first-time adopter is encouraged to eliminate only those known balances, transactions revenues and expenses.

- BC75. For the same reason, the IPSASB agreed that a similar exemption should also be provided where a first-time adopter has one or more jointly controlled entity in terms of IPSAS 8, and where it has one or more associate in terms of IPSAS 7.

Providing a three year relief for the initial recognition and/or measurement of interests in other entities

- BC76. Following comments received on Exposure Draft, the IPSASB agreed that relief should be provided to a first-time adopter for the initial recognition and/or measurement of its interests in other entities. This relief would allow those first-time adopters that have not gathered the necessary information on the date of adoption, more time to appropriately classify and measure their interests in other entities. The relief provided is consistent with that provided for financial instruments.

Presenting consolidated financial statements where the three year relief is adopted for the initial recognition and/or measurement of interests in other entities and/or to not eliminate inter-entity balances, transactions, revenue and expenses

- BC77. Some respondents to the Exposure Draft expressed a view that relief should be provided from preparing consolidated financial statements where a first-time adopter has elected to not eliminate some, or all of the inter-entity balances, transactions, revenue and expenses between entities within the economic entity. The IPSASB concluded that the financial statements that are presented where a first-time adopter has taken advantage of the three year relief for the initial recognition and/or measurement of interests in other entities, and/or where it has elected to not eliminate some, or all inter-entity balances, transactions, revenue and expenses, cannot be presented as consolidated financial statements, until (a) the exemptions that provided the relief have expired, and/or (b) inter-entity balances, transactions, revenue and expenses have been eliminated, and/or (c) its interests other entities have been recognized and/or measured appropriately. The IPSASB agreed that disclosure requirements should be added to explain to users why the financial statements are not presented as consolidated financial statements.
- BC78. The IPSASB agreed that providing this clarification is necessary because, where a first-time adopter has not eliminated inter-entity balances, transactions, revenue and expenses as required by IPSAS 35 preparing consolidated financial statements will merely be an aggregation of inter-entity balances, transactions, revenue and expenses within the economic entity. Such statements would not be useful for accountability and decision-making purposes.
- BC79. Likewise eliminating the carrying amount of an investment in the controlled entity as required by IPSAS 35 may not be possible if the first-time adopter

has not recognized and/measured its interest in other entities as required by the applicable IPSASs.

IPSAS 40, Public Sector Combinations

BC79A. In developing IPSAS 40, *Public Sector Combinations*, the IPSASB considered whether it should provide transitional relief that allows a first-time adopter not to recognize and/or measure all the assets and/or liabilities associated with a public sector combination. The IPSASB noted that IPSAS 40 is applied prospectively, and so its application would not require a first-time adopter to adjust their accounting for a public sector combination that occurred prior to the application of that Standard. However, a public sector combination could occur during a first-time adopter's three year transitional relief period. The IPSASB considered that requiring a first-time adopter to recognize and measure all the assets and liabilities associated with a public sector combination without requiring them to recognize and measure all similar assets and liabilities would not provide useful information for the users of the financial statements.

BC79B. Consequently, the IPSASB agreed to provide transitional relief that allows a first-time adopter not to recognize and/or measure all the assets and/or liabilities associated with a public sector combination as part of this Standard. The IPSASB also agreed that a first-time adopter should not recognize goodwill where it did not recognize and/or measure all the assets and/or liabilities associated with a public sector combination.

Exemptions that Do Not Affect Fair Presentation and Compliance with Accrual Basis IPSAS

Deemed Cost

Deemed Cost for Assets and/or Liabilities

BC80. Some measurements in accordance with IPSASs are based on an accumulation of past costs or other transaction data. If a first-time adopter has not previously collected the necessary information, collecting or estimating it retrospectively may be costly and/or impractical. To avoid excessive cost, this IPSAS allows a first-time adopter to use the fair value as a substitute for the initial cost of inventory, investment property where the first-time adopter elects to use the cost model in IPSAS 16, property, plant and equipment, financial instruments and service concession assets at the date of adoption of IPSASs. Where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets, the fair value is the deemed cost at the date at which the asset is recognized and/or measured during the period of transition.

- BC81. While it could be argued that the use of fair value would lead to a lack of comparability, the IPSASB noted that cost is generally equivalent to fair value at the date of acquisition. Therefore, the use of fair value as the deemed cost of an asset means that a first-time adopter reports the same cost data as if it had acquired an asset with the same value or same remaining service potential at the date of adoption of IPSASs. If there is any lack of comparability, it arises from the aggregation of costs incurred at different dates, rather than from the use of fair value as deemed cost for some assets at a date. In the view of the IPSASB, using deemed cost facilitates the introduction of IPSASs in a cost-effective way.
- BC82. Under the revaluation model in IPSAS 17, if an entity revalues an asset, it must revalue all assets in that class. This restriction prevents selective revaluation of only those assets whose revaluation would lead to a particular result. The IPSASB considered whether a similar restriction should be included in determining a deemed cost. IPSAS 21, *Impairment of Non-cash-generating Assets* and IPSAS 26, *Impairment of Cash-generating Assets* requires an impairment test if there is any indication that an asset is impaired. Thus, if a first-time adopter uses fair value as deemed cost for assets whose fair value is likely to be above cost, it cannot ignore indications that the recoverable amount or recoverable service amount of other assets may have fallen below their carrying amount.
- BC83. The IPSASB also considered the circumstances under which a first-time adopter should be allowed to determine a deemed cost on initial adoption of IPSAS, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets. The IPSASB considered whether the use of a deemed cost should be restricted to those situations where cost information is not available for assets, or whether it should be allowed in all circumstances, irrespective of whether cost information is available on the date of adoption of IPSASs, or the date on which the asset is recognized and/or measured where a first-time adopter has taken advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets.
- BC84. The IPSASB agreed that, to avoid the selective valuation of assets, the use of a deemed cost should be restricted to those circumstances where reliable information about the historical cost of the asset is not available.

Deemed Cost for Investments in Controlled Entities, Joint Ventures or Associates

- BC85. The IPSASB also agreed that a first-time adopter may elect to measure an investment in a controlled entity, joint venture or associate at cost in its separate financial statements on the date of adoption of IPSASs at either cost as determined in accordance with IPSAS 6, or deemed cost. Deemed

cost is determined as fair value in accordance with IPSAS 29, *Financial Instruments: Recognition and Measurement*.

Deemed Cost for Intangible Assets

- BC86. In considering whether a first-time adopter should be allowed to determine a deemed cost for intangible assets, the IPSASB considered the existing transitional provisions in IPSAS 31. IPSAS 31 allows a first-time adopter to use a previous revaluation of intangible assets at, or before, the date of transition as deemed cost at the date of the revaluation if the revaluation is broadly comparable to fair value or cost or depreciated cost that is adjusted to reflect for example, changes in a general or specific price index. IPSAS 31, however, only allows a first-time adopter to determine a deemed cost if the recognition criteria in IPSAS 31 (including the reliable measurement of original cost), and the criteria for revaluation (including the existence of an active market), have been met.
- BC87. The IPSASB debated whether public sector entities will be likely to fulfil the second criterion on initial adoption of IPSAS, i.e. existence of an active market. The IPSASB acknowledged that it may be uncommon for an active market to exist in the public sector for intangible assets, and as a consequence, the use of the deemed cost approach will likely be considerably restricted. As a result, a first-time adopter may be unable to determine a deemed cost for some intangible assets such as in-house developed IT systems.
- BC88. The IPSASB considered whether the reliable measurement of original cost should be required for first-time adopters which previously applied a cash basis of accounting, as some entities might find it cumbersome to identify the original cost of their intangible assets. It was also argued that where a first-time adopter has previously applied the accrual basis of accounting and it has acquired intangible assets through a non-exchange transaction, it might not be able to reliably measure original cost.
- BC89. Based on these considerations, the IPSASB concluded that the reliable measurement of the original cost should be excluded as a criterion for the application of the deemed cost approach on first-time adoption of IPSASs.
- BC90. The IPSASB therefore agreed that a first-time adopter is allowed to determine a deemed cost for intangible assets where that deemed costs meets: (a) the recognition criteria in IPSAS 31 (excluding the reliable measurement criterion) and (b) the criteria in IPSAS 31 for revaluation (including the existence of an active market).
- BC91. In considering whether a first-time adopter should be allowed to determine a deemed cost for internally generated intangible assets, the IPSASB concluded that it would be difficult to retrospectively assess the probability of expected future economic benefits or service potential through reasonable and supportable assumptions as management would not be able to apply hindsight

in obtaining such information. Due to the absence of reliable information on the date of adoption of IPSASs, it was therefore agreed that a deemed cost may not be determined for internally generated intangible assets.

Alternative Measurement Bases for Fair Value in Determining Deemed Cost

- BC92. The IPSASB considered whether some revaluations in accordance with a first-time adopter's previous basis of accounting might be more relevant to users than original cost. It was concluded that it would not be reasonable to require a time-consuming and expensive estimation of cost, if previous revaluations already comply with IPSASs. This IPSAS therefore allows a first-time adopter to use a revaluation under its previous basis of accounting for property, plant and equipment determined at or before the date of adoption of IPSASs, as deemed cost. This may be used if the revaluation is, at the date of the revaluation, broadly comparable to:
- (a) Fair value; or
 - (b) Cost or depreciated cost, where appropriate, in accordance with IPSASs adjusted to reflect, for example, changes in a general or specific price index.
- BC93. In determining "fair value", the guidance in each applicable IPSAS is considered, where such guidance is provided. In IPSAS 17 it is noted that fair value is normally determined by reference to market-based evidence, often by appraisal. IPSAS 17 also states that if market based evidence is not available to measure items of property, plant and equipment, an entity can estimate fair value using replacement cost, reproduction cost or a service units approach.
- BC94. The IPSASB noted that the fair value guidance in IPSAS 16 only considers a market-based value, and that limited guidance is provided in IPSAS 12 in determining fair value. The IPSASB concluded that because a first-time adopter may find it difficult to determine a market-based fair value for all investment properties and all inventories, other measurement alternatives may need to be considered in determining deemed cost for inventory or investment property.
- BC95. The IPSASB agreed that a first-time adopter may consider the following measurement alternatives in determining a deemed cost if reliable market-based evidence of fair value is not available on the date of adoption of IPSASs, or on the date that the asset is recognized and/or measured where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets:
- (a) For inventory, current replacement cost; and

- (b) For investment property of a specialized nature, depreciated replacement cost.

Determining a Deemed Cost Where the First-Time Adopter has Taken Advantage of the Three Year Transitional Exemption Period

- BC96. The IPSASB concluded that, to the extent that a first-time adopter has elected to adopt one of more of the transitional exemptions that provides relief for the recognition and/or measurement of assets, it may not be able to retrospectively adjust the value of the asset to the date of adoption of accrual basis IPSASs. Retrospectively adjusting the value of the asset would require consideration of the price of the asset and other market factors that existed on the date of adoption of accrual basis IPSASs, including whether there was any indication that the asset was impaired.
- BC97. The IPSASB concluded that this would not be cost effective. It was therefore agreed that, where a first-time adopter takes advantage of the exemption which allows a three year transitional relief period to not recognize and/or measure an asset, it may determine a deemed cost for that asset at any point of time within the three year transitional relief period. Any adjustments resulting from the recognition of the asset are recognized against the opening accumulated surplus or deficit in the year in which asset is recognized and/or measured.

IPSAS 18, Segment Reporting

- BC98. The IPSASB considered whether relief should be provided to a first-time adopter for the presentation of segment information. The IPSASB agreed that, despite the fact that the presentation of segment information might be useful, a first-time adopter should be provided a relief period, as the information used in presenting segment information needs to be built on existing information in the financial statements.
- BC99. As the IPSASB agreed to allow a three year transitional relief period for the recognition and/or measurement of assets and liabilities, the information which is needed to present segment information may only be available when the exemptions that provided the relief have expired, or when the relevant items are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier). As relevant and reliable information may not be available to present a meaningful segment report during the period of transition, and because the presentation of a segment report may not be a priority for users during the transition to accrual basis IPSASs it was agreed that a three year exemption period should also be provided for the presentation of segment information.

BC100. The IPSASB also concluded that, because segment information is additional to the information required on the elements presented in the financial statements, allowing this relief is appropriate.

IPSAS 20, Related Party Disclosures

BC101. In providing a first-time adopter time to build up information on its related party relationships and related party transactions, the IPSASB agreed that the disclosure of related party relationships, related party transactions and information about key management personnel should be treated in the same way as the required eliminations of balances, transactions, revenue and expenses between entities in IPSAS 6 to 8.

BC102. This IPSAS therefore provides a transitional exemption for a period of three years for the disclosure of related party relationships, related party transactions and information about key management personnel.

IPSAS 21, Impairment of Non-Cash-Generating Assets and IPSAS 26, Impairment of Cash-Generating Assets

BC103. The IPSASB acknowledged that a first-time adopter may have applied an accounting policy for the recognition and reversal of impairment losses that are different to the requirements in IPSAS 21 and 26, or may have not considered impairment at all. On adoption of IPSASs, it may be difficult to determine the amount of adjustments resulting from retrospective application of a change in an accounting policy, as this requires hindsight.

BC104. As a result, the IPSASB agreed that IPSAS 21 and 26 should be applied prospectively, but that the first-time adopter should be required to assess whether an indicator of impairment has been triggered for its cash-generating and non-cash-generating assets in the opening statement of financial position.

BC105. In recognizing the effect of an impairment loss on first-time adoption of IPSAS 21 or IPSAS 26, the IPSASB considered two options. The first option was to measure such assets at their recoverable amount, or recoverable service amount and use that as the deemed cost. The IPSASB noted that the effect of applying this option may mean that impairment losses could not be reversed in the future. This option was therefore not seen as appropriate.

BC106. The second option, which provides more relevant information is to measure the assets at their recoverable amount, or recoverable service amount, and report the effect in net assets/equity. The IPSASB supported this option.

Timing of Impairment Test for Assets Where an Entity Adopts the Relief Period for the Recognition of Assets

- BC107. The IPSASB concluded that where a first-time adopter takes advantage of the exemption that provides relief for the recognition and/or measurement of assets, it may be difficult to retrospectively adjust the value of the asset to the date of adoption of IPSASs. A first-time adopter may find it difficult to determine the amount of adjustments that would be required based on impairment that may or may not have existed at the date of transition.
- BC108. The IPSASB therefore agreed that IPSAS 21 and IPSAS 26 should be applied prospectively from the date when the transitional exemptions that provided the relief have expired, or when the relevant asset is recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).

IPSAS 39, Employee Benefits

- BC109. The IPSASB also agreed that, where a first-time adopter takes advantage of the exemptions that provide relief for the recognition and/or measurement of liabilities, it should provide information about amounts for the current and previous four annual periods of the present value of the defined benefit obligation, the fair value of the plan assets, and the surplus or deficit in the plan and adjustments as required by IPSAS 39 prospectively.

IPSAS 28, Financial Instruments: Presentation

- BC110. IPSAS 28 requires an entity to split a compound financial instrument at inception of the agreement, into separate liability and equity components. It was concluded that separating these two portions would be costly and would not provide relevant information to users of financial statements if the liability component of the compound instrument is no longer outstanding at the date of adoption of IPSASs. As a result, this IPSAS requires that, if the liability component is no longer outstanding at the date of adoption of IPSAS, the first-time adopter need not separate the cumulative interest on the liability component from the net assets/equity component.

IPSAS 29, Financial Instruments: Recognition and Measurement

- BC111. The IPSASB concluded that, as it is in most instances impracticable to apply impairment principles retrospectively, the impairment of financial instruments should be applied prospectively. This exemption is consistent with the exemption provided for non-cash-generating assets and cash-generating assets in accordance with IPSAS 21 and 26.

IPSAS 30, Financial Instruments: Disclosures

- BC112. The IPSASB concluded that if a first-time adopter did not disclose information relating to financial instruments, and the nature and extent of risks arising

from financial instruments under its previous basis of accounting, obtaining such information may be costly, and therefore is not feasible.

BC113. The IPSASB therefore agreed that the disclosure requirements relating to financial instruments should be applied prospectively from the date of adoption of IPSAS, or where the first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure financial assets, when the exemptions expire, or when the relevant items are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).

BC114. To the extent that a first-time adopter elects to present comparative information, it was agreed that a first-time adopter need not present comparative information for disclosures relating to the nature and extent of risks arising from financial instruments for the comparative period because obtaining such information may be costly, and is therefore not feasible.

IPSAS 31, Intangible Assets

BC115. On first-time adoption of IPSASs, a first-time adopter will be required to recognize all assets and liabilities for which recognition is required by IPSASs. IPSAS 31 requires that past expenditure on an intangible asset that was initially recognized as an expense should not be recognized as part of the cost of an intangible asset at a later date.

BC116. The IPSASB concluded that, because a first-time adopter may have expensed costs incurred on intangible assets under its previous basis of accounting prior to the adoption of IPSASs, a first-time adopter should be allowed to recognize all intangible assets that meet the recognition criteria and other criteria in IPSAS 31 (i.e., identifiable control of an asset and that future economic benefits or service potential that are attributable to the asset will flow to the entity), even though such costs may have been expensed prior to adoption of IPSASs. It was however, confirmed that such assets should only be recognized as intangible assets if reliable cost information is available and an active market exists for that asset on the date of adoption of IPSASs.

Interests in Other Entities

BC117. The IPSASB considered whether IPSAS 33 should refer to IPSAS 6, *Consolidated and Separate Financial Statements*, IPSAS 7, *Investments in Associates*, and IPSAS 8, *Interests in Joint Ventures*, as well as IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements*, and IPSAS 36, *Investments in Associates and Joint Ventures*, which were published in January 2015 with an effective date of January 1, 2017, with early adoption permitted. The IPSASB noted that as IPSAS 33 was published in January 2015, any entity adopting IPSAS 33 and electing to apply the 3 year exemptions, would be required to apply IPSASs 34–36 by the time the transitional period is complete. The IPSASB formed a view that

it was very unlikely that entities adopting IPSAS 33, prior to January 1, 2017, would adopt IPSASs 6–8 as this would require a further transition to IPSAS 34–36 shortly afterwards. The IPSASB therefore concluded that IPSAS 33 should not include provisions relating to IPSASs 6–8.

Revision of IPSAS 33 as a result of the IPSASB’s *The Applicability of IPSASs*, issued in April 2016

BC118. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

- (a) Removes the standard paragraphs about the applicability of IPSASs to “public sector entities other than GBEs” from the scope section of each Standard;
- (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and
- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 33.

- IG1. The purpose of this Implementation Guidance is to illustrate certain aspects of the requirements of IPSAS 33.

Date of Adoption of IPSASs

- IG2. The date of adoption of IPSASs is the date an entity adopts accrual basis IPSAS for the first time in preparing its financial statements.
- IG3. Prior to the adoption of this IPSAS, a first-time adopter shall have adequately prepared for its transition to accrual basis IPSASs. The guidance provided in Study 14, *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities* issued by the IPSASB, may assist a first-time adopter with planning the conversion to accrual basis IPSASs. The relief provided in this IPSAS shall therefore not be seen as a complete roadmap for the adoption of accrual basis IPSASs, but rather the end stage of the adoption process.
- IG4. A first-time adopters' date of adoption will therefore to be the start of the reporting period in which it elects to adopt accrual basis IPSASs for which it presents its transitional IPSAS financial statements or its first IPSAS financial statements. For example, an entity elects to adopt accrual basis IPSASs from January 1, 20X1 for its reporting period ending December 31, 20X1. The date of adoption of IPSASs will be January 1, 20X1.

Transitional IPSAS Financial Statements

- IG5. On the date of adoption of IPSASs, a first-time adopter may elect to adopt one of more of the exemptions included in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)*. Some of the exemptions included in IPSAS 33 affect the fair presentation of a first-time adopter's financial statements and its ability to assert compliance with accrual basis IPSASs (Appendix A lists the transitional exemptions and provisions that a first-time adopter is required to apply and/or can elect to apply on adoption of accrual basis IPSASs and illustrates whether fair presentation and the first-time adopter's ability to assert compliance with accrual basis IPSASs will be affected).
- IG6. As a first-time adopter is not able to make an explicit and unreserved statement of compliance with accrual basis IPSASs following the adoption of the exemptions provided in IPSAS 33, the financial statements presented for the first reporting period following the adoption of accrual basis IPSASs, will be referred to as the "transitional IPSAS financial statements".

- IG7. For example, if the first-time adopter adopts the transitional exemption that provides relief for the recognition of certain items of property, plant and equipment when adopting accrual basis IPSASs on January 1, 20X1, it would not be able to make an explicit and unreserved statement of compliance with accrual basis IPSASs at the end of its first reporting period, i.e. December 31, 20X1. The financial statements prepared for the first reporting period, will therefore be referred to as the “first transitional IPSAS financial statements”.
- IG8. The financial statements presented during the period of transition until the exemptions that provided the relief have expired, and/or when the relevant items are recognized and/or measured in the financial statements in accordance with the applicable IPSASs, will be referred to as the “transitional IPSAS financial statements”.

Basis of Preparation When Preparing Transitional IPSAS Financial Statements

- IG9. As stated in paragraph 27 of IPSAS 33, a first-time adopter that elects to adopt one or more of the exemptions included in IPSAS 33, may not be able to make an explicit and unreserved statement of compliance with accrual basis IPSASs as required by IPSAS 1. During the period of transition, this fact shall be highlighted to the users of financial statements in presenting the “basis of preparation” in the financial statements.
- IG10. As an illustration, if a first-time adopter elected to adopt the transitional exemption that allows it three years in which to recognize and/or measure investment property, the following explanation may be provided in the “basis of preparation” paragraph in the financial statements during the period of transition:

Basis of preparation

The financial statements have been prepared in accordance with accrual basis International Public Sector Accounting Standards (IPSASs). IPSAS 33 allows a first-time adopter a period of up to three years to recognize and/or measure certain assets and/or liabilities.

In its transition to accrual basis IPSASs, Public Sector Entity X took advantage of this transitional exemption for investment property. As a result, it is unable to make an explicit and unreserved statement of compliance with accrual basis IPSASs in preparing its transitional IPSAS financial statements for this reporting period. Public Sector Entity X intends to recognize and/or measure its investment property by 20X3.

First IPSAS Financial Statements

- IG11. A first-time adopter's first IPSAS financial statements will be the first set of financial statements that it presents in which it makes an explicit and unreserved statement of compliance with accrual basis IPSASs.
- IG12. A first-time adopter will not be able to prepare its first IPSAS financial statements until the exemptions in IPSAS 33 that provided relief which affected fair presentation and compliance with IPSAS, have expired, or when the relevant items are recognized, measured and/or the relevant information has been presented and/or disclosed in accordance with the applicable IPSASs (whichever is earlier).
- IG13. Following from the example in IG5, the transitional exemptions that provided the relief for the recognition of certain items of property, plant and equipment expire after three years, i.e. December 31, 20X3. If it is assumed that the entity has not adopted any other transitional exemptions in IPSAS 33 that affect fair presentation and compliance with IPSASs, and that it recognizes and/or measures the items of property, plant and equipment during the transitional period, a first-time adopter will present its first IPSAS financial statements for the period ending December 31, 20X3.
- IG14. If a first-time adopter has not adopted any of the exemptions in IPSAS 33 that affect fair presentation and its ability to claim compliance with accrual basis IPSASs, its first accrual financial statements will also be its first IPSAS financial statements.

To illustrate:

Timeline – First Time Adoption IPSAS (assuming that entity elects to apply the three year transitional relief for the recognition and/or measurement of certain assets)

An entity adopts accrual basis IPSASs on 1 January 20X0 by applying IPSAS 33, *First Time Adoption of Accrual Basis IPSASs*

The first-time adopter elects to apply the three year relief for the recognition of property, plant and equipment. Assume that it does not adopt of any other relief periods. It also elects not to present comparative information.

The first-time adopter recognizes all property, plant and equipment by 31 December 20X2.

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

Start of second reporting period
1 January 20X1

Start of third reporting period
1 January 20X2

Year 1

Year 2

Year 3

Date of adoption
1 January 20X0

End of first reporting period
31 December 20X0

End of second reporting period
31 December 20X1

End of third reporting period
31 December 20X2

Year 1 (ending 31 December 20X0) – First Transitional IPSAS Financial Statements
Cannot assert compliance with accrual basis IPSASs

Present the following statements:
*opening statement of financial position as at 01/01/20X0
*statement of financial position as at 31/12/20X0
*statement of financial performance for 31/12/20X0
*statement of changes in net assets as at 31/12/20X0
*cash flow statement for 31/12/20X0
*statement of comparison of budget and actual information for 31/12/20X0
(depending on the policy chosen for presentation of information the first-time adopter may include an additional column in the annual financial statements)

Present the following in the notes:
*reconciliation of changes from its previous basis of accounting (reflect adjustments related to the adoption of all IPSASs besides IPSAS 17)

Note: If the first-time adopter elected to present comparative information, the following statements shall have been presented:
*opening statement of financial position as at 01/01/19X0
*statement of financial position as at 31/12/19X0 and 31/12/20X0
*statement of financial performance for 31/12/19X0 and 31/12/20X0
*statement of changes in net assets as at 31/12/19X0 and 31/12/20X0
*cash flow statement for 31/12/19X0 and 31/12/20X0
*statement of comparison of budget and actual information for 31/12/19X0 and 31/12/20X0

Year 2 (ending 31 December 20X1) – Transitional IPSAS Financial Statements
Cannot assert compliance with IPSASs

Present the following statements for both 31/12/20X1 and 20X0:
*statement of financial position
*statement of financial performance
*statement of changes in net assets
*cash flow statement

Present the statement of comparison of budget and actual information for 31/12/20X1 only (depending on policy chosen for presentation of information the first-time adopter may include an additional column in the annual financial statements)

Year 3 (ending 31 December 20X2) – First IPSAS Financial Statements
Can assert compliance with IPSASs

Present the following statements for both 31/12/20X2 and 20X1:
*statement of financial position
*statement of financial performance
*statement of changes in net assets
*cash flow statement

Present the statement of comparison of budget and actual information for 31/12/20X2 only (depending on policy chosen for presentation of information, the first-time adopter may include an additional column in the annual financial statements)

Present the following in the notes:
*reconciliation of adjustments made to recognize property, plant and equipment

Estimates

- IG15. Paragraph 23 of IPSAS 33 requires that a first-time adopter's estimates in accordance with IPSASs at the date of adoption of IPSASs shall be consistent with estimates made at the end of its comparative period in accordance with the previous basis of accounting (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error. An entity may receive information after the date of adoption of IPSASs about estimates that it had made under the previous basis of accounting. In accordance with paragraph 24, a first-time adopter shall treat the receipt of that information in the same way as non-adjusting events after the reporting period in accordance with IPSAS 14, *Events after the Reporting Period*.
- IG16. For example, assume that a first-time adopter's date of adoption of IPSASs is January 1, 20X4 and new information on July 15, 20X4 requires the revision of an estimate made in accordance with the previous basis of accounting at December 31, 20X3. The first-time adopter shall not reflect that new information in its opening statement of financial position (unless the estimates require adjustment for any differences in accounting policies or there is objective evidence that the estimates were in error). Instead, the first-time adopter shall reflect that new information in surplus or deficit for the year ended December 31, 20X4.

Transitional Exemptions that Provide Three Year Relief for the Recognition and/or Measurement of Assets and/or Liabilities

- IG17. IPSAS 33 provides a first-time adopter a period of up to three years' relief in which it is allowed to not recognize and/or measure certain assets and liabilities. Where a first-time adopter takes advantage of this exemption, it will have to consider and analyze title deeds, contracts and other similar arrangements in accounting for, and classifying these assets in accordance with the applicable IPSAS.
- IG18. For example, assume that a first-time adopter controls a wide range of property, plant and equipment when it adopts accrual basis IPSASs on January 1, 20X1. If the first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure the property, plant and equipment, it may recognize and/or measure the property, plant and equipment during the period of transition from January 1, 20X1 until December 31, 20X3. If the property, plant and equipment is recognized for example, on April 1, 20X2, the first-time adopter shall adjust the opening accumulated surplus or deficit on January 1, 20X2. As required by paragraph 142 of IPSAS 33, the first-time adopter shall, as part of the notes to the financial statements, provide a reconciliation to the accumulated surplus or deficit as at December 31, 20X1 (i.e. the opening balance as at

January 1, 20X2) for the property, plant and equipment that was recognized on April 1, 20X2.

- IG19. Where a first-time adopter has taken advantage of the three year relief period, it shall not derecognise any of the assets and/or liabilities that were recognized under its previous basis of accounting unless it is to comply with an IPSAS requirement. Any adjustments to the assets and/or liabilities recognized under its previous basis of accounting shall be adjusted during the period of transition against the opening accumulated surplus of deficit in the period in which the adjustment is made.

Accounting for Finance Leases Assets and Finance Lease Liabilities

- IG20. Where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize its finance lease assets, it will also not be able to comply with the recognition requirements relating to the finance lease liabilities, until the transitional exemptions related to the finance leased assets have expired, or the finance leased assets have been recognized in accordance with IPSAS 13.
- IG21. For example, assume that a first-time has a motor vehicle that is subject to a finance lease agreement on the date of adoption of accrual basis IPSASs on January 1, 20X1. The first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize the motor vehicle. The motor vehicle is recognized on December 31, 20X3 when the exemption expires. IPSAS 33 requires the first-time adopter to only recognize the corresponding finance lease liability for the motor vehicle on December 31, 20X3, i.e. on the date that the finance lease asset (the motor vehicle) is recognized.

Recognition of Provisions Included in the Initial Cost of an Item of Property, Plant and Equipment

- IG22. IPSAS 17 recognizes that in some cases, the construction or commissioning of an item of property, plant and equipment will result in an obligation for an entity to dismantle or remove the item of property, plant and equipment and restore the site on which the asset is located. An entity is required to apply IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* in recognising and measuring the resulting provision to be included in the initial cost of the item of property, plant and equipment.
- IG23. IPSAS 33 provides an exemption for the recognition of this liability. A first-time adopter is allowed to not recognize and/or measure the liability relating to the initial estimate of costs of dismantling and removing the item and restoring the site on which it is located, until such time as the exemption for IPSAS 17 expires and/or the relevant asset is recognized and/or measured and relevant information has been presented and/or disclosed in the financial statements in accordance with IPSAS 17 (whichever is earlier).

- IG24. For example, an entity adopts accrual basis IPSASs on January 1, 20X1 and takes advantage of the exemption in IPSAS 33 that provides a three year transitional relief period to not recognize a government owned nuclear power station. The first-time adopter determines a deemed cost for the asset on June 30, 20X3 and recognizes the asset on that date at CU1,000,000. The first-time adopter determines that it has a decommissioning obligation under IPSAS 19 of CU500,000 at the date of adoption of IPSASs. The obligation amounts to CU550,000 on June 30, 20X3 when the asset is recognized.
- IG25. IPSAS 33 requires the first-time adopter to only recognize and/or measure its obligation relating to the dismantling and restoring of the site on June 30, 20X3, i.e. the date on which the asset is recognized. The liability will be measured at CU550,000 which reflects the first-time adopter's obligation on the date that the asset is recognized. The first-time adopter shall, as part of the notes to the financial statements, provide a reconciliation to the accumulated surplus or deficit as at December 31, 20X2 (i.e. the opening balance as at January 1, 20X3) for the recognition of the obligation and the related asset that was recognized on June 30, 20X2.

Borrowing Costs Incurred on Qualifying Assets

- IG26. Paragraph 90 of IPSAS 33 requires that, where a first-time adopter elects to account for borrowing costs in accordance with the allowed alternative treatment, it is required to apply the requirements in IPSAS 5, *Borrowing Costs* retrospectively, for any borrowing costs incurred on qualifying assets before the date for adoption of IPSASs.
- IG27. Paragraph 44 of IPSAS 33 provides an exemption to this requirement by allowing a first-time adopter to commence capitalization of borrowings costs incurred on qualifying assets after the recognition of an asset where the first-time adopter takes advantage of the exemption that provides a three year transitional relief period for the recognition of assets.
- IG28. For example, a first-time adopter adopts the allowed alternative treatment in accounting for borrowing costs incurred on qualifying assets. The date of adoption of IPSASs is January 1, 20X1. The first-time adopter determines that the borrowing cost incurred prior to the adoption of IPSASs on January 1, 20X1 amounts to CU500,000 and that borrowing costs incurred at the end following two reporting periods amounted to CU20,000 and CU30,000. In addition, the first-time adopter adopts the exemption that provides three year transitional relief from the recognition of property, plant and equipment and as a result, recognizes the item of property, plant and equipment at the end of the second reporting period at CU1,000,000.

At the end of 20X2, the item of property, plant and equipment recognized on the statement of financial position will be CU1,030,000 (CU1,000,000 + CU30,000). Borrowing costs incurred prior to the recognition of the item of

property, plant and equipment, i.e. CU500,000 and CU20,000 shall not be included as part of the cost of the qualifying asset.

Presenting Comparative Information

IG29. Paragraph 78 of IPSAS 33 encourages, but does not require an entity to present comparative information in its transitional IPSAS financial statements or its first IPSAS financial statements in accordance with this IPSAS. The decision to present comparative information affects not only the extent of the information presented, but also the date of adoption of IPSASs.

Date of Adoption of IPSASs

IG30. To illustrate: The end of a first-time adopter's first accrual basis reporting period is December 31, 20X5. The first-time adopter decides to present comparative information in those financial statements for one year only (see paragraph 78 of IPSAS 33). Therefore, its date of adoption of IPSASs is the beginning of the comparative period i.e. January 1, 20X4 (or equivalently December 31, 20X3).

Information Presented when a First-Time Adopter Elects to Prepare Comparative Information

- IG31. Where the first-time adopter elects to prepare comparative information, it is required to apply the accrual basis IPSASs effective for periods ending on December 31, 20X5 in:
- (a) Preparing and presenting its opening accrual basis statement of financial position at January 1, 20X4; and
 - (b) Preparing and presenting its:
 - (i) Statement of financial position for December 31, 20X5 (including comparative amounts for 20X4);
 - (ii) Statement of financial performance (including comparative amounts for 20X4);
 - (iii) Statement of changes in net assets/equity for December 31, 20X5 (including comparative amounts for 20X4);
 - (iv) Statement of cash flows for the year to December 31, 20X5 (including comparative amounts for 20X4);
 - (v) Disclosures (including comparative information for 20X4);
 - (vi) A comparison of budget and actual amounts for the year to December 31, 20X5; and
 - (vii) Reconciliations in accordance with paragraph 142.

First-Time Adopter Elects to Not Prepare Comparative Information

IG32. Where a first-time adopter elects to not prepare comparative information, it is required to apply the accrual basis effective for periods ending on December 31, 20X5:

- (a) Preparing and presenting its opening accrual basis statement of financial position at 1 January 20X5; and
- (b) Preparing and presenting its:
 - (i) Statement of financial position for December 31, 20X5;
 - (ii) Statement of financial performance for December 31, 20X5;
 - (iii) Statement of changes in net assets/equity for December 31, 20X5;
 - (iv) Statement of cash flows for the year to December 31, 20X5;
 - (v) Disclosures;
 - (vi) A comparison of budget and actual amounts for the year to December 31, 20X5; and
 - (vii) Reconciliations in accordance with paragraph 142.

Adoption of Three Year Transitional Relief Period

IG33. Where the first-time adopter takes advantage of the exemptions that provide relief from the recognition and/or measurement of assets and/or liabilities, IPSAS 33 requires it to only adjust comparative information for reporting periods following the date of adoption of IPSASs to the extent that reliable and relevant information is available about the items that have been recognized and/or measured.

IG34. To illustrate: The end of a first-time adopter's first accrual basis reporting period is December 31, 20X2. The first-time adopter on the date of adoption of IPSASs on January 1, 20X1, adopts the transitional exemption providing a three year relief period for the recognition of investment property. At the end of 20X3 the first-time adopter has recognized the investment property, which is included in the statement of financial position as at December 31, 20X3. Only if reliable and relevant information is available about the value of the investment property recognized during 20X3, will the first-time adopter adjust the comparative information presented (i.e., for the period ending December 31, 20X2).

Presenting Reconciliations

IG35. Paragraph 142 of IPSAS 33 requires a first-time adopter to present a reconciliation of its closing balances reported under its previous basis of accounting, to its net assets/equity in accordance with IPSASs for the

transitional IPSAS financial statements or its first IPSAS financial statements. A reconciliation is presented of its surplus or deficit in accordance with its previous basis of accounting to its opening balance of surplus or deficit at the date of adoption of IPSASs.

- IG36. For example, a first-time adopter, which previously applied a modified-accrual basis of accounting, adopts accrual basis IPSASs on January 1, 20X4 and elects to present comparative information as permitted in IPSAS 33. The first-time adopter shall, in accordance with paragraphs 142 and 143 of IPSAS 33, present a reconciliation in the notes to its transitional IPSAS financial statements that provides sufficient detail to enable users to understand the material adjustments to the opening statement of financial position as at January 1, 20X4, and the restated comparative statement of financial performance, where applicable.
- IG37. Paragraph 146 further requires a first-time adopter that takes advantage of the exemptions that provide a three year transitional relief period to not recognize and/or measure items, to present a reconciliation of items that have been recognized and/or measured during the reporting period which were not recognized and/or measured in the previous financial statements.
- IG38. Following from the example in IG29, a first-time adopter adopts the exemption in IPSAS 33 that allows it to not recognize investment property for a period of three years. The first-time adopter applies this exemption and only recognizes the investment property at the end of year three, i.e. December 31, 20X4. As an adjustment is made to the opening balance of accumulated surplus or deficit as on January 1, 20X4 in recognizing the investment property, paragraph 146 requires the first-time adopter to present a reconciliation in its notes to the financial statements for the year ending December 31, 20X4 to allow users to understand the adjustment that was made following the recognition of the investment property.

Deemed Cost

- IG39. IPSAS 33 allows a first-time adopter to determine a deemed cost as a substitute for acquisition cost or depreciated cost at the date of adoption of IPSASs, where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets and/or liabilities. A deemed cost may however only be determined if no cost information is available about the historical cost of the asset and/or liability. When a first-time adopter initially measures these assets on the date of adoption of IPSASs, or when the transitional exemptions that provided the first-time adopter with a three year relief period to not recognize and/or measure certain assets have expired, it recognizes the effect:

- (a) As an adjustment to the opening balance of accumulated surplus or deficit in the opening statement of financial position in the period in which the deemed is determined; or
- (b) In the revaluation surplus if the first-time adopter adopts the revaluation model in IPSAS 17 or in IPSAS 31, *Intangible Assets*.

To illustrate:

Public Sector Entity X adopted accrual basis IPSAS on January 1, 20X4 and applied deemed cost to measure investment property. In applying deemed cost, investment property was valued at CU 1,800,000 on the date of adoption. Public Sector Entity X elected to not present comparative information.

Statement of Changes in Net Assets/Equity for the Year ended December 31, 20X4

	Attributable to owners of the controlling entity		Total net assets/equity
	Accumulated surplus/deficit CU	Other Reserves CU	CU
Opening balance as at January 1, 20X4	210,000	10,000	220,000
Measurement of investment property at deemed cost in accordance with IPSAS 33 (see note 34)	1,500,000		1,500,000
Restated opening balance as at January 1, 20X4	1,710,000	10,000	1,720,000
Surplus for the period	5,000		5,000
Balance as at December 31, 20X4	1,715,000	10,000	1,725,000

Notes to the financial statements of Public Sector Entity X as at December 31, 20X4:

Note 34 – Investment Property

	<i>December 31, 20X4</i> <i>CU</i>
Opening balance of investment property recognized under previous basis of accounting	300,000
Investment property measured at deemed cost as provided in IPSAS 33 on January 1, 20X4	1,500,000
Restated opening balance of investment property at January 1, 20X4	1,800,000
Additions

Transitional exemptions adopted in IPSAS 33 on adoption of accrual basis IPSASs

Public Sector Entity X adopted accrual basis IPSAS on January 1, 20X4 and applied deemed cost in measuring investment property as reliable cost information about some investment properties was not available. As a result, Public Sector Entity X restated its opening balance of investment property with an additional value of CU1,500,000 on January 1, 20X4.

Note 54 – Reconciliation of net assets/equity and surplus or deficit on January 1, 20X4

Reconciliation of net assets/equity as on January 1, 20X4

	Net assets/equity as on January 1, 20X4
	CU
<i>Opening balance of net assets/equity as on January 1, 20X4 reported under previous basis of accounting</i>	220,000
<i>Recognition of investment property at deemed cost (see note 34)</i>	1,500,000
<i>Restated opening balance of net assets/equity as on January 1, 20X4</i>	1,720,000

Reconciliation of surplus or deficit on January 1, 20X4

	Surplus or deficit on January 1, 20X4
	CU
<i>Surplus or deficit as at 31, December 20X3 as reported under previous basis of accounting</i>	<i>210,000</i>
<i>Recognition of investment property at deemed cost (see note 34)</i>	<i>1,500,000</i>
<i>Restated surplus or deficit as on January 1, 20X4</i>	<i>1,710,000</i>

Determining a Deemed Cost During the Period of Transition

- IG40. If a first-time adopter takes advantage of the exemption in IPSAS 33 that provides a three year transitional relief period to not recognize and/or measure an asset, the IPSAS requires that it may determine a deemed cost for that asset during any point of time within the three year transitional relief period.
- IG41. Subsequent depreciation and amortization, if applicable, is based on that deemed cost and starts from the date of adoption of IPSASs, or when the transitional exemptions that provided the relief have expired, or when the relevant items are recognized and/or measured in accordance with the applicable IPSASs (whichever is earlier).
- IG42. For example, a first-time adopter adopts IPSASs on January 1, 20X1 and adopts the exemption that provides a three year transitional relief period for the recognition of an investment property. Because the first-time adopter does not have reliable cost information about the historical cost of the investment property on the date of adoption of IPSASs it decides to determine a deemed cost for the investment property. The deemed cost for the investment property is determined during the second reporting period (i.e. 20X2) in which the first-time adopter applies the exemption. IPSAS 33 allows the first-time adopter to use the deemed cost determined during 20X2 in recognizing the investment property by adjusting the opening accumulated surplus and deficit on January 1, 20X2. The deemed cost as determined on January 1, 20X2 will be used in determining subsequent depreciation and in assessing impairment where the first-time adopter elects to apply the cost model as its subsequent measurement basis in applying IPSAS 16.

IPSAS 5, Borrowing Costs

- IG43. An entity adopts the accrual basis IPSASs on January 1, 20X3 and adopts the allowed alternative treatment in accounting for borrowing costs. Borrowing costs directly attributable to the acquisition of the asset amounts to CU525,000, of which CU500,000 was incurred prior to the adoption of accrual basis IPSASs, while CU25,000 was incurred in the first reporting period ending December 31, 20X3. Paragraph 90 of IPSAS 33 requires the first-time adopter to retrospectively recognize any borrowing costs incurred prior to the adoption of accrual basis IPSASs when it adopts the allowed alternative method. Therefore, CU500,000 shall be capitalized to the cost of the asset recognized in the opening statement of financial position as at January 1, 20X3.
- IG44. If the entity has elected to apply the benchmark treatment, paragraph 88 of IPSAS 33 encourages, but does not require, the first-time adopter to apply the accounting policy retrospectively. If the first-time adopter elects to apply its accounting policy prospectively, it will only expense CU25,000 in the statement of financial performance for the period ending December 31, 20X3.

IPSAS 9, Revenue from Exchange Transactions

- IG45. If a first-time adopter has received amounts that do not yet qualify for recognition as revenue in accordance with IPSAS 9 (for example, the proceeds of a sale that does not qualify for recognition as revenue), the first-time adopter recognizes the amounts received as a liability in its opening statement of financial position and measures that liability at the amount received. It shall derecognize the liability and recognize the revenue in its statement of financial performance when the recognition criteria in IPSAS 9 are met.

IPSAS 10, Financial Reporting in Hyperinflationary Economies

- IG46. A first-time adopter complies with IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* in determining its functional currency and presentation currency. When the first-time adopter prepares its opening statement of financial position, it applies IPSAS 10, *Hyperinflationary Economies*, to any periods during which the economy of the functional currency or presentation currency was hyperinflationary.
- IG47. If the first-time adopter elects to use the exemptions in paragraphs 64 to 76 of IPSAS 33, it applies IPSAS 10 to periods after the date for which the revalued amount or fair value was determined.

IPSAS 14, Events After the Reporting Date

IG48. Except as described in paragraph IG49, a first-time adopter applies IPSAS 14, *Events After the Reporting Date* in determining whether:

- (a) Its opening statement of financial position reflects an event that occurred after the date of transition; and
- (b) Comparative amounts in its transitional IPSAS financial statements or its first IPSAS financial statements, where applicable, reflect an event that occurred after the end of that comparative period.

IG49. Paragraphs 23–26 of IPSAS 33 require some modifications to the principles in IPSAS 14 when a first-time adopter determines whether changes in estimates are adjusting or non-adjusting events at the date of adoption of IPSASs (or, when applicable, the end of the comparative period). Cases 1 and 2 below illustrate those modifications. In case 3 below, paragraphs 23–26 of IPSAS 33 do not require modifications to the principles in IPSAS 14.

- (a) Case 1—If a first-time adopter’s previous basis of accounting required estimates of similar items for the date of adoption of IPSASs, using an accounting policy that is consistent with IPSASs. In this case, the estimates in accordance with IPSASs need to be consistent with estimates made for that date in accordance with previous basis of accounting, unless there is objective evidence that those estimates were in error (see IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*). The first-time adopter reports later revisions to those estimates as events of the period in which it makes the revisions, rather than as adjusting events resulting from the receipt of further evidence about conditions that existed at the date of adoption of IPSASs.
- (b) Case 2—Previous basis of accounting required estimates of similar items for the date of adoption of IPSASs, but the first-time adopter made those estimates using accounting policies that are not consistent with its accounting policies in accordance with IPSASs. In this case, the estimates in accordance with IPSASs need to be consistent with the estimates required in accordance with the previous basis of accounting for that date (unless there is objective evidence that those estimates were in error), after adjusting for the difference in accounting policies. The opening statement of financial position reflects those adjustments for the difference in accounting policies. As in case 1, the first-time adopter reports later revisions to those estimates as events of the period in which it makes the revisions.

For example, the previous basis of accounting may have required a first-time adopter to recognize and measure provisions on a basis consistent with IPSAS 19, *Provisions, Contingent Liabilities and*

Contingent Assets, except that the previous basis of accounting's measurement was on an undiscounted basis. In this example, the first-time adopter uses the estimates in accordance with its previous basis of accounting as inputs in making the discounted measurement required by IPSAS 19.

- (c) Case 3—Previous basis of accounting did not require estimates of similar items for the date of adoption of IPSASs. Estimates in accordance with IPSASs for that date reflect conditions existing at that date. In particular, estimates of market prices, interest rates or foreign exchange rates at the date of adoption of IPSASs reflect market conditions at that date. This is consistent with the distinction in IPSAS 14 between adjusting events after the reporting period and non-adjusting events after the reporting period.

IG50. To illustrate: Entity A's first transitional IPSAS financial statements are for the period ending December 31, 20X5 with the first-time adopter electing to present comparative information. In terms of its previous basis of accounting the following transactions and events are noted in entity A's financial statements for December 31, 20X3 and 20X4:

- (a) Estimates of accrued expenses and provisions were made at those dates;
- (b) The entity accounted on a cash basis for a defined benefit pension plan; and
- (c) No provision was recognized for a court case arising from events that occurred in September 20X4. When the court case was concluded on June 30, 20X5, entity A was required to pay CU1000 and paid this on July 10, 20X5.

In preparing its transitional IPSAS financial statements, entity A concludes that its estimates in accordance with its previous basis of accounting of accrued expenses and provisions at December 31, 20X3 and 20X4 were made on a basis consistent with its accounting policies in accordance with IPSASs. Although some of the accruals and provisions turned out to be overestimates and others to be underestimates, entity A concludes that its estimates were reasonable and that, therefore, no error had occurred. As a result, accounting for those overestimates and underestimates involves the routine adjustment of estimates in accordance with IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Application of Requirements

In preparing its opening statement of financial position at January 1, 20X4 and in its comparative statement of financial position at December 31, 20X4, entity A:

- (a) Does not adjust the previous estimates for accrued expenses and provisions; and
- (b) Makes estimates (in the form of actuarial assumptions) necessary to account for the pension plan in accordance with IPSAS 39, *Employee Benefits*. Entity A's actuarial assumptions at January 1, 20X4 and December 31, 20X4 do not reflect conditions that arose after those dates. For example, entity A's:
 - (i) Discount rates at January 1, 20X4 and December 31, 20X4 for the pension plan and for provisions reflect market conditions at those dates; and
 - (ii) Actuarial assumptions at January 1, 20X4 and December 31, 20X4 about future employee turnover rates do not reflect conditions that arose after those dates—such as a significant increase in estimated employee turnover rates as a result of a curtailment of the pension plan in 20X5.

The treatment of the court case at December 31, 20X4 depends on the reason why entity A did not recognize a provision in accordance with its previous basis of accounting at that date.

Assumption 1 – The previous basis of accounting was consistent with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*. Entity A concluded that the recognition criteria were not met. In this case, entity A's assumptions in accordance with IPSASs are consistent with its assumptions in accordance with its previous basis of accounting. Therefore, entity A does not recognize a provision at December 31, 20X4.

Assumption 2 – Entity A's previous basis of accounting was not consistent with IPSAS 19. Therefore, entity A develops estimates in accordance with IPSAS 19. Under IPSAS 19, an entity determines whether an obligation exists at the end of the reporting period by taking account of all available evidence, including any additional evidence provided by events after the reporting period. Similarly, in accordance with IPSAS 14, *Events after the Reporting Period*, the resolution of a court case after the reporting period is an adjusting event after the reporting period if it confirms that the entity had a present obligation at that date. In this instance, the resolution of the court case confirms that entity A had a liability in September 20X4 (when the events occurred that gave rise to the court case). Therefore, entity A recognizes a provision at December 31, 20X4. Entity A measures that provision by discounting the CU1 000

paid on July 10, 20X5 to its present value, using a discount rate that complies with IPSAS 19 and reflects market conditions at December 31, 20X4.

IG51. Paragraphs 23–26 of the IPSAS 33 do not override requirements in other IPSASs that base classifications or measurements on circumstances existing at a particular date. Examples include:

- (a) The distinction between finance leases and operating leases (see IPSAS 13, *Leases*); and
- (b) The distinction between financial liabilities and equity instruments (see IPSAS 28, *Financial Instruments: Presentation*).

IPSAS 13, Leases

IG52. In accordance with paragraph 95 of IPSAS 33 and paragraph 18 of IPSAS 13, a lessee or lessor classifies leases as operating leases or finance leases on the basis of circumstances existing at the inception of the lease, on the date of adoption of accrual basis IPSASs. In some cases, the lessee and the lessor may agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification in accordance with IPSAS 13 had the changed terms been in effect at the inception of the lease. If so, the revised agreement is considered as a new agreement over its term from the date of adoption of accrual basis IPSASs. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee) do not give rise to a new classification of a lease.

IPSAS 17, Property, Plant and Equipment

IG53. If a first-time adopter's depreciation methods and rates in accordance with its previous basis of accounting are acceptable in accordance with IPSASs, it accounts for any change in estimated useful life or depreciation pattern prospectively from when it makes that change in estimate (paragraphs 22 and 26 of IPSAS 33 and paragraph 76 of IPSAS 17. However, in some cases, a first-time adopter's depreciation methods and rates in accordance with its previous basis of accounting may differ from those that would be acceptable in accordance with IPSASs (for example, if they do not reflect a reasonable estimate of the asset's useful life). If those differences have a material effect on the financial statements, the entity adjusts accumulated depreciation in its opening statement of financial position retrospectively so that it complies with IPSASs.

- IG54. A first-time adopter may elect to use one of the following amounts as the deemed cost of property, plant and equipment:
- (a) Fair value at the date of adoption of IPSASs (paragraph 67 of IPSAS 33), in which case the first-time adopter provides the disclosures required by paragraph 148 of IPSAS 33; or
 - (b) A revaluation in accordance with its previous basis of accounting that meets the criteria in paragraph 67 of IPSAS 33.
- IG55. Subsequent depreciation is based on that deemed cost and starts from the date for which the first-time adopter determined the deemed cost, or where the first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize certain assets, when the exemptions providing the relief have expired, or the asset has been recognized in accordance with IPSAS 17 (whichever is earlier).
- IG56. If a first-time adopter chooses as its accounting policy the revaluation model in IPSAS 17 for some or all classes of property, plant and equipment, it presents the cumulative revaluation surplus as a separate component of net assets/equity. The revaluation surplus at the date of adoption of IPSASs is based on a comparison of the carrying amount of the asset at that date with its cost or deemed cost. If the deemed cost is the fair value at the date of adoption of IPSASs or where the first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets, when the exemptions providing the relief have expired, or the asset has been recognized and/or measured in accordance with IPSAS 17 (whichever is earlier), the first-time adopter provides the disclosures required by paragraph 148 of IPSAS 33.
- IG57. If revaluations in accordance with the first-time adopter's previous basis of accounting did not satisfy the criteria in paragraphs 67 or 69 of IPSAS 33, the first-time adopter measures the revalued assets in its opening statement of financial position on one of the following bases:
- (a) Cost (or deemed cost) less any accumulated depreciation and any accumulated impairment losses under the cost model in IPSAS 17;
 - (b) Deemed cost, being the fair value or an alternative when market-based evidence of fair value is not available, at the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets, the date at which the asset is recognized and/or measured during the period of transition, or when the transitional exemptions expire (whichever is earlier); or
 - (c) A revalued amount, if the entity adopts the revaluation model in IPSAS 17 as its accounting policy in accordance with IPSASs for all items of property, plant and equipment in the same class.

- IG58. IPSAS 17 requires each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item to be depreciated separately. However, IPSAS 17 does not prescribe the unit of measurement for recognition of an asset, i.e. what constitutes an item of property, plant and equipment. Thus, judgment is required in applying the recognition criteria to an entity's specific circumstances (paragraphs 18 and 59).

IPSAS 39, Employee Benefits

- IG59. At the date of adoption of IPSASs, a first-time adopter applies IPSAS 39 in measuring defined benefits plans and other long-term employee benefits, and recognizes all cumulative actuarial gains or losses from the inception of the plan until the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides a three year transitional relief period from the recognition of defined benefit plans and other long-term employee benefits, the date on which the exemptions expire or when the defined benefits plans and other long-term employee benefits are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier).
- IG60. A first-time adopter's actuarial assumptions at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemptions that provide relief from the recognition of defined benefit plans and other long-term employee benefits, the date on which the exemptions expire or when the defined benefits plans and other long-term employee benefits are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier), are consistent with actuarial assumptions made at the end of its comparative period (if the first-time adopter elects to present comparative information in accordance with paragraph 78 of IPSAS 33) in accordance with its previous basis of accounting (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those assumptions were in error (paragraph 23 of the IPSAS 33). Any later revisions to those assumptions are an actuarial gain or loss of the period in which the first-time adopter makes the revisions.
- IG61. A first-time adopter may need to make actuarial assumptions at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemptions that provide relief from the recognition of defined benefit plans and other long-term employee benefits, the date on which the exemptions expire or when the defined benefits plans and other long-term employee benefits are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier), that were not necessary in accordance with its basis of accounting. Such actuarial assumptions do not reflect conditions that arose after the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemptions that provide relief from the recognition of defined benefit plans and other long-term employee benefits, the date on

which the exemptions expire or when the defined benefits plans and other long-term employee benefits are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier). In particular, discount rates and the fair value of plan assets at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemptions that provide relief from the recognition of defined benefit plans and other long-term employee benefits, the date on which the exemptions expire or when the liabilities are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier), reflect market conditions at that date. Similarly, the first-time adopter's actuarial assumptions at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemptions that provide relief from the recognition of defined benefit plans and other long-term employee benefits, the date on which the exemptions expire or when the defined benefits plans and other long-term employee benefits are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier), about future employee turnover rates do not reflect a significant increase in estimated employee turnover rates as a result of a curtailment of the pension plan that occurred after the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemptions that provide relief from the recognition of defined benefit plans and other long-term employee benefits, the date on which the exemptions expire or when the defined benefits plans and other long-term employee benefits are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier) (paragraph 23 of IPSAS 33).

- IG62. In many cases, a first-time adopter's transitional IPSAS financial statements or its first IPSAS financial statements will reflect measurements of employee benefit obligations at three dates (where a first-time adopter elects to present comparative information in accordance with paragraph 78 of IPSAS 33): the end of the first reporting period, the date of the comparative statement of financial position (where the first-time adopter elects to present comparative information) and the date of adoption of IPSASs, or where the first-time adopter takes advantages of the exemptions that provide relief from the recognition of defined benefit plans and other long-term employee benefits, the date on which the exemptions expire or when the defined benefits plans and other long-term employee benefits are recognized and/or measured in accordance with IPSAS 39 (whichever is earlier). IPSAS 39 encourages the first-time adopter to involve a qualified actuary in the measurement of all material post-employment benefit obligations. To minimize costs, a first-time adopter may request a qualified actuary to carry out a detailed actuarial valuation at one or two of these dates and roll the valuation(s) forward or back to the other date(s). Any such roll forward or roll back reflects any material transactions and other material events (including changes in market prices and interest rates) between those dates (paragraph 68 of IPSAS 25).

IPSAS 21, Impairment of Non-Cash-Generating Assets and IPSAS 26, Impairment of Cash-Generating Assets

- IG63. Paragraph 98 and 108 of IPSAS 33 requires a first-time adopter to apply the requirements in IPSAS 21 and IPSAS 26 prospectively from the date of adoption of accrual basis IPSASs, or where a first-time adopter takes advantage of the exemptions that provide a three year transitional relief period to not recognize and/or measure an asset, the date when the exemptions that provided the relief expire and/or the asset is recognized and/or measured. For example, if an entity adopts accrual basis IPSASs on January 1, 20X1 and takes advantage of the three year transitional relief period to not recognize and/or measure an item or property, plant and equipment, it would not be required to assess the item of property, plant and equipment for impairment until (a) December 31, 20X3 (i.e. the date on which the transitional exemption expire) or (b) the date following the recognition of the item of property, plant and equipment if it was recognized and/or measured during the period of transition (whichever is earlier).
- IG64. The estimates used to determine whether a first-time adopter recognizes an impairment loss (and to measure any such impairment loss) at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of assets, the date on which the exemptions expire or when the assets are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier) are consistent with estimates made for at the end of its comparative period (if the first-time adopter elects to present comparative information in accordance with paragraph 78 of IPSAS 33) the first-time adopter's previous basis of accounting (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error (paragraphs 23 and 24 of IPSAS 33). The first-time adopter reports any later revisions to those estimates as an event of the period in which it makes the revisions.
- IG65. In assessing whether it needs to recognize an impairment loss (and in measuring any such impairment loss) at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of assets, the date on which the exemptions expire or when the assets are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), the first-time adopter may need to make estimates for that date that were not necessary in accordance with its previous basis of accounting. Such estimates and assumptions do not reflect conditions that arose after the date of transition, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of assets, the date on which the exemptions expire or when the

assets are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier) (paragraph 25 of IPSAS 33).

IPSAS 28, Financial Instruments: Presentation

- IG66. In its opening statement of financial position, a first-time adopter applies the criteria in IPSAS 28 to classify financial instruments issued (or components of compound instruments issued) as either financial liabilities or net asset/equity instruments in accordance with the substance of the contractual arrangement when the instrument first satisfied the recognition criteria in IPSAS 28 (paragraphs 13 and 35), without considering events after that date (other than changes to the terms of the instruments).

IPSAS 29, Financial Instruments: Recognition and Measurement

Recognition

- IG67. A first-time adopter recognizes all financial assets and financial liabilities (including all derivatives) that qualify for recognition in accordance with IPSAS 29 and have not yet qualified for derecognition in accordance with IPSAS 29, except non-derivative financial assets and non-derivative financial liabilities derecognized in accordance with its previous basis of accounting before the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), to which the first-time adopter does not choose to apply paragraph 116 of IPSAS 33 (see paragraphs 115 and 116 of IPSAS 33).
- IG68. For example, a first-time adopter that does not apply paragraph 116 of IPSAS 33 does not recognize assets transferred in a securitization, transfer or other derecognition transaction that occurred before the date of adoption of IPSASs if those transactions qualified for derecognition in accordance with its previous basis of accounting. However, if the first-time adopter uses the same securitization arrangement or other derecognition arrangement for further transfers after the date of transition to IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), those further transfers qualify for derecognition only if they meet the derecognition criteria of IPSAS 29.

Embedded Derivatives

- IG69. When IPSAS 29 requires a first-time adopter to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IPSAS 29 reflect circumstances at that date (IPSAS 29 paragraph 12). If the first-time adopter cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it measures the entire combined contract as at fair value through surplus or deficit (IPSAS 29 paragraph 14).

Measurement

- IG70. In preparing its opening statement of financial position, a first-time adopter applies the criteria in IPSAS 29 to identify those financial assets and financial liabilities that are measured at fair value and those that are measured at amortized cost.

Adjusting the Carrying Amount of Financial Instruments on the Date of Adoption of Accrual Basis IPSASs or During the Period of Transition

- IG71. A first-time adopter shall treat an adjustment to the carrying amount of a financial asset or financial liability as an adjustment to be recognized in the opening balance of accumulated surplus or deficit at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), only to the extent that it results from adopting IPSAS 29. Because all derivatives, other than those that are financial guarantee contracts or are designated and effective hedging instruments, are classified as held for trading, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives are recognized as an adjustment of the balance of accumulated surplus or deficit at the beginning of the financial year in which IPSAS 29 is initially applied, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier).

Hedge Accounting

- IG72. Paragraphs 117 to 119 of IPSAS 33 deal with hedge accounting. The designation and documentation of a hedge relationship must be completed on or before the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition

and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier) if the hedge relationship is to qualify for hedge accounting from that date. Hedge accounting can be applied prospectively only from the date that the hedge relationship is fully designated and documented.

IG73. A first-time adopter may, in accordance with its previous basis of accounting, have deferred or not recognized gains and losses on a fair value hedge of a hedged item that is not measured at fair value. For such a fair value hedge, a first-time adopter adjusts the carrying amount of the hedged item at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier). The adjustment is the lower of:

- (a) That portion of the cumulative change in the fair value of the hedged item that reflects the designated hedged risk and was not recognized in accordance with its previous basis of accounting; and
- (b) That portion of the cumulative change in the fair value of the hedging instrument that reflects the designated hedged risk and, in accordance with its previous basis of accounting, was either (i) not recognized or (ii) deferred in the statement of financial position as an asset or liability.

IG74. A first-time adopter may, in accordance with its previous basis of accounting, have deferred gains and losses on a cash flow hedge of a forecast transaction. If, at the date of adoption of IPSAS, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier), the hedged forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognized in net assets/equity. Any net cumulative gain or loss that has been reclassified to net assets/equity on initial application of IPSAS 29 or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier) remains in net assets/equity until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, (b) the forecast transaction affects surplus or deficit or (c) subsequently circumstances change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss is reclassified from net assets/equity to surplus or deficit. If the hedging

instrument is still held, but the hedge does not qualify as a cash flow hedge in accordance with IPSAS 29, hedge accounting is no longer appropriate starting from the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition and/or measurement of financial instruments, the date on which the exemptions expire or when the financial instruments are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier).

IPSAS 31, Intangible Assets

- IG75. A first-time adopter's opening statement of financial position excludes all intangible assets and other intangible items that do not meet the criteria for recognition in accordance with IPSAS 31 at the date of adoption of IPSAS, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of intangible assets, the date on which the exemptions expire and/or when the intangible assets are recognized and/or measured in accordance with the applicable IPSAS (whichever is earlier) and includes all intangible assets that meet the recognition criteria in IPSAS 31 at that date.
- IG76. The criteria in IPSAS 31 require an entity to recognize an intangible asset if, and only if:
- (a) It is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
 - (b) The cost of the asset can be measured reliably.

IPSAS 31 supplements these two criteria with further, more specific, criteria for internally generated intangible assets.

- IG77. In accordance with paragraphs 63 and 66 of IPSAS 31, an entity capitalises the costs of internally generated intangible assets prospectively from the date when the recognition criteria are met. IPSAS 33 allows an entity to recognize previously expensed intangible assets to the extent that the item meets the definition of an intangible asset, and the recognition criteria in IPSAS 31. Thus, if an internally generated intangible asset qualifies for recognition at the date of adoption of IPSASs, or where the first-time adopter takes advantage of the exemption that provides relief from the recognition of intangible assets, the date on which the exemptions expire and/or when the intangible assets are recognized and/or measured in accordance with the IPSAS 31 (whichever is earlier) the first-time adopter recognizes and/or measures the asset in its opening statement of financial position even if it had recognized the related expenditure as an expense in accordance with its previous basis of accounting.

- IG78. If the asset does not qualify for recognition in accordance with IPSAS 31 until a later date, its cost is the sum of the expenditure incurred from that later date.
- IG79. The criteria in paragraph IG76 also apply to intangible assets acquired separately. In many cases, contemporaneous documentation prepared to support the decision to acquire the asset will contain an assessment of the future economic benefits or service potential. Furthermore, as explained in paragraph 33 of IPSAS 31, the cost of a separately acquired intangible asset can usually be measured reliably.
- IG80. A first-time adopter may elect to use one of the following amounts as the deemed cost of intangible assets (except for internally generated intangible assets):
- (a) Fair value at the date of adoption of IPSASs, or where a first-time adopter takes advantage of the exemption that provides a three year transitional relief period to not recognize and/or measure certain assets, the date at which the asset is recognized and/or measured during the period of transition, or the date on which the exemptions expire (whichever is earlier) (paragraph 67 of IPSAS 33), in which case the entity gives the disclosures required by paragraph 148 of IPSAS 33; or
 - (b) A revaluation in accordance with its previous basis of accounting that meets the criteria in paragraph 67 of IPSAS 33.
- IG81. If a first-time adopter's amortization methods and rates in accordance with its previous basis of accounting are acceptable in accordance with IPSASs, it accounts for any change in estimated useful life or amortization pattern prospectively from when it makes that change in estimate (paragraphs 23 and 24 of IPSAS 33 and paragraph 103 of IPSAS 31). However, in some cases, the first-time adopter's amortization methods and rates in accordance with its previous basis of accounting may differ from those that would be acceptable in accordance with IPSASs (for example, if they do not reflect a reasonable estimate of the asset's useful life). If those differences have a material effect on the financial statements, the first-time adopter adjusts accumulated amortization on in its opening statement of financial position retrospectively so that it complies with IPSASs.

IPSAS 35, Consolidated Financial Statements

- IG82. If a first-time adopter did not consolidate a controlled entity in accordance with its previous basis of accounting, then, in its consolidated financial statements, the first-time adopter measures the controlled entity's assets and liabilities at the same carrying amounts as in the accrual basis financial statements of the controlled entity following its adoption of IPSASs, after adjusting for consolidation procedures and for the effects of the public sector combination in which it acquired the controlled entity (paragraph 130 of IPSAS 33). If

the controlled entity has not adopted accrual basis IPSASs in its financial statements, the carrying amounts described in the previous sentence are those that IPSASs would require in those financial statements.

Controlling Entity Adopts Accrual Basis IPSASs Before the Controlled Entity

Background

IG83. Controlling entity A presents its (consolidated) first IPSAS financial statements in 20X5. Its controlled entity B, wholly owned by controlling entity A since formation, prepares information in accordance with accrual basis IPSASs for internal consolidation purposes from that date, but controlled entity B does not present its first IPSAS financial statements until 20X7.

Application of Requirements

IG84. If controlled entity B applies paragraph 129(a) of IPSAS 33, the carrying amounts of its assets and liabilities are the same in both its opening IPSAS statement of financial position at January 1, 20X6 and controlling entity's A consolidated statement of financial position (except for adjustments for consolidation procedures) and are based on controlled entity B's date of adoption of IPSASs.

IG85. Alternatively, controlled entity B, in accordance with paragraph 129(b) of IPSAS 33, measure all its assets or liabilities based on its own date of adoption of IPSASs (January 20X6). However, the fact that controlled entity B becomes a first-time adopter in 20X7 does not change the carrying amounts of its assets and liabilities in controlling entity A's consolidated financial statements.

Controlled Entity Adopts Accrual Basis IPSASs Before the Controlling Entity

Background

IG86. Controlling entity C presents its (consolidated) transitional IPSAS financial statements IPSASs in 20X7. Its controlled entity D, wholly owned by controlling entity C since formation, presented its transitional IPSAS financial statements in 20X5. Until 20X7, controlled entity D prepared information for internal consolidation purposes in accordance with controlling entity's C previous basis of accounting.

Application of Requirements

IG87. The carrying amounts of controlled entity D's assets and liabilities at January 1, 20X6 are the same in both controlling entity's C (consolidated) opening accrual basis statement of financial position and controlled entity D's financial statements (except for adjustments for consolidation procedures) and are based on controlled entity D's date of adoption of IPSASs. The fact that controlling entity C becomes a first-time adopter in 20X7 does not change those carrying amounts (paragraph 129 of IPSAS 33).

- IG88. Paragraphs 129 and 130 of IPSAS 33 do not override the following requirements:
- (a) The rest of IPSAS 33 in measuring all assets and liabilities for which paragraphs 129 and 130 of IPSAS 33 are not relevant.
 - (b) To give all disclosures required by this IPSAS as of the first-time adopter's own date of transition to IPSASs.
- IG89. Paragraph 129 of IPSAS 33 applies if a controlled entity becomes a first-time adopter later than its controlling entity, for example if the controlling entity previously prepared a reporting package in accordance with accrual basis IPSASs for consolidation purposes but did not present a full set of financial statements in accordance with IPSASs. This may be relevant not only when a controlling entity reporting package complies fully with the recognition and measurement requirements of IPSASs, but also when it is adjusted centrally for matters such as review of events after the reporting date and central allocation of pension costs. However, paragraph 129 of IPSAS 33 does not permit a controlled entity to ignore misstatements that are immaterial to the consolidated financial statements of its controlling entity but material to its own financial statements.

Presentation and Disclosure

- IG90. Paragraphs 135 to 140 in IPSAS 33 require a first-time adopter to disclose certain information when it has taken advantage of the transitional exemptions and provisions in its adoption of accrual basis IPSASs.

To illustrate:

Notes to the financial statements for the year ending December 31, 20X2

Note 48 – Adoption of transitional exemptions and provisions in IPSAS 33

Public Sector Entity X adopted accrual basis IPSAS on January 1, 20X1 and elected to adopt the transitional exemption in IPSAS 33 that allows it to apply a deemed cost and a period of up to three years in which to measure land and buildings and investment property.

Public Sector Entity X took advantage of these exemptions in determining a deemed cost, and to measure its land and buildings and investment property. As a result of adopting these transitional exemptions and provisions the entity is not able to make an explicit and unreserved statement about its compliance with accrual basis IPSASs, as the adoption of these transitional exemptions affect the fair presentation of Public Sector Entity X's financial statements and its ability to assert compliance with accrual basis IPSASs.

No other transitional exemptions that affect fair presentation and compliance with accrual basis IPSASs during the period of transition were adopted or applied to any other assets and/or liabilities.

During the period under review, Public Sector Entity X restated its opening balance of investment property with an additional value of CU 1 200 000 after determining the deemed cost on June 30, 20X2 for the investment property under its control.

As at year end, Public Sector Entity X has not yet determined a deemed cost for land and buildings and has not yet measured these assets in its financial statements. Land and buildings reflect a closing balance of CU 2 500 000 as at December 31, 20X2. This value was determined under Public Sector Entity X's previous basis of accounting.

Public Sector Entity X plans to apply a three year transitional exemption for measuring its land and buildings and in determining a deemed cost for these asset.

Public Sector Entity X has appointed an appraiser to value the land and has developed a model for the measurement of buildings. The progress in determining the valuations for land and buildings is in accordance with its implementation plan.

Summary of Transitional Exemptions and Provisions Included in IPSAS 33 *First-time Adoption of Accrual Basis IPSASs*

IG91. The diagram below summarizes the transitional exemptions and provisions included in other accrual basis IPSASs

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 1, <i>Presentation of Financial Statements</i>						√ To extent that 3 year relief period was adopted		<ul style="list-style-type: none">Presenting comparative info encouraged
IPSAS 2, <i>Cash Flow Statements</i>	√							
IPSAS 3, <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>	√							
IPSAS 4, <i>The Effects of Changes in Foreign Exchange Rates</i>								<ul style="list-style-type: none">Exemption to comply with requirements for cumulative translation
IPSAS 5, <i>Borrowing Costs</i>			√ When allowed alternative is elected as accounting policy					<ul style="list-style-type: none">Encouraged to apply benchmark treatment retrospectivelyAllowed alternative must be applied retrospectively

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						Other
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	
IPSAS 9, <i>Revenue from Exchange Transactions</i>	√				To extent that 3 year relief period was adopted for assets and/or liabilities			
IPSAS 10, <i>Financial Reporting In Hyperinflationary Economies</i>								• Provisions around severe hyperinflation
IPSAS 11, <i>Construction Contracts</i>	√							
IPSAS 12, <i>Inventories</i>		√	Inventory not recognized under previous basis of accounting	Inventory recognized under previous basis of accounting	√			
IPSAS 13, <i>Leases</i>			√ Leased assets and/or liabilities not recognized under previous basis of accounting	√ Leased assets and/or liabilities recognized under previous basis of accounting				

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 14, <i>Events After the Reporting Date</i>	√							
IPSAS, 16 <i>Investment Property</i>		√	Investment property not recognized under previous basis of accounting	Investment property recognized under previous basis of accounting				
IPSAS 17, <i>Property, Plant and Equipment</i>		√	√ Property, plant and equipment not recognized under previous basis of accounting	√ Property, plant and equipment recognized under previous basis of accounting				

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 18, <i>Segment Reporting</i>	√ No segment report to the extent that 3 year relief period was adopted							

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 19, Provisions, Contingent Liabilities and Contingent Assets			√ Only liabilities related to assets not recognized under previous basis of accounting to be included initial estimate of cost of dismantling/ removing item/ restoring site	√ Only liabilities related to assets recognized under previous basis of accounting to be included initial estimate of cost of dismantling/ removing item/ restoring site				
IPSAS 20, Related Party Disclosures						√		
IPSAS 21, Impairment of Non-Cash-Generating Assets								<ul style="list-style-type: none">Prospective application

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 22, <i>Disclosure of Information About the General Government Sector</i>	√							
IPSAS 23, <i>Revenue from Non-Exchange Transactions</i>			√ All non-exchange revenue not recognized under previous basis of accounting	√ All non-exchange revenue recognized under previous basis of accounting	√ To extent that 3 year relief period was adopted for assets and/or liabilities			

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 24, <i>Presentation of Budget Information in Financial Statements</i>	√							
IPSAS 26, <i>Impairment of Cash-Generating Assets</i>			√					• Prospective application
IPSAS 27, <i>Agriculture</i>			√ Biological and agricultural activities not recognized under previous basis of accounting	√ Biological and agricultural activities recognized under previous basis of accounting				

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 28, <i>Financial Instruments: Presentation</i>								<ul style="list-style-type: none">Provisions not to separate liability and net asset/equity component under specific circumstances
IPSAS 29, <i>Financial Instruments: Recognition and Measurement</i>		√	√ For financial instruments not recognized under previous basis of accounting	√ For financial instruments recognized under previous basis of accounting				<ul style="list-style-type: none">Provisions around designation/ derecognition/ hedge accountingApply impairment principles prospectively

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 30, <i>Financial Instruments: Disclosure</i>								<ul style="list-style-type: none"> No comparative info about nature and extent of risks
IPSAS 31, <i>Intangible Assets</i>		√ Intangible assets other than internally generated I/A	√ Intangible assets not recognized under previous basis of accounting	√ Intangible assets recognized under previous basis of accounting				<ul style="list-style-type: none"> Provision to recognise previously expensed internally generated intangible assets
IPSAS 32, <i>Service Concession Arrangements: Grantor</i>		√ Service concession asset	√ Service concession asset and related liability not recognized under previous basis of accounting	√ Service concession asset and related liability recognized under previous basis of accounting				<ul style="list-style-type: none"> Provision on how to recognize related liability

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 35, Consolidated Financial Statements		√			√ To appropriately classify and identify interests in other entities		√	<ul style="list-style-type: none">Provisions when controlling and/or controlled entity adopts IPSAS at different timeExemption to not prepare financial statements as consolidated financial statements(Assess if investment entity on date of adoption and measure at fair value at that date)

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 36, <i>Investments in Associates and Joint Ventures</i>		√			√ To appropriately classify and identify interests in other entities		√	<ul style="list-style-type: none">• Provisions when controlling entity and associate adopts IPSAS at different time• Exemption to not include investment in associate in consolidated financial statements
		√			√ To appropriately classify and identify interests in other entities		√	<ul style="list-style-type: none">• Provisions when controlling entity and jointly controlled entities adopt IPSAS at different time• Exemption to not include interests in joint venture in consolidated financial statements

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

IPSAS	Transitional exemption provided							
	NO	YES						
		Deemed cost	3 year transitional relief for recognition	3 year transitional relief for measurement	3 year transitional relief for recognition and/or measurement	3 year transitional relief for disclosure	Elimination of transactions, balances, revenue and expenses	Other
IPSAS 37, <i>Joint Arrangements</i>								<ul style="list-style-type: none">Provision on how to measure investment in joint venture previously accounted for using proportionate consolidation
IPSAS 39, <i>Employee Benefits</i>			√ defined benefit plans and other long-term employee benefits not recognized under previous basis of accounting	√ for defined benefit and other long-term employee benefits recognized under previous basis of accounting				<ul style="list-style-type: none">Provisions on how to determine initial liabilityProvision to not separate cumulative actuarial gains and lossesProspective disclosure on experience adjustments

Appendix

Differentiation between transitional exemptions and provisions that a first-time adopter is required to apply and/or can elect to apply on adoption of accrual basis IPSASs

This Appendix summarises how the transitional exemptions and provisions that a first-time adopter is required to apply in terms of this IPSAS, and those that a first-time adopter may elect to apply on adoption of accrual basis IPSASs.

As the transitional exemptions and provisions that may be elected can also affect the fair presentation and the first-time adopter’s ability to assert compliance with accrual basis IPSASs as explained in paragraphs 27 to 32 of IPSAS 33, the Appendix makes a distinction between those transitional exemptions and provisions that affect fair presentation and the ability to assert compliance with accrual basis IPSASs, and those that do not.

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 1 <ul style="list-style-type: none">• Present comparative information		✓	
IPSAS 4 <ul style="list-style-type: none">• Cumulative transitional differences at the date of adoption		✓	

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 5</p> <ul style="list-style-type: none"> Allowed alternative treatment and has taken advantage of relief period Adopt allowed alternative treatment on date of adoption – retrospective application Adopt bench mark treatment on the date of adoption – retrospective application of costs incurred before and after date of adoption 	✓	✓
<p>IPSAS 9</p> <ul style="list-style-type: none"> Relief for recognition and/or measurement of revenue related to adoption of three year relief period for recognition and/or measurement of financial instruments 		✓

Transitional exemption or provision	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	
		Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected
		Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS
		Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 10			
<ul style="list-style-type: none">• Determine if hyperinflationary economy is subject to severe hyperinflation at the date of adoption• Measure assets and liabilities if date of adoption is on or after normalisation date		✓	
IPSAS 12		✓	
<ul style="list-style-type: none">• Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets			✓

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 13</p> <ul style="list-style-type: none"> No recognition and/or measurement of finance lease liability and finance lease asset if relief period for recognition and/or measurement of assets is adopted Classification of lease based on circumstances at adoption of accrual basis IPSAS 	√		√
<p>IPSAS 16</p> <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets 			√
<p>IPSAS 17</p> <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets 			√

Transitional exemption or provision	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	
		Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected
		Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS
		Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 18 <ul style="list-style-type: none">• No preparation of segment report within three years of adoption			√
IPSAS 19 <ul style="list-style-type: none">• No recognition and measurement of liability relating to initial estimate of costs of dismantling and removing item if relief for recognition and/or measurement of assets are adopted			√
IPSAS 20 <ul style="list-style-type: none">• No disclosure of related party relationships, related party transactions and information about key management personnel			√

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 21</p> <ul style="list-style-type: none"> • Apply impairment provisions prospectively on date of adoption or when assets are recognised when relief period was applied 	√		
<p>IPSAS 26</p> <ul style="list-style-type: none"> • Apply impairment provisions prospectively on date of adoption or when assets are recognised when relief period was applied 	√		
<p>IPSAS 27</p> <ul style="list-style-type: none"> • Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets 			√

Transitional exemption or provision	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	
		Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected
		Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS
IPSAS 28			
<ul style="list-style-type: none">• Determine if financial instrument has liability and net asset/equity component on date of adoption• Do not separate compound financial instrument if no liability exists on date of adoption		√	
		√	

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 29</p> <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and/or liabilities and changing the accounting policy to measure assets and/or liabilities <p><i>Designation</i></p> <ul style="list-style-type: none"> Designate financial asset or liability at fair value through surplus or deficit on date of adoption <p><i>Impairment</i></p> <ul style="list-style-type: none"> Apply impairment provisions prospectively on date of adoption 	<p>√</p> <p>√</p>		<p>√</p>

Transitional exemption or provision	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected
Transitional exemption or provision	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected
Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 29 <i>Derecognition</i> <ul style="list-style-type: none">• Apply derecognition provisions prospectively on date of adoption• Apply derecognition provisions retrospectively if information is available as at the date of initial accounting	✓		✓	
<i>Hedge accounting</i> <ul style="list-style-type: none">• Measure derivatives at fair value• Eliminate all deferred losses and gains• Only reflect hedges that qualify for hedge accounting on date of adoption• Discontinue hedge transaction if conditions of hedge accounting on date of adoption are not met	✓ ✓ ✓ ✓			

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 30</p> <ul style="list-style-type: none"> No disclosure of information about nature and extent of risks 		√	
<p>IPSAS 31</p> <ul style="list-style-type: none"> Three year relief for recognition and/or measurement of assets and changing the accounting policy to measure assets Recognize all internally generated intangible assets 	√		√

Transitional exemption or provision	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	
		Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected
		Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS
		Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
IPSAS 32 <ul style="list-style-type: none">• Three year relief for recognition and/or measurement of assets and/or liabilities and changing the accounting policy to measure assets and/or liabilities• Measure liability either under financial liability model or grant of a right to the operator model on date of adoption or when asset is recognised if relief period is adopted	✓		✓
Applying deemed cost to assets and/or liabilities			✓
Applying deemed cost to assets acquired in a non-exchange transaction			✓
Using deemed cost for investments in controlled entities, jointly controlled entities and associates			✓

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
		Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
Preparing reconciliations during transitional period	√		
IPSAS 35 <ul style="list-style-type: none"> • Relief to recognize and/or measure interests in controlled entity • Elect to not eliminate inter-entity balances, transactions, revenue and expenses • Controlled entity becomes first-time adopter later or earlier than its controlling entity 	√		√
<ul style="list-style-type: none"> • Not present financial statements as consolidated financial statements if three year relief for recognition and/or measurement and/or elimination option was adopted • <i>Assess if investment entity on date of adoption and determine fair value at that date)</i> 	√		√

Transitional exemption or provision	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected	Transitional exemptions or provisions that may be applied or elected
<p>IPSAS 36</p> <ul style="list-style-type: none"> • Relief to recognize and/or measure interest in associate • Elect to not eliminate share in associate's surplus and deficit • Associate becomes first-time adopter later or earlier than its controlling entity • Not present investment in associates in consolidated financial statements if three year relief for recognition and/or measurement and/or elimination option was adopted 	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
			<p>✓</p> <p>✓</p> <p>✓</p>
<p>IPSAS 37</p> <ul style="list-style-type: none"> • <i>Measure investment in joint venture previously accounted for using proportionate consolidation</i> 	✓		

FIRST-TIME ADOPTION OF ACCRUAL BASIS IPSAS

Transitional exemption or provision	Transitional exemptions or provisions that have to be applied	Transitional exemptions or provisions that may be applied or elected	
	Do not affect fair presentation and compliance with accrual basis IPSAS	Do not affect fair presentation and compliance with accrual basis IPSAS	Affect fair presentation and compliance with accrual basis IPSAS
<p>IPSAS 39</p> <ul style="list-style-type: none"> • Three year relief for recognition and/or measurement of assets and/or liabilities and changing the accounting policy to measure assets and/or liabilities • Determine initial liability for defined benefit and other long-term employee benefit plans on date of adoption or when relief period expired 	<p>✓</p> <p>✓</p>		<p>✓</p>
<ul style="list-style-type: none"> • Recognize increase/decrease on date of adoption or when relief period expires in opening accumulated surplus/deficit 			

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IPSAS 34—SEPARATE FINANCIAL STATEMENTS

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 27, *Separate Financial Statements* published by the International Accounting Standards Board (IASB). Extracts from IAS 27 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 34—SEPARATE FINANCIAL STATEMENTS

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 34, *Separate Financial Statements* was issued in January 2015.

Since then, IPSAS 34 has been amended by the following IPSASs:

- *The Applicability of IPSASs* (issued April 2016)

Table of Amended Paragraphs in IPSAS 34

Paragraph Affected	How Affected	Affected By
4	Deleted	The Applicability of IPSASs April 2016
5	Deleted	The Applicability of IPSASs April 2016
32A	New	The Applicability of IPSASs April 2016

IPSAS 34—SEPARATE FINANCIAL STATEMENTS**CONTENTS**

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International Public Sector Accounting Standard 34, *Separate Financial Statements*, is set out in paragraphs 1–34. All the paragraphs have equal authority. IPSAS 34 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to prescribe the accounting and disclosure requirements for investments in controlled entities, joint ventures and associates when an entity prepares separate financial statements.

Scope

2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for investments in controlled entities, joint ventures and associates when it elects, or is required by regulations, to present separate financial statements.**
3. This Standard does not mandate which entities produce separate financial statements. It applies when an entity prepares separate financial statements that comply with International Public Sector Accounting Standards (IPSASs).
4. [Deleted]
5. [Deleted]

Definitions

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

Consolidated financial statements are the financial statements of an economic entity in which the assets, liabilities, net assets/equity, revenue, expenses and cash flows of the controlling entity and its controlled entities are presented as those of a single economic entity.

Separate financial statements are those presented by an entity, in which the entity could elect, subject to the requirements in this Standard, to account for its investments in controlled entities, joint ventures and associates either at cost, in accordance with IPSAS 29, *Financial Instruments: Recognition and Measurement* or using the equity method as described in IPSAS 36, *Investments in Associates and Joint Ventures*.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately. The following terms are defined in IPSAS 35, *Consolidated Financial Statements*, IPSAS 36, *Investments in Associates and Joint Ventures* or IPSAS 37, *Joint Arrangements*: associate, control, controlled entity, controlling entity, economic entity, equity method, investment entity, joint control, joint operation, joint venture, joint venturer and significant influence.

7. Separate financial statements are those presented in addition to consolidated financial statements or in addition to the financial statements of an investor

that does not have controlled entities but has investments in associates or joint ventures in which the investments in associates or joint ventures are required by IPSAS 36 to be accounted for using the equity method, other than in the circumstances set out in paragraphs 9–10.

8. The financial statements of an entity that does not have a controlled entity, associate or joint venturer's interest in a joint venture are not separate financial statements.
9. An entity that is exempted in accordance with paragraph 5 of IPSAS 35, from consolidation or paragraph 23 of IPSAS 36, from applying the equity method may present separate financial statements as its only financial statements.
10. An investment entity that is required, throughout the current period and all comparative periods presented, to measure its investment in all its controlled entities at fair value through surplus or deficit in accordance with paragraph 56 of IPSAS 35, presents separate financial statements as its only financial statements.

Preparation of Separate Financial Statements

11. **Separate financial statements shall be prepared in accordance with all applicable IPSASs, except as provided in paragraph 12.**
12. **When an entity prepares separate financial statements, it shall account for similar investments in controlled entities, joint ventures and associates either:**
 - (a) **At cost;**
 - (b) **In accordance with IPSAS 29; or**
 - (c) **Using the equity method as described in IPSAS 36.**
13. **If an entity elects, in accordance with paragraph 24 of IPSAS 36, to measure its investments in associates or joint ventures at fair value through surplus or deficit in accordance with IPSAS 29, it shall also account for those investments in the same way in its separate financial statements.**
14. **If a controlling entity is required, in accordance with paragraph 56 of IPSAS 35, to measure its investment in a controlled entity at fair value through surplus or deficit in accordance with IPSAS 29, it shall also account for that investment in the same way in its separate financial statements. If a controlling entity that is not itself an investment entity is required, in accordance with paragraph 58 of IPSAS 35, to measure the investments of a controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and consolidate the other assets and liabilities and revenue and expenses of the controlled**

investment entity, it shall also account for that investment in the controlled investment entity in the same way in its separate financial statements.

15. When a controlling entity ceases to be an investment entity, or becomes an investment entity, it shall account for the change from the date when the change in status occurred, as follows:
 - (a) When an entity ceases to be an investment entity, the entity shall account for an investment in a controlled entity in accordance with paragraph 12. The date of the change of status shall be the deemed acquisition date. The fair value of the controlled entity at the deemed acquisition date shall represent the transferred deemed consideration when accounting for the investment in accordance with paragraph 12.
 - (b) When an entity becomes an investment entity, it shall account for an investment in a controlled entity at fair value through surplus or deficit in accordance with IPSAS 29. The difference between the previous carrying amount of the controlled entity and its fair value at the date of the change of status of the investor shall be recognized as a gain or loss in surplus or deficit. The cumulative amount of any gain or loss previously recognized directly in net assets/equity in respect of those controlled entities shall be treated as if the investment entity had disposed of those controlled entities at the date of change in status.
16. Dividends or similar distributions from a controlled entity, a joint venture or an associate are recognized in the separate financial statements of an entity when the entity's right to receive the dividend or similar distribution is established. The dividend or similar distribution is recognized in surplus or deficit unless the entity elects to use the equity method, in which case the dividend or similar distribution is recognized as a reduction from the carrying amount of the investment.
17. When a controlling entity reorganizes the structure of its economic entity by establishing a new entity as its controlling entity in a manner that satisfies the following criteria:
 - (a) The new controlling entity obtains control of the original controlling entity either (i) by issuing equity instruments in exchange for existing equity instruments of the original controlling entity or (ii) by some other mechanism which results in the new controlling entity having a controlling ownership interest in the original controlling entity;

- (b) **The assets and liabilities of the new economic entity and the original economic entity are the same immediately before and after the reorganization; and**
- (c) **The owners of the original controlling entity before the reorganization have the same absolute and relative interests in the net assets of the original economic entity and the new economic entity immediately before and after the reorganization;**

and the new controlling entity accounts for its investment in the original controlling entity in accordance with paragraph 12(a) in its separate financial statements, the new controlling entity shall measure cost at the carrying amount of its share of the net assets/equity items shown in the separate financial statements of the original controlling entity at the date of the reorganization.

18. Similarly, an entity that is not a controlling entity might establish a new entity as its controlling entity in a manner that satisfies the criteria in paragraph 17. The requirements in paragraph 17 apply equally to such reorganizations. In such cases, references to “original controlling entity” and “original economic entity” are to the “original entity”.

Disclosure

19. **An entity shall apply all applicable IPSASs when providing disclosures in its separate financial statements, including the requirements in paragraphs 20–23.**
20. **When a controlling entity, in accordance with paragraph 5 of IPSAS 35, elects not to prepare consolidated financial statements and instead prepares separate financial statements, it shall disclose in those separate financial statements:**
- (a) **The fact that the financial statements are separate financial statements; that the exemption from consolidation has been used; the name of the entity whose consolidated financial statements that comply with IPSASs have been produced for public use; and the address where those consolidated financial statements are obtainable.**
 - (b) **A list of significant investments in controlled entities, joint ventures and associates, including:**
 - (i) **The name of those controlled entities, joint ventures and associates.**
 - (ii) **The jurisdiction in which those controlled entities, joint ventures and associates operate (if it is different from that of the controlling entity).**

- (iii) **Its proportion of the ownership interest held in those entities and a description of how that ownership interest has been determined.**
 - (c) **A description of the method used to account for the controlled entities, joint ventures and associates listed under (b).**
21. **When an investment entity that is a controlling entity (other than a controlling entity covered by paragraph 20) prepares, in accordance with paragraph 10, separate financial statements as its only financial statements, it shall disclose that fact. The investment entity shall also present the disclosures relating to investment entities required by IPSAS 38, *Disclosure of Interests in Other Entities*.**
22. **If a controlling entity that is not itself an investment entity is required, in accordance with paragraph 56 of IPSAS 35, to measure the investments of a controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and consolidate the other assets and liabilities and revenue and expenses of the controlled investment entity, it shall disclose that fact. The entity shall also present the disclosures relating to investment entities required by IPSAS 38, *Disclosure of Interests in Other Entities*.**
23. **When a controlling entity (other than a controlling entity covered by paragraphs 20–21) or an investor with joint control of, or significant influence over, an investee prepares separate financial statements, the controlling entity or investor shall identify the financial statements prepared in accordance with IPSAS 35, IPSAS 36 or IPSAS 37, to which they relate. The controlling entity or investor shall also disclose in its separate financial statements:**
- (a) **The fact that the statements are separate financial statements and the reasons why those statements are prepared, if not required by legislation or other authority.**
 - (b) **A list of significant controlled entities, joint ventures and associates, including:**
 - (i) **The name of those controlled entities, joint ventures and associates.**
 - (ii) **The jurisdiction in which those controlled entities, joint ventures and associates operate (if different from that of the controlling entity).**
 - (iii) **Its proportion of the ownership interest held in those entities and a description of how that ownership interest has been determined.**

- (c) A description of the method used to account for the controlled entities, joint ventures and associates listed under (b).

Transitional Provisions

24. At the date of initial application, an investment entity that previously measured its investment in a controlled entity at cost shall instead measure that investment at fair value through surplus or deficit as if the requirements of this Standard had always been effective. The investment entity shall adjust retrospectively the annual period immediately preceding the date of initial application and shall adjust accumulated surplus/deficit at the beginning of the immediately preceding period for any difference between:
- (a) The previous carrying amount of the investment; and
 - (b) The fair value of the investor's investment in the controlled entity.
25. At the date of initial application, an investment entity that previously measured its investment in a controlled entity at fair value directly to net assets/equity shall continue to measure that investment at fair value. The cumulative amount of any fair value adjustment previously recognized in net assets/equity shall be transferred to accumulated surplus/deficit at the beginning of the annual period immediately preceding the date of initial application.
26. At the date of initial application, an investment entity shall not make adjustments to the previous accounting for an interest in a controlled entity that it had previously elected to measure at fair value through surplus or deficit in accordance with IPSAS 29, as permitted in paragraph 12.
27. An investment entity shall use the fair value amounts previously reported to investors or to management.
28. If measuring the investment in the controlled entity in accordance with paragraphs 24–27 is impracticable (as defined in IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*), an investment entity shall apply the requirements of this Standard at the beginning of the earliest period for which application of paragraphs 24–27 is practicable, which may be the current period. The investor shall adjust retrospectively the annual period immediately preceding the date of initial application, unless the beginning of the earliest period for which application of this paragraph is practicable is the current period. When the date that it is practicable for the investment entity to measure the fair value of the controlled entity is earlier than the beginning of the immediately preceding period, the investor shall adjust net assets/equity at the beginning of the immediately preceding period for any difference between:

- (a) The previous carrying amount of the investment; and
- (b) The fair value of the investor's investment in the controlled entity.

If the earliest period for which application of this paragraph is practicable is the current period, the adjustment to net assets/equity shall be recognized at the beginning of the current period.

29. If an investment entity has disposed of, or lost control of, an investment in a controlled entity before the date of initial application of this Standard, the investment entity is not required to make adjustments to the previous accounting for that investment.
30. At the date of initial application, a controlling entity that is not itself an investment entity but which is required, in accordance with paragraph 56 of IPSAS 35, to measure the investments of a controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and consolidate the other assets and liabilities and revenue and expenses of the controlled investment entity, shall use the transitional provisions in paragraphs 24–29 in accounting for its investment in the controlled investment entity in its separate financial statements.
31. The transitional provisions for changes in the accounting, in an entity's separate financial statements, for its interest in a joint operation are set out in IPSAS 37, *Joint Arrangements*.

Effective Date

32. An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2017, it shall disclose that fact and apply IPSAS 35, IPSAS 36, IPSAS 37, and IPSAS 38 at the same time.
- 32A. Paragraphs 4 and 5 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.
33. When an entity adopts the accrual basis IPSASs as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards (IPSASs)* for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.

Withdrawal and Replacement of IPSAS 6 (December 2006)

34. This Standard is issued concurrently with IPSAS 35. Together, the two Standards supersede IPSAS 6, *Consolidated and Separate Financial Statements* (December 2006). IPSAS 6 remains applicable until IPSAS 34 and IPSAS 35 are applied or become effective, whichever is earlier.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 34.

Objective

BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in IPSAS 34. As this Standard is based on IAS 27, *Separate Financial Statements* (Amended in 2011, including amendments up to December 31, 2014), issued by the International Accounting Standards Board (IASB), the Basis for Conclusions outlines only those areas where IPSAS 34 departs from the main requirements of IAS 27 (Amended in 2011), or where the IPSASB considered such departures.

Overview

BC2. In 2012 the IPSASB commenced work on a project to update those IPSASs that dealt with accounting for interests in controlled entities, associates and joint ventures. In October 2013 the IPSASB issued Exposure Drafts (EDs) 48 to 52 which were collectively referred to as *Interests in Other Entities*. ED 48, *Separate Financial Statements*, was based on IAS 27 *Separate Financial Statements* (Amended in 2011), having regard to the relevant public sector modifications in IPSAS 6, *Consolidated and Separate Financial Statements*. In January 2015 the IPSASB issued five new IPSASs, including IPSAS 34. These new IPSASs supersede IPSAS 6, IPSAS 7, *Investments in Associates*, and IPSAS 8, *Interests in Joint Ventures*.

Use of the Equity Method in Separate Statements

BC3. IPSAS 6 permitted an entity, in its separate financial statements, to measure investments in controlled entities, jointly controlled entities and associates:

- (a) Using the equity method;
- (b) At cost; or
- (c) As a financial instrument in accordance with IPSAS 29.

BC4. The IPSASB noted that in 2003 the IASB limited the measurement options for investments presented in an entity's separate financial statements by removing the option to use the equity method. The IPSASB noted that the reasons given by the IASB for making this change included the following:

- (a) The focus in separate financial statements is on the performance of the assets as investments. Cost and fair value can provide relevant information for this; and

- (b) To the extent that the equity method provides information about the profit and loss of a subsidiary or an associate, that information would be available in the consolidated financial statements.

BC5. The IPSASB also noted that, at the time it issued ED 48, the IASB had signaled its intention to reconsider the use of the equity method in separate financial statements. In deciding to reconsider this issue the IASB acknowledged that corporate law in some countries requires that the equity method of accounting be used to measure certain investments when presenting separate financial statements.

BC6. The IPSASB decided to continue to permit the use of the equity method in separate financial statements for the following reasons:

- (a) The equity method is a well-established method of accounting for certain investments in the public sector. In many circumstances where investments are held by public sector entities, the equity method can provide information that is reliable¹ and useful, and possibly at a lower cost than either the cost method or the fair value method. In the public sector, investment entities are often used more as “instruments” to enable service provision, rather than as a holding for investment purposes, as might generally be the case in the private sector. The equity method may therefore, in some circumstances, be better suited to meeting user needs in the public sector, as it allows the financial statements to portray the fluctuations in the equity of, and performance by, an investment over time, in a cost effective and easily understood manner.
- (b) Although application of the cost method is often relatively straightforward, where investments have been held for some time, using the cost method may result in outdated and less relevant information, in which case, it would not meet user needs.
- (c) In the public sector there is likely to be a higher proportion of investments for which there are no active markets and in respect of which fair values are not readily observable. Although the guidance in IPSAS 29 can be used to derive a value for such investments, the IPSASB considered that this approach would generally result in information that did not faithfully represent the underlying circumstances.

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

- BC7. A majority of the respondents to ED 48 supported the proposal to permit the use of the equity method in separate financial statements. A further group of respondents also supported this proposal, subject to the IASB reinstating the use of the equity method in separate financial statements. In August 2014 the IASB issued the *Equity Method in Separate Financial Statements (Amendments to IAS 27)*, which reinstated the equity method as an option in separate financial statements. The IPSASB noted the support it had received for this proposal and the reinstatement of the equity method in IAS 27, and agreed to continue to permit the use of the equity method in separate financial statements.

Separate Financial Statements of Investment Entities

- BC8. In developing IPSAS 35 the IPSASB decided to introduce the concept of investment entities and to require that a controlling entity that is an investment entity measure its investments in most controlled entities at fair value through surplus or deficit in accordance with IPSAS 29. Consequently, the IPSASB decided to require that an investment entity measure its investments in controlled entities at fair value through surplus or deficit in its separate financial statements. The IPSASB also decided that an investment entity preparing separate financial statements as its only financial statements, should also make the disclosures required in IPSAS 38 about its interests in controlled entities.
- BC9. The IPSASB also decided to require a controlling entity of an investment entity that is not itself an investment entity to present consolidated financial statements in which it (i) measures the investments of a controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity. Consequently, the IPSASB decided to require that a non-investment controlling entity should measure its investment in a controlled investment entity in the same way in its separate financial statements.

Revision of IPSAS 34 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

- BC10. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:
- (a) Removes the standard paragraphs about the applicability of IPSASs to “public sector entities other than GBEs” from the scope section of each Standard;
 - (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and

- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

Comparison with IAS 27 (Amended in 2011)

IPSAS 34, *Separate Financial Statements*, is drawn primarily from IAS 27, *Separate Financial Statements* (Amended in 2011, including amendments up to December 31, 2014). At the time of issuing this Standard, the IPSASB has not considered the applicability to public sector entities of IFRS 9, *Financial Instruments*. References to IFRS 9 in the underlying IASB standard have therefore been replaced by references to the IPSASs dealing with financial instruments.

The main differences between IPSAS 34 and IAS 27 (Amended in 2011) are as follows:

- IPSAS 34 uses different terminology, in certain instances, from IAS 27 (Amended in 2011). The most significant examples are the use of the terms “net assets/equity,” “economic entity,” “controlling entity,” “controlled entity,” “revenue”. The equivalent terms in IAS 27 (Amended in 2011) are “equity,” “group,” “parent,” “subsidiary” and “income.”
- IPSAS 34 contains specific requirements for a controlling entity that is not itself an investment entity but which has an investment in a controlled investment entity. IAS 27 (Amended in 2011) does not specify different requirements for such controlling entities because it requires that such investments be consolidated.

IPSAS 35—CONSOLIDATED FINANCIAL STATEMENTS

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Financial Reporting Standard (IFRS) 10, *Consolidated Financial Statements* published by the International Accounting Standards Board (IASB). Extracts from IFRS 10 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 35—CONSOLIDATED FINANCIAL STATEMENTS

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 35, *Consolidated Financial Statements* was issued in January 2015.

Since then, IPSAS 35 has been amended by the following IPSASs:

- IPSAS 40, *Public Sector Combinations* (issued January 2017)
- IPSAS 39, *Employee Benefits* (issued July 2016)
- *The Applicability of IPSASs* (issued April 2016)

Table of Amended Paragraphs in IPSAS 35

Paragraph Affected	How Affected	Affected By
4	Amended	IPSAS 40 January 2017
6	Amended	IPSAS 39 July 2016
8	Amended	The Applicability of IPSASs April 2016
11	Deleted	The Applicability of IPSASs April 2016
12	Deleted	The Applicability of IPSASs April 2016
13	Deleted	The Applicability of IPSASs April 2016
40	Amended	IPSAS 40 January 2017
52	Amended	IPSAS 40 January 2017
55A	New	IPSAS 40 January 2017
56	Amended	IPSAS 40 January 2017
57	Amended	IPSAS 40 January 2017
63	Amended	IPSAS 40 January 2017

Paragraph Affected	How Affected	Affected By
79A	New	The Applicability of IPSASs April 2016
79B	New	IPSAS 39 July 2016
79C	New	IPSAS 40 January 2017
79D	New	IPSAS 40 January 2017

IPSAS 35—CONSOLIDATED FINANCIAL STATEMENTS

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International Public Sector Accounting Standard 35, *Consolidated Financial Statements*, is set out in paragraphs 1–81. All the paragraphs have equal authority. IPSAS 35 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.
2. To meet the objective in paragraph 1, this Standard:
 - (a) Requires an entity (the controlling entity) that controls one or more other entities (controlled entities) to present consolidated financial statements;
 - (b) Defines the principle of control, and establishes control as the basis for consolidation;
 - (c) Sets out how to apply the principle of control to identify whether an entity controls another entity and therefore must consolidate that entity;
 - (d) Sets out the accounting requirements for the preparation of consolidated financial statements; and
 - (e) Defines an investment entity and sets out an exception to consolidating particular controlled entities of an investment entity.

Scope

3. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in the preparation and presentation of consolidated financial statements for the economic entity.**

Public Sector Combinations

4. This Standard does not deal with the accounting requirements for public sector combinations and their effect on consolidation, including goodwill arising on a public sector combination (see IPSAS 40, *Public Sector Combinations*).

Presentation of Consolidated Financial Statements

5. **An entity that is a controlling entity shall present consolidated financial statements. This Standard applies to all entities, except that a controlling entity need not present consolidated financial statements if it meets all the following conditions:**
 - (a) **It is itself a controlled entity and the information needs of users are met by its controlling entity's consolidated financial statements, and, in the case of a partially owned controlled entity, all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity not presenting consolidated financial statements;**

- (b) **Its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);**
 - (c) **It did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and**
 - (d) **Its ultimate or any intermediate controlling entity produces financial statements that are available for public use and comply with International Public Sector Accounting Standards (IPSASs), in which controlled entities are consolidated or are measured at fair value through surplus or deficit in accordance with this Standard.**
6. This Standard does not apply to post-employment benefit plans or other long-term employee benefit plans to which IPSAS 39, *Employee Benefits* applies.
 7. **A controlling entity that is an investment entity shall not present consolidated financial statements if it is required, in accordance with paragraph 56 of this Standard, to measure all of its controlled entities at fair value through surplus or deficit.**
 8. A controlled entity is not excluded from consolidation because its activities are dissimilar to those of the other entities within the economic entity, for example, the consolidation of commercial public sector entities with entities in the budget sector. Relevant information is provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities. For example, the disclosures required by IPSAS 18, *Segment Reporting*, help to explain the significance of different activities within the economic entity.
 9. The exemption from preparing consolidated financial statements in paragraph 5 does not apply where the information needs of a controlled entity's users would not be met by the consolidated financial statements of its controlling entity. For example, consolidated financial statements at a whole-of-government level may not meet the information needs of users in respect of key sectors or activities of a government. In many jurisdictions there are legislated financial reporting requirements intended to address the information needs of such users.
 10. An entity may be required, (for example, by legislation, or by external users) to prepare aggregated financial statements which are for a different economic entity than that required by this Standard. Although such financial statements fall outside the scope of this Standard and would not comply with the requirements in this Standard, an entity could use the guidance in this Standard in the preparation of such aggregated financial statements.

Government Business Enterprises

11. [Deleted]
12. [Deleted]
13. [Deleted]

Definitions

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

Benefits are the advantages an entity obtains from its involvement with other entities. Benefits may be financial or non-financial. The actual impact of an entity's involvement with another entity can have positive or negative aspects.

Binding arrangement: For the purposes of this Standard, a binding arrangement is an arrangement that confers enforceable rights and obligations on the parties to it as if it were in the form of a contract. It includes rights from contracts or other legal rights.

Consolidated financial statements are the financial statements of an economic entity in which the assets, liabilities, net assets/equity, revenue, expenses and cash flows of the controlling entity and its controlled entities are presented as those of a single economic entity.

Control: An entity controls another entity when the entity is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature or amount of those benefits through its power over the other entity.

A **controlled entity** is an entity that is controlled by another entity.

A **controlling entity** is an entity that controls one or more entities.

A **decision-maker** is an entity with decision-making rights that is either a principal or an agent for other parties.

An **economic entity** is a controlling entity and its controlled entities.

An **investment entity** is an entity that:

- (a) Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- (b) Has the purpose of investing funds solely for returns from capital appreciation, investment revenue, or both; and
- (c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

A non-controlling interest is the net assets/equity in a controlled entity not attributable, directly or indirectly, to a controlling entity.

Power consists of existing rights that give the current ability to direct the relevant activities of another entity.

Protective rights are rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

Relevant activities: For the purpose of this Standard, relevant activities are activities of the potentially controlled entity that significantly affect the nature or amount of the benefits that an entity receives from its involvement with that other entity.

Removal rights are rights to deprive the decision maker of its decision-making authority.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately. The following terms are defined in either IPSAS 36, *Investments in Associates and Joint Ventures*, IPSAS 37, *Joint Arrangements*, or IPSAS 38, *Disclosure of Interests in Other Entities*: associate, interest in another entity, joint venture and significant influence.

Binding Arrangement

15. Binding arrangements can be evidenced in several ways. A binding arrangement is often, but not always, in writing, in the form of a contract or documented discussions between the parties. Statutory mechanisms such as legislative or executive authority can also create enforceable arrangements, similar to contractual arrangements, either on their own or in conjunction with contracts between the parties.

Economic Entity

16. The term economic entity is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities. Other terms sometimes used to refer to an economic entity include administrative entity, financial entity, consolidated entity, and group. An economic entity may include entities with both social policy and commercial objectives.
17. The determination of the economic entity will need to be made having regard to the constitutional arrangements in a jurisdiction, in particular the ways in which government power is limited and allocated, and how the government system is set up and operates. For example, in jurisdictions with an executive, legislature and judiciary, these may collectively form an economic entity in respect of which there is a user need for consolidated financial statements.

Such consolidated financial statements are commonly referred to as whole-of-government financial statements.

Control (see paragraphs AG2–AG87)

18. **An entity, regardless of the nature of its involvement with another entity, shall determine whether it is a controlling entity by assessing whether it controls the other entity.**
19. **An entity controls another entity when it is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature or amount of those benefits through its power over the other entity.**
20. **Thus, an entity controls another entity if and only if the entity has all the following:**
 - (a) **Power over the other entity (see paragraphs 23–29);**
 - (b) **Exposure, or rights, to variable benefits from its involvement with the other entity (see paragraphs 30–34); and**
 - (c) **The ability to use its power over the other entity to affect the nature or amount of the benefits from its involvement with the other entity (see paragraphs 35–37).**
21. **An entity shall consider all facts and circumstances when assessing whether it controls another entity. The entity shall reassess whether it controls another entity if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 20 (see paragraphs AG82–AG87).**
22. Two or more entities collectively control another entity when they must act together to direct the relevant activities. In such cases, because no single entity can direct the activities without the co-operation of the others, no single entity controls the other entity. Each entity would account for its interest in the other entity in accordance with the relevant IPSASs, such as IPSAS 36, IPSAS 37, or the IPSASs dealing with financial instruments (IPSAS 28, *Financial Instruments: Presentation*, IPSAS 29, *Financial Instruments: Recognition and Measurement*, and IPSAS 30, *Financial Instruments: Disclosures*).

Power

23. An entity has power over another entity when the entity has existing rights that give it the current ability to direct the relevant activities, i.e., the activities that significantly affect the nature or amount of the benefits from its involvement with the other entity. The right to direct the financial and operating policies of another entity indicates that an entity has the ability to direct the relevant activities of another entity and is frequently the way in which power is demonstrated in the public sector.

24. Power arises from rights. In some cases assessing power is straightforward, such as when power over another entity is obtained directly and solely from the voting rights granted by equity instruments such as shares, and can be assessed by considering the voting rights from those shareholdings. However, public sector entities often obtain power over another entity from rights other than voting rights. They may also obtain power over another entity without having an equity instrument providing evidence of a financial investment. An entity may have rights conferred by binding arrangements. These rights may give an entity power to require the other entity to deploy assets or incur liabilities in a way that affects the nature or amount of benefits received by the first-mentioned entity. The assessment of whether such rights give rise to power over another entity may be complex and require more than one factor to be considered.
25. An entity can have power over another entity even if it does not have responsibility for the day-to-day operation of the other entity or the manner in which prescribed functions are performed by that other entity. Legislation may give statutory bodies or statutory officers powers to carry out their functions independently of government. For example, the Auditor-General and Government Statistician usually have statutory powers to obtain information and publish reports without recourse to government and the judiciary often has special powers to give effect to the concept of judicial independence. Legislation may also set out the broad parameters within which the statutory body is required to operate, and result in the statutory body operating in a manner consistent with the objectives set by Parliament or a similar body. The existence of statutory powers to operate independently does not, of itself, preclude an entity having the ability to direct the operating and financial policies of another entity with statutory powers so as to obtain benefits. For example, the independence of a central bank in relation to monetary policy does not preclude the possibility of the central bank being controlled. All facts and circumstances would still need to be considered.
26. The existence of rights over another entity does not necessarily give rise to power for the purposes of this Standard. An entity does not have power over another entity solely due to the existence of:
 - (a) Regulatory control (see paragraph AG12); or
 - (b) Economic dependence (see paragraphs AG41–AG42).
27. An entity with the current ability to direct the relevant activities has power even if its rights to direct have yet to be exercised. Evidence that the entity has been directing the relevant activities of the entity being assessed for control can help determine whether the entity has power, but such evidence is not, in itself, conclusive in determining whether the entity has power over the entity being assessed for control. In the case of an entity established with

predetermined activities, the right to direct the relevant activities may have been exercised at the time that the entity was established.

28. If two or more entities each have existing rights that give them the unilateral ability to direct different relevant activities, the entity that has the current ability to direct the activities that most significantly affect the nature or amount of benefits from that entity has power over that other entity.
29. An entity can have power over an entity being assessed for control even if other entities have existing rights that give them the current ability to participate in the direction of the relevant activities, for example when another entity has significant influence. However, an entity that holds only protective rights does not have power over another entity (see paragraphs AG29–AG31), and consequently does not control the other entity.

Benefits

30. An entity is exposed, or has rights, to variable benefits from its involvement with an entity being assessed for control when the benefits that it seeks from its involvement have the potential to vary as a result of the other entity's performance. Entities become involved with other entities with the expectation of positive financial or non-financial benefits over time. However, in a particular reporting period, the actual impact of an entity's involvement with the entity being assessed for control can be only positive, only negative or a mix of both positive and negative.
31. The entity's benefits from its involvement with the entity being assessed for control can be only financial, only non-financial or both financial and non-financial. Financial benefits include returns on investment such as dividends or similar distributions and are sometimes referred to as "returns". Non-financial benefits include advantages arising from scarce resources that are not measured in financial terms and economic benefits received directly by service recipients of the entity. Non-financial benefits can occur when the activities of another entity are congruent with, (that is, they are in agreement with), the objectives of the entity and support the entity in achieving its objectives. For example, an entity may obtain benefits when another entity with congruent activities provides services that the first entity would have otherwise been obliged to provide. Congruent activities may be undertaken voluntarily or the entity may have the power to direct the other entity to undertake those activities. Non-financial benefits can also occur when two entities have complementary objectives (that is, the objectives of one entity add to, and make more complete, the objectives of the other entity).
32. The following examples illustrate financial benefits that an entity may receive from its involvement with another entity:

- (a) Dividends, variable interest on debt securities, other distributions of economic benefits;
 - (b) Exposure to increases or decreases in the value of an investment in another entity;
 - (c) Exposure to loss from agreements to provide financial support, including financial support for major projects;
 - (d) Cost savings (for example, if an entity would achieve economies of scale or synergies by combining the operations or assets of the other entity with its own operations or assets);
 - (e) Residual interests in the other entity's assets and liabilities on liquidation of that other entity; and
 - (f) Other exposures to variable benefits that are not available to other entities.
33. Examples of non-financial benefits include:
- (a) The ability to benefit from the specialized knowledge of another entity;
 - (b) The value to the entity of the other entity undertaking activities that assist the entity in achieving its objectives;
 - (c) Improved outcomes;
 - (d) More efficient delivery of outcomes;
 - (e) More efficient or effective production and delivery of goods and services;
 - (f) Having an asset and related services available earlier than otherwise would be the case; and
 - (g) Having a higher level of service quality than would otherwise be the case.
34. Although only one entity can control another entity, more than one party can share in the benefits of that other entity. For example, holders of non-controlling interests can share in the financial benefits such as surpluses or distributions from an entity or the non-financial benefits such as congruence of activities with desired outcomes.

Link between Power and Benefits

35. An entity controls another entity if the entity not only has power over the entity being assessed for control and exposure or rights to variable benefits from its involvement with the other entity, but also has the ability to use its power to affect the nature or amount of the benefits from its involvement with the entity being assessed for control.

36. The existence of congruent objectives alone is insufficient for an entity to conclude that it controls another entity. In order to have control the entity would also need to have the ability to use its power over the entity being assessed for control to direct that other entity to work with it to further its objectives.
37. **An entity with decision-making rights shall determine whether it is a principal or an agent. An entity shall also determine whether another entity with decision-making rights is acting as an agent for the entity. An agent is a party primarily engaged to act on behalf and for the benefit of another party or parties (the principal(s)) and therefore does not control the other entity when it exercises its decision-making authority. Thus, sometimes a principal's power may be held and exercisable by an agent, but on behalf of the principal.**

Accounting Requirements

38. **A controlling entity shall prepare consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.**
39. **Consolidation of a controlled entity shall begin from the date the entity obtains control of the other entity and cease when the entity loses control of the other entity.**

Consolidation Procedures

40. Consolidated financial statements:
 - (a) Combine like items of assets, liabilities, net assets/equity, revenue, expenses and cash flows of the controlling entity with those of its controlled entities.
 - (b) Offset (eliminate) the carrying amount of the controlling entity's investment in each controlled entity and the controlling entity's portion of net assets/equity of each controlled entity (IPSAS 40 explains how to account for any related goodwill).
 - (c) Eliminate in full intra-economic entity assets, liabilities, net assets/equity, revenue, expenses and cash flows relating to transactions between entities of the economic entity (surpluses or deficits resulting from intra-economic entity transactions that are recognized in assets, such as inventory and fixed assets, are eliminated in full). Intra-economic entity losses may indicate an impairment that requires recognition in the consolidated financial statements.

Uniform Accounting Policies

41. If a member of the economic entity uses accounting policies other than those adopted in the consolidated financial statements for like transactions

and events in similar circumstances, appropriate adjustments are made to that member's financial statements in preparing the consolidated financial statements to ensure conformity with the economic entity's accounting policies.

Measurement

42. An entity includes the revenue and expenses of a controlled entity in the consolidated financial statements from the date it gains control until the date when the entity ceases to control the controlled entity. Revenue and expenses of the controlled entity are based on the amounts of the assets and liabilities recognized in the consolidated financial statements at the acquisition date. For example, depreciation expense recognized in the consolidated statement of financial performance after the acquisition date is based on the values of the related depreciable assets recognized in the consolidated financial statements at the acquisition date.

Potential Voting Rights

43. When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of surplus or deficit and changes in net assets/equity allocated to the controlling entity and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives, unless paragraph 44 applies.
44. In some circumstances an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to the benefits associated with an ownership interest. In such circumstances, the proportion allocated to the controlling entity and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the benefits.
45. IPSAS 28 and IPSAS 29 do not apply to interests in controlled entities that are consolidated. When instruments containing potential voting rights in substance currently give access to the benefits associated with an ownership interest in a controlled entity, the instruments are not subject to the requirements of IPSAS 28 and IPSAS 29. In all other cases, instruments containing potential voting rights in a controlled entity are accounted for in accordance with IPSAS 28 and IPSAS 29.

Reporting Dates

46. **The financial statements of the controlling entity and its controlled entities used in the preparation of the consolidated financial statements shall be prepared as at the same reporting date. When the end of the**

reporting period of the controlling entity is different from that of a controlled entity, the controlling entity either:

- (a) Obtains, for consolidation purposes, additional financial information as of the same date as the financial statements of the controlling entity; or**
- (b) Uses the most recent financial statements of the controlled entity adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the consolidated financial statements.**

Non-Controlling Interests

- 47. A controlling entity shall present non-controlling interests in the consolidated statement of financial position within net assets/equity, separately from the net assets/equity of the owners of the controlling entity.**
- 48. Changes in a controlling entity's interest in a controlled entity that do not result in the controlling entity losing control of the controlled entity are transactions with owners in their capacity as owners.**
- 49. An entity shall attribute the surplus or deficit and each gain or loss recognized directly in net assets/equity to the owners of the controlling entity and to the non-controlling interests. The entity shall also attribute the total amount recognized in the statement of changes in net assets/equity to the owners of the controlling entity and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.**
- 50. If a controlled entity has outstanding cumulative preference shares that are classified as equity instruments and are held by non-controlling interests, the entity shall compute its share of surplus or deficit after adjusting for the dividends on such shares, whether or not such dividends have been declared.**

Changes in the Proportion held by Non-Controlling Interests

- 51. When the proportion of the net assets/equity held by non-controlling interests changes, an entity shall adjust the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the controlled entity. The entity shall recognize directly in net assets/equity any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received, and attribute it to the owners of the controlling entity.**

Loss of Control

52. **If a controlling entity loses control of a controlled entity, the controlling entity:**
 - (a) **Derecognizes the assets and liabilities of the former controlled entity from the consolidated statement of financial position;**
 - (b) **Recognizes any investment retained in the former controlled entity when control is lost and subsequently accounts for it and for any amounts owed by or to the former controlled entity in accordance with relevant IPSASs. That retained interest is remeasured, as described in paragraphs 54(b)(iii) and 55A. The remeasured value at the date that control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with IPSAS 29 or the cost on initial recognition of an investment in an associate or joint venture, if applicable; and**
 - (c) **Recognizes the gain or loss associated with the loss of control attributable to the former controlling interest, as specified in paragraphs 54–55A.**
53. **A controlling entity might lose control of a controlled entity in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a controlling entity shall consider all the terms and conditions of the arrangements and their economic effects. One or more of the following indicate that the controlling entity should account for the multiple arrangements as a single transaction:**
 - (a) **They are entered into at the same time or in contemplation of each other.**
 - (b) **They form a single transaction designed to achieve an overall commercial effect.**
 - (c) **The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.**
 - (d) **One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when a disposal of an investment is priced below market and is compensated for by a subsequent disposal priced above market.**
54. **If a controlling entity loses control of a controlled entity, it shall:**
 - (a) **Derecognize:**

- (i) **The assets (including any goodwill) and liabilities of the controlled entity at their carrying amounts at the date when control is lost; and**
- (ii) **The carrying amount of any non-controlling interests in the former controlled entity at the date when control is lost (including any gain or loss recognized directly in net assets/equity attributable to them).**
- (b) **Recognize:**
 - (i) **The fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;**
 - (ii) **If the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the controlled entity to owners in their capacity as owners, that distribution; and**
 - (iii) **Any investment retained in the former controlled entity at its fair value at the date when control is lost.**
- (c) **Transfer directly to accumulated surplus/deficit, if required by other IPSASs, the amounts recognized directly in net assets/equity in relation to the controlled entity on the basis described in paragraph 55.**
- (d) **Recognize any resulting difference as a gain or loss in surplus or deficit attributable to the controlling entity.**

55. If a controlling entity loses control of a controlled entity, the controlling entity shall account for all amounts previously recognized directly in net assets/equity in relation to that controlled entity on the same basis as would be required if the controlling entity had directly disposed of the related assets or liabilities. If a revaluation surplus previously recognized directly in net assets/equity would be transferred directly to accumulated surplus/deficit on the disposal of the asset, the controlling entity shall transfer the revaluation surplus directly to accumulated surplus/deficit when it loses control of the controlled entity.

55A. If a controlling entity loses control of a controlled entity that does not contain an operation, as defined in IPSAS 40, as a result of a transaction involving an associate or a joint venture that is accounted for using the equity method, the controlling entity determines the gain or loss in accordance with paragraphs 54–55. The gain or loss resulting from the transaction is recognized in the controlling entity’s surplus or deficit only to the extent of the unrelated investors’ interests in that associate or joint venture. The remaining part of the gain is eliminated against

the carrying amount of the investment in that associate or joint venture. In addition, if the controlling entity retains an investment in the former controlled entity and the former controlled entity is now an associate or a joint venture that is accounted for using the equity method, the controlling entity recognizes the part of the gain or loss resulting from the remeasurement at fair value of the investment retained in that former controlled entity in its surplus or deficit only to the extent of the unrelated investors' interests in the new associate or joint venture. The remaining part of that gain is eliminated against the carrying amount of the investment retained in the former controlled entity. If the controlling entity retains an investment in the former controlled entity that is now accounted for in accordance with IPSAS 29, the part of the gain or loss resulting from the remeasurement at fair value of the investment retained in the former controlled entity is recognized in full in the controlling entity's surplus or deficit.

Investment Entities: Fair Value Requirement

56. Except as described in paragraph 57, an investment entity shall not consolidate its controlled entities or apply IPSAS 40 when it obtains control of another entity. Instead, an investment entity shall measure an investment in a controlled entity at fair value through surplus or deficit in accordance with IPSAS 29.
57. Notwithstanding the requirement in paragraph 56, if an investment entity has a controlled entity that is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity's investment activities (see paragraphs AG98–AG100), it shall consolidate that controlled entity in accordance with paragraphs 38–55 of this Standard and apply the requirements of IPSAS 40 to the acquisition of any such controlled entity.
58. A controlling entity of an investment entity that is not itself an investment entity shall present consolidated financial statements in which it (i) measures the investments of a controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity in accordance with paragraphs 38–55 of this Standard.

Determining Whether an Entity is an Investment Entity

59. An entity shall consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. Paragraphs AG89–AG106 describe aspects of the definition of an investment entity in more detail. If facts and circumstances indicate that there are changes to one or more of the three elements that make up

the definition of an investment entity, a controlling entity shall reassess whether it is an investment entity.

- 60. A controlling entity that either ceases to be an investment entity or becomes an investment entity shall account for the change in its status prospectively from the date at which the change in status occurred (see paragraphs 63–64).**

Judgments and Assumptions

- 61. An investment entity shall disclose the information required by paragraph 15 of IPSAS 38 about significant judgments and assumptions made in determining that it is an investment entity unless it has all of the following characteristics:**
- (a) It has obtained funds from more than one investor (see paragraphs AG89–AG90);**
 - (b) It has ownership interests in the form of equity or similar interests (see paragraphs AG91–AG92); and**
 - (c) It has more than one investment (see paragraphs AG96–AG97).**
- 62. The absence of any of these characteristics does not necessarily disqualify an entity from being classified as an investment entity. However, the absence of any of these characteristics means that an entity is required to disclose information about the significant judgments and assumptions made in determining that it is an investment entity.**

Accounting for a Change in Investment Entity Status

- 63. When an entity ceases to be an investment entity, it shall apply IPSAS 40 to any controlled entity that was previously measured at fair value through surplus or deficit in accordance with paragraph 56. The date of the change of status shall be the deemed acquisition date. The fair value of the controlled entity at the deemed acquisition date shall represent the transferred deemed consideration when measuring any goodwill or gain from a bargain purchase that arises from the deemed acquisition. All controlled entities shall be consolidated in accordance with paragraphs 38–51 of this Standard from the date of change of status.**
- 64. When an entity becomes an investment entity, it shall cease to consolidate its controlled entities at the date of the change in status, except for any controlled entity that shall continue to be consolidated in accordance with paragraph 57. The investment entity shall apply the requirements of paragraphs 52 and 53 to those controlled entities that it ceases to consolidate as though the investment entity had lost control of those controlled entities at that date.**

Transitional Provisions

65. **An entity shall apply this Standard retrospectively, in accordance with IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 66–78.**
66. **Notwithstanding the requirements of paragraph 33 of IPSAS 3, when this Standard is first applied an entity need only present the quantitative information required by paragraph 33(f) of IPSAS 3 for the annual period immediately preceding the date of initial application of this Standard (the “immediately preceding period”). An entity may also present this information for the current period or for earlier comparative periods, but is not required to do so.**
67. For the purposes of this Standard, the date of initial application is the beginning of the annual reporting period for which this Standard is applied for the first time.
68. At the date of initial application, an entity is not required to make adjustments to the previous accounting for its involvement with either:
 - (a) Entities that would be consolidated at that date in accordance with IPSAS 6, *Consolidated and Separate Financial Statements*, and are still consolidated in accordance with this Standard; or
 - (b) Entities that would not be consolidated at that date in accordance with IPSAS 6, and are not consolidated in accordance with this Standard.
69. **At the date of initial application, an entity shall assess whether it is an investment entity on the basis of the facts and circumstances that exist at that date. If, at the date of initial application, an entity concludes that it is an investment entity, it shall apply the requirements of paragraphs 70–73 instead of paragraphs 77–78.**
70. **Except for any controlled entity that is consolidated in accordance with paragraph 57 (to which paragraph 68 or paragraphs 77–78, whichever is relevant, apply), an investment entity shall measure its investment in each controlled entity at fair value through surplus or deficit as if the requirements of this Standard had always been effective. The investment entity shall retrospectively adjust both the annual period that immediately precedes the date of initial application and net assets/equity at the beginning of the immediately preceding period for any difference between:**
 - (a) **The previous carrying amount of the controlled entity; and**
 - (b) **The fair value of the investment entity’s investment in the controlled entity.**

The cumulative amount of any fair value adjustments previously recognized directly in net assets/equity shall be transferred to accumulated surplus/deficit at the beginning of the annual period immediately preceding the date of initial application.

- 71. An investment entity shall use the fair value amounts that were previously reported to investors or to management.**
- 72. If measuring an investment in a controlled entity in accordance with paragraph 70 is impracticable (as defined in IPSAS 3), an investment entity shall apply the requirements of this Standard at the beginning of the earliest period for which application of paragraph 70 is practicable, which may be the current period. The investor shall retrospectively adjust the annual period that immediately precedes the date of initial application, unless the beginning of the earliest period for which application of this paragraph is practicable is the current period. If this is the case, the adjustment to net assets/equity shall be recognized at the beginning of the current period.**
- 73. If an investment entity has disposed of, or has lost control of, an investment in a controlled entity before the date of initial application of this Standard, the investment entity is not required to make adjustments to the previous accounting for that controlled entity.**
- 74. If, at the date of initial application, an entity concludes that it shall consolidate another entity that was not consolidated in accordance with IPSAS 6, the entity shall measure the assets, liabilities and non-controlling interests in that previously unconsolidated entity as if that other entity had been consolidated from the date when the entity obtained control of that other entity on the basis of the requirements of this Standard. The entity shall adjust retrospectively the annual period immediately preceding the date of initial application. When the date that control was obtained is earlier than the beginning of the immediately preceding period, the entity shall recognize, as an adjustment to net assets/equity at the beginning of the immediately preceding period, any difference between:**
 - (a) The amount of assets, liabilities and non-controlling interests recognized; and**
 - (b) The previous carrying amount of the entity's involvement with the other entity.**
- 75. If measuring a controlled entity's assets, liabilities and non-controlling interests in accordance with paragraph 74(a) or (b) is impracticable (as defined in IPSAS 3), an entity shall measure the assets, liabilities and non-controlling interests in that previously unconsolidated entity as if that entity had been consolidated from the deemed acquisition date. The**

deemed acquisition date shall be the beginning of the earliest period for which the application of this paragraph is practicable, which may be the current period.

76. The entity shall adjust retrospectively the annual period immediately preceding the date of initial application, unless the beginning of the earliest period for which application of this paragraph is practicable is the current period. When the deemed acquisition date is earlier than the beginning of the immediately preceding period, the entity shall recognize, as an adjustment to net assets/equity at the beginning of the immediately preceding period, any difference between:

- (a) The amount of assets, liabilities and non-controlling interests recognized; and
- (b) The previous carrying amounts of the entity's involvement with the other entity.

If the earliest period for which application of this paragraph is practicable is the current period, the adjustment to net assets/equity shall be recognized at the beginning of the current period.

77. If, at the date of initial application, an entity concludes that it will no longer consolidate an entity that was consolidated in accordance with IPSAS 6, the entity shall measure its interest in the other entity at the amount at which it would have been measured if the requirements of this Standard had been effective when the entity became involved with, or lost control of, the other entity. The entity shall adjust retrospectively the annual period immediately preceding the date of initial application. When the date that the entity became involved with (but did not obtain control in accordance with this Standard), or lost control of, the other entity is earlier than the beginning of the immediately preceding period, the entity shall recognize, as an adjustment to net assets/equity at the beginning of the immediately preceding period, any difference between:

- (a) The previous carrying amount of the assets, liabilities and non-controlling interests; and
- (b) The recognized amount of the entity's interest in the other entity.

78. If measuring the interest in the other entity in accordance with paragraph 77 is impracticable (as defined in IPSAS 3), an entity shall apply the requirements of this Standard at the beginning of the earliest period for which application of paragraph 77 is practicable, which may be the current period. The entity shall adjust retrospectively the annual period immediately preceding the date of initial application, unless the beginning of the earliest period for which application of this paragraph is practicable is the current period. When the date that the entity became involved with (but did not obtain control in accordance with this

Standard), or lost control of, the other entity is earlier than the beginning of the immediately preceding period, the entity shall recognize, as an adjustment to net assets/equity at the beginning of the immediately preceding period, any difference between:

- (a) The previous carrying amount of the assets, liabilities and non-controlling interests; and
- (b) The recognized amount of the entity's interest in the other entity.

If the earliest period for which application of this paragraph is practicable is the current period, the adjustment to net assets/equity shall be recognized at the beginning of the current period.

Effective Date

- 79. An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2017, it shall disclose that fact and apply IPSAS 34, *Separate Financial Statements*, IPSAS 36, IPSAS 37, and IPSAS 38 at the same time.
- 79A. Paragraphs 11, 12 and 13 were deleted and paragraph 8 was amended by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.
- 79B. Paragraph 6 was amended by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.
- 79C. Paragraphs 4, 40, 56, 57 and 63 were amended by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments for annual financial statements covering periods beginning on or after January 1, 2019. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2019 it shall disclose that fact and apply IPSAS 40 at the same time.
- 79D. Paragraph 52 was amended and paragraph 55A added by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments prospectively for annual financial statements covering periods beginning on or after a date to be determined by the IPSASB. Earlier application is permitted. If an entity applies the

amendments earlier, it shall disclose that fact and, if it has not already done so, apply IPSAS 40 at the same time.

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

Withdrawal and Replacement of IPSAS 6 (December 2006)

81. This Standard is issued concurrently with IPSAS 34. Together, the two Standards supersede IPSAS 6 (December 2006). IPSAS 6 remains applicable until IPSAS 34 and IPSAS 35 are applied or become effective, whichever is earlier.

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 35.

AG1. The examples in this appendix portray hypothetical situations. Although some aspects of the examples may be present in actual fact patterns, all facts and circumstances of a particular fact pattern would need to be evaluated when applying IPSAS 35, *Consolidated Financial Statements*.

Assessing Control

AG2. To determine whether it controls another entity an entity shall assess whether it has all the following:

- (a) Power over the other entity;
- (b) Exposure, or rights, to variable benefits from its involvement with the other entity; and
- (c) The ability to use its power over the other entity to affect the nature or amount of the benefits from its involvement with the other entity.

AG3. Consideration of the following factors may assist in making that determination:

- (a) The purpose and design of the other entity (see paragraphs AG5–AG8);
- (b) What the relevant activities are and how decisions about those activities are made (see paragraphs AG13–AG15);
- (c) Whether the rights of the entity give it the current ability to direct the relevant activities of the other entity (see paragraphs AG16–AG56);
- (d) Whether the entity is exposed, or has rights, to variable benefits from its involvement with the other entity (see paragraph AG57–AG58); and
- (e) Whether the entity has the ability to use its power over the other entity to affect the nature or amount of the benefits from its involvement with the other entity (see paragraphs AG60–AG74).

AG4. When assessing whether it controls another entity, an entity shall consider the nature of its relationship with other parties (see paragraphs AG75–AG77).

Purpose and Design of another Entity

- AG5. An entity shall consider the purpose and design of the entity being assessed for control in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who benefits from those activities.
- AG6. When the purpose and design of the entity being assessed for control are considered, it may be clear that the entity being assessed for control is controlled by means of equity instruments that give the holder proportionate voting rights, such as ordinary shares. In this case, in the absence of any additional arrangements that alter decision-making, the assessment of control focuses on which party, if any, is able to exercise voting rights sufficient to determine the operating and financing policies of the entity being assessed for control (see paragraphs AG32–AG52). In the most straightforward case, the entity that holds a majority of those voting rights, in the absence of any other factors, controls the other entity.
- AG7. To determine whether an entity controls another entity in more complex cases, it may be necessary to consider some or all of the other factors in paragraph AG3.
- AG8. Voting rights may not be the dominant factor in deciding who controls the entity being assessed for control. If there are voting rights they may be limited in scope. The relevant activities of the entity being assessed for control may be directed by means of binding arrangements or provisions in founding documents such as articles of association or a constitution. In such cases, an entity's consideration of the purpose and design of the entity being assessed for control shall also include consideration of the risks to which the other entity was designed to be exposed, the risks it was designed to pass on to the parties involved and whether the entity is exposed to some or all of those risks. Consideration of the risks includes not only the downside risk, but also the potential for upside.

Power

- AG9. To have power over another entity, an entity must have existing rights that give it the current ability to direct the relevant activities. For the purpose of assessing power, only substantive rights and rights that are not protective shall be considered (see paragraphs AG25–AG31).
- AG10. The determination about whether an entity has power depends on the relevant activities, the way decisions about the relevant activities are made and the rights of the entity and other entities in relation to the potentially controlled entity.
- AG11. An entity normally will have power over an entity that it has established when the constituting document or enabling legislation specifies the operating and financing activities that are to be carried out by that entity. However, the

impact of the constituting document or legislation is evaluated in the light of other prevailing circumstances, as all facts and circumstances need to be considered in assessing whether an entity has power over another entity. For example, a government may not have power over a research and development corporation that operates under a mandate created, and limited, by legislation if that or other legislation assigns power to direct the relevant activities to other entities that are not controlled by the government.

Regulatory Control

AG12. Regulatory control does not usually give rise to power over an entity for the purposes of this Standard. Governments and other public sector bodies, including supranational bodies, may have wide ranging powers to establish the regulatory framework within which entities operate, to impose conditions or sanctions on their operations and to enforce those conditions or sanctions. For example, governments and other public sector bodies may enact regulations to protect the health and safety of the community, restrict the sale or use of dangerous goods or specify the pricing policies of monopolies. However, when regulation is so tight as to effectively dictate how the entity performs its business, then it may be necessary to consider whether the purpose and design of the entity is such that it is controlled by the regulating entity.

Relevant Activities and Direction of Relevant Activities

AG13. For many entities, a range of operating and financing activities significantly affect the benefits they generate. Any activity that assists in achieving or furthering the objectives of a controlled entity may affect the benefits to the controlling entity. Examples of activities that, depending on the circumstances, can be relevant activities include, but are not limited to:

- (a) Using assets and incurring liabilities to provide services to service recipients;
- (b) Distributing funds to specified individuals or groups;
- (c) Collecting revenue through non-exchange transactions;
- (d) Selling and purchasing of goods or services;
- (e) Managing physical assets;
- (f) Managing financial assets during their life (including upon default);
- (g) Selecting, acquiring or disposing of assets;
- (h) Managing a portfolio of liabilities;
- (i) Researching and developing new products or processes; and
- (j) Determining a funding structure or obtaining funding.

- AG14. Examples of decisions about relevant activities include but are not limited to:
- (a) Establishing operating and capital decisions of an entity, including budgets; and
 - (b) Appointing and remunerating an entity's key management personnel or service providers and terminating their services or employment.
- AG15. In some situations, activities both before and after a particular set of circumstances arises or event occurs, may be relevant activities. When two or more entities have the current ability to direct relevant activities and those activities occur at different times, those entities shall determine which entity is able to direct the activities that most significantly affect those benefits consistently with the treatment of concurrent decision-making rights (see paragraph 28). The entities concerned shall reconsider this assessment over time if relevant facts or circumstances change.

Rights that Give an Entity Power over another Entity

- AG16. Power arises from rights. To have power over another entity, an entity must have existing rights that give the entity the current ability to direct the relevant activities of the other entity. The rights that may give an entity power can differ.
- AG17. Examples of rights that, either individually or in combination, can give an entity power include but are not limited to:
- (a) Rights to give policy directions to the governing body of another entity that give the holder the ability to direct the relevant activities of the other entity;
 - (b) Rights in the form of voting rights (or potential voting rights) of another entity (see paragraphs AG32–AG52);
 - (c) Rights to appoint, reassign or remove members of another entity's key management personnel who have the ability to direct the relevant activities;
 - (d) Rights to appoint or remove another entity that directs the relevant activities;
 - (e) Rights to approve or veto operating and capital budgets relating to the relevant activities of another entity;
 - (f) Rights to direct the other entity to enter into, or veto any changes to, transactions for the benefit of the entity;

- (g) Rights to veto key changes to the other entity, such as the sale of a major asset or of the other entity as a whole; and
- (h) Other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

AG18. In considering whether it has power, an entity will need to consider the binding arrangements that are in place and the mechanism(s) by which it has obtained power. Ways in which an entity may have obtained power, either individually or in combination with other arrangements, include:

- (a) Legislative or executive authority;
- (b) Administrative arrangements;
- (c) Contractual arrangements;
- (d) Founding documents (for example, articles of association); and
- (e) Voting or similar rights.

AG19. To determine whether an entity has rights sufficient to give it power, the entity shall also consider the purpose and design of the other entity (see paragraphs AG5–AG8) and the requirements in paragraphs AG53–AG56 together with paragraphs AG20–AG22.

AG20. In some circumstances it may be difficult to determine whether an entity's rights are sufficient to give it power over another entity. In such cases, to enable the assessment of power to be made, the entity shall consider evidence of whether it has the practical ability to direct the relevant activities unilaterally. Consideration is given, but is not limited, to the following, which, when considered together with its rights and the indicators in paragraphs AG21 and AG22, may provide evidence that the entity's rights are sufficient to give it power over the other entity:

- (a) The entity can, without having the contractual right to do so, appoint or approve the other entity's key management personnel who have the ability to direct the relevant activities;
- (b) The entity can, without having the contractual right to do so, direct the other entity to enter into, or can veto any changes to, significant transactions for the benefit of the entity;
- (c) The entity can dominate either the nominations process for electing members of the other entity's governing body or the obtaining of proxies from other holders of voting rights;
- (d) The other entity's key management personnel are related parties of the entity (for example, the chief executive officer of the other entity and the chief executive officer of the entity are the same person); or

- (e) The majority of the members of the other entity's governing body are related parties of the entity.

AG21. Sometimes there will be indications that the entity has a special relationship with the other entity, which suggests that the entity has more than a passive interest in the other entity. The existence of any individual indicator, or a particular combination of indicators, does not necessarily mean that the power criterion is met. However, if an entity has more than a passive interest in another entity this may indicate that the entity has other related rights sufficient to give it power or provide evidence of existing power over another entity. For example, the following suggests that the entity has more than a passive interest in the other entity and, in combination with other rights, may indicate power:

- (a) The relationship between the entity and the other entity's operations is one of dependence, such as in the following situations:
 - (i) The entity funds a significant portion of the other entity's operations and the other entity depends on this.
 - (ii) The entity guarantees a significant portion of the other entity's obligations, and the other entity depends on this.
 - (iii) The entity provides critical services, technology, supplies or raw materials to the other entity, and the other entity depends on this.
 - (iv) The entity controls assets such as licenses or trademarks that are critical to the other entity's operations and the other entity depends on this.
 - (v) The entity provides key management personnel to the other entity (for example, when the entity's personnel have specialized knowledge of the other entity's operations) and the other entity depends on this.
- (b) A significant portion of the other entity's activities either involve or are conducted on behalf of the entity.
- (c) The entity's exposure, or rights, to benefits from its involvement with the other entity is disproportionately greater than its voting or other similar rights. For example, there may be a situation in which an entity is entitled, or exposed, to more than half of the benefits of the other entity but holds less than half of the voting rights of the other entity.

AG22. Public sector entities often have special relationships with other parties as a result of the indicators listed in paragraph AG21. Public sector entities often fund the activities of other entities. Economic dependence is discussed in paragraphs AG41 to AG42.

- AG23. The greater an entity's exposure, or rights, to variability of benefits from its involvement with another entity, the greater is the incentive for the entity to obtain rights sufficient to give it power. Therefore, having a large exposure to variability of benefits is an indicator that the entity may have power. However, the extent of the entity's exposure does not, in itself, determine whether an entity has power over the other entity.
- AG24. When the factors set out in paragraph AG20 and the indicators set out in paragraphs AG21–AG23 are considered together with an entity's rights, greater weight shall be given to the evidence of power described in paragraph AG20.

Substantive Rights

- AG25. An entity, in assessing whether it has power, considers only substantive rights relating to another entity (held by the entity and others). For a right to be substantive, the holder must have the practical ability to exercise that right.
- AG26. Determining whether rights are substantive requires judgment, taking into account all facts and circumstances. Factors to consider in making that determination include but are not limited to:
- (a) Whether there are any barriers (economic or otherwise) that prevent the holder (or holders) from exercising the rights. Examples of such barriers include but are not limited to:
 - (i) Financial penalties and incentives that would prevent (or deter) the holder from exercising its rights.
 - (ii) An exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights.
 - (iii) Terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise.
 - (iv) The absence of an explicit, reasonable mechanism in the founding documents of another entity or in applicable laws or regulations that would allow the holder to exercise its rights.
 - (v) The inability of the holder of the rights to obtain the information necessary to exercise its rights.
 - (vi) Operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (e.g., the absence of other managers willing or able to provide specialized services or provide the services and take on other interests held by the incumbent manager).

- (vii) Legal or regulatory requirements that limit the manner in which rights may be exercised or that prevent the holder from exercising its rights (e.g., where another entity has statutory powers which permit it to operate independently of the government or where a foreign entity is prohibited from exercising its rights).
 - (b) When the exercise of rights requires the agreement of more than one party, or when the rights are held by more than one party, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so. The lack of such a mechanism is an indicator that the rights may not be substantive. The more parties that are required to agree to exercise the rights, the less likely it is that those rights are substantive. However, a board of directors (or other governing body) whose members are independent of the decision maker may serve as a mechanism for numerous entities (or other parties) to act collectively in exercising their rights. Therefore, removal rights exercisable by an independent board of directors (or other governing body) are more likely to be substantive than if the same rights were exercisable individually by a large number of entities (or other parties).
 - (c) Whether the party or parties that hold the rights would benefit from the exercise of those rights. For example, the holder of potential voting rights in another entity (see paragraphs AG49–AG52) shall consider the exercise or conversion price of the instrument. The terms and conditions of potential voting rights are more likely to be substantive when the instrument is in the money or the entity would benefit for other reasons (e.g., by realizing synergies between the entity and the other entity) from the exercise or conversion of the instrument.
- AG27. To be substantive, rights also need to be exercisable when decisions about the direction of the relevant activities need to be made. Usually, to be substantive, the rights need to be currently exercisable. However, sometimes rights can be substantive, even though the rights are not currently exercisable.
- AG28. Substantive rights exercisable by other parties can prevent an entity from controlling the entity being assessed for control, to which those rights relate. Such substantive rights do not require the holders to have the ability to initiate decisions. As long as the rights are not merely protective (see paragraphs AG29–AG31), substantive rights held by other parties may prevent the entity from controlling the entity being assessed for control even if the rights give the holders only the current ability to approve or block decisions that relate to the relevant activities.

Protective Rights

- AG29. In evaluating whether rights give an entity power over another entity, the entity shall assess whether its rights, and rights held by others, are protective rights. Protective rights relate to fundamental changes to the activities of another entity or apply in exceptional circumstances. However, not all rights that apply in exceptional circumstances or are contingent on events are protective (see paragraphs AG15 and AG55).
- AG30. Because protective rights are designed to protect the interests of their holder without giving that party power over the entity to which those rights relate, an entity that holds only protective rights cannot have power or prevent another party from having power over the entity to which those rights relate (see paragraph 29).
- AG31. Examples of protective rights include but are not limited to:
- (a) A lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender.
 - (b) The right of a party holding a non-controlling interest in an entity to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments.
 - (c) The right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.
 - (d) The right of a regulator to curtail or close the operations of entities that are not complying with regulations or other requirements. For example, a pollution control authority may be able to close down activities of an entity that breaches environmental regulations.
 - (e) The right to remove members of the governing body of another entity under certain restricted circumstances. For example, a state government may be able to remove or suspend the chairman of a municipality and appoint an administrator if the municipality is unable to make timely decisions about key policies.
 - (f) The right of the government to remove tax deductibility for contributions to a not-for-profit entity if the entity significantly changes its objectives or activities.
 - (g) The right of an entity providing resources to a charity to demand that, if the charity were to be liquidated, the net assets of the charity would be distributed to an organization undertaking similar activities. (However, if the entity had the power to determine specifically to where the charity's net assets would be distributed upon liquidation, the entity would have substantive rights in relation to the charity).

Voting Rights

AG32. Where an entity has voting or similar rights in respect of another entity, an entity should consider whether those rights give it the current ability to direct the relevant activities of the other entity. An entity considers the requirements in this section (paragraphs AG33–AG52) in making that assessment.

Power with a Majority of the Voting Rights

AG33. An entity that holds more than half of the voting rights of another entity has power in the following situations, unless paragraph AG34 or paragraph AG35 applies:

- (a) The relevant activities are directed by a vote of the holder of the majority of the voting rights; or
- (b) A majority of the members of the governing body that directs the relevant activities are appointed by a vote of the holder of the majority of the voting rights.

Majority of the Voting Rights but no Power

AG34. For an entity that holds more than half of the voting rights of another entity, to have power over that other entity, the entity's voting rights must be substantive, in accordance with paragraphs AG25–AG28, and must provide the entity with the current ability to direct the relevant activities, which often will be through determining operating and financing policies. If another entity has existing rights that provide that entity with the right to direct the relevant activities and that entity is not an agent of the entity making the assessment of control, the entity making the assessment of control does not have power over the other entity.

AG35. An entity does not have power over another entity, even though the entity holds the majority of the voting rights in the other entity, when those voting rights are not substantive. For example, an entity that has more than half of the voting rights in another entity cannot have power if the relevant activities are subject to direction by a government, court, administrator, receiver, liquidator or regulator.

Power without a Majority of the Voting Rights

AG36. An entity can have power even if it holds less than a majority of the voting rights of another entity. An entity can have power with less than a majority of the voting rights of another entity, for example, through:

- (a) The power to appoint or remove a majority of the members of the board of directors (or other governing body), and control of the other entity is by that board or by that body (see paragraph AG38);

- (b) A binding arrangement between the entity and other vote holders (see paragraph AG39);
- (c) Rights arising from other binding arrangements (see paragraph AG40);
- (d) The entity's voting rights (see paragraphs AG37 and AG43–AG48);
- (e) Potential voting rights (see paragraphs AG49–AG52); or
- (f) A combination of (a)–(e).

Special Voting Rights Attaching to Ownership Interests (Golden Shares)

AG37. An entity may have the right of decisive vote, thus to veto all other voting rights of another entity. This type of right is sometimes referred to as a “golden share”. Such special voting rights may give rise to power. Usually these rights are documented in the founding documents of the other entity (such as articles of association), and are designed to restrict the level of voting or other rights that may be held by certain parties. They may also give an entity veto powers over any major change in the other entity, such as the sale of a major asset or the sale of the other entity as a whole.

Control of the Board or Other Governing Body

AG38. An entity may have the power to appoint or remove a majority of the members of the board of directors (or other governing body) as a result of binding arrangements (including existing legislation, executive authority, regulation, contractual, or other arrangements).

Binding Arrangement with Other Vote Holders

AG39. A binding arrangement between an entity and other vote holders can give the entity the right to exercise voting rights sufficient to give the entity power, even if the entity does not have voting rights sufficient to give it power without the binding arrangement. However, a binding arrangement might ensure that the entity can direct enough other vote holders on how to vote to enable the entity to make decisions about the relevant activities.

Rights from Other Binding Arrangements

AG40. Other decision-making rights, in combination with voting rights, can give an entity the current ability to direct the relevant activities. For example, the rights specified in a binding arrangement in combination with voting rights may give an entity the current ability to direct the operating or financing policies or other key activities of another entity that significantly affect the benefits received by the entity. However, an entity would not control another entity if that other entity were able to determine its policy or program to a significant extent, (for example, by failing to comply with the binding

arrangement and accepting the consequences, or by changing its constitution or dissolving itself).

Economic Dependence

AG41. Economic dependence, alone, does not give rise to power over an entity for the purposes of this Standard. Economic dependence may occur when:

- (a) An entity has a single major client and the loss of that client could affect the existence of the entity's operations; or
- (b) An entity's activities are predominantly funded by grants and donations and it receives the majority of its funding from a single entity.

AG42. An entity may be able to influence the financial and operating policies of another entity that is dependent on it for funding. However, a combination of factors will need to be considered to determine whether the economic dependence is such that the economically dependent entity no longer has the ultimate power to govern its own financial or operating policies. If an economically dependent entity retains discretion as to whether it will take funding from an entity, or do business with an entity, the economically dependent entity still has the ultimate power to govern its own financial or operating policies. For example, a private school that accepts funding from a government but whose governing body has retained discretion with respect to accepting funds or the manner in which those funds are to be used, would still have the ultimate power to govern its own financial or operating policies. This may be so even if government grants provided to such an entity requires it to comply with specified conditions. Although the entity might receive government grants for the construction of capital assets and operating costs subject to specified service standards or restrictions on user fees, its governing bodies may have ultimate discretion about how assets are used; the entity would therefore control its financial and operating policies. It is also important to distinguish between the operations of an entity and an entity itself. The loss of a major client might affect the viability of the operations of an entity but not the existence of the entity itself.

The Entity's Voting Rights

AG43. An entity with less than a majority of the voting rights has rights that are sufficient to give it power when the entity has the practical ability to direct the relevant activities unilaterally.

AG44. When assessing whether an entity's voting rights are sufficient to give it power, an entity considers all facts and circumstances, including:

- (a) The size of the entity's holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that:

- (i) The more voting rights an entity holds, the more likely the entity is to have existing rights that give it the current ability to direct the relevant activities;
- (ii) The more voting rights an entity holds relative to other vote holders, the more likely the entity is to have existing rights that give it the current ability to direct the relevant activities;
- (iii) The more parties that would need to act together to outvote the entity, the more likely the entity is to have existing rights that give it the current ability to direct the relevant activities;
- (b) Potential voting rights held by the entity, other vote holders or other parties (see paragraphs AG49–AG52);
- (c) Rights arising from other binding arrangements (see paragraph AG40); and
- (d) Any additional facts and circumstances that indicate the entity has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders' meetings.

AG45. When the direction of relevant activities is determined by majority vote and an entity holds significantly more voting rights than any other vote holder or organized group of vote holders, and the other shareholdings are widely dispersed, it may be clear, after considering the factors listed in paragraph AG44(a)–(c) alone, that the entity has power over the other entity.

AG46. In other situations, it may be clear after considering the factors listed in paragraph AG44(a)–(c) alone that an entity does not have power.

AG47. However, the factors listed in paragraph AG44(a)–(c) alone may not be conclusive. If an entity, having considered those factors, is unclear whether it has power, it shall consider additional facts and circumstances, such as whether other shareholders are passive in nature as demonstrated by voting patterns at previous shareholders' meetings. This includes the assessment of the factors set out in paragraph AG20 and the indicators in paragraphs AG21–AG23. The fewer voting rights the entity holds, and the fewer parties that would need to act together to outvote the entity, the more reliance would be placed on the additional facts and circumstances to assess whether the entity's rights are sufficient to give it power. When the facts and circumstances in paragraphs AG20–AG23 are considered together with the entity's rights, greater weight shall be given to the evidence of power in paragraph AG20 than to the indicators of power in paragraphs AG21–AG23.

AG48. If it is not clear, having considered the factors listed in paragraph AG44(a)–(d), that the entity has power, the entity does not control the other entity.

Potential Voting Rights

- AG49. When assessing control, an entity considers its potential voting rights as well as potential voting rights held by other parties, to determine whether it has power. Potential voting rights are rights to obtain voting rights of another entity, such as those arising from convertible instruments or options, including forward contracts. Those potential voting rights are considered only if the rights are substantive (see paragraphs AG25–AG28).
- AG50. When considering potential voting rights, an entity shall consider the purpose and design of the instrument, as well as the purpose and design of any other involvement the entity has with the other entity. This includes an assessment of the various terms and conditions of the instrument as well as the entity's apparent expectations, motives and reasons for agreeing to those terms and conditions.
- AG51. If the entity also has voting or other decision-making rights relating to the other entity's activities, the entity assesses whether those rights, in combination with potential voting rights, give the entity power.
- AG52. Substantive potential voting rights alone, or in combination with other rights, can give an entity the current ability to direct the relevant activities. For example, this is likely to be the case when an entity holds 40 per cent of the voting rights of another entity and, in accordance with paragraph AG26, holds substantive rights arising from options to acquire a further 20 per cent of the voting rights.

Power when Voting or Similar Rights do not have a Significant Effect on Benefits

- AG53. In assessing the purpose and design of another entity (see paragraphs AG5–AG8), an entity shall consider the involvement and decisions made at the inception of the other entity as part of its design and evaluate whether the transaction terms and features of the involvement provide the entity with rights that are sufficient to give it power. Being involved in the design of another entity alone is not sufficient to give an entity control of that other entity. However, involvement in the design of the other entity may indicate that the entity had the opportunity to obtain rights that are sufficient to give it power over the other entity and hence the ability to determine the purpose and design of an entity may give rise to power. In the case of an entity established with most (or all) of its relevant activities predetermined at inception, having the ability to determine the purpose and design of an entity may be more relevant to the control assessment than any on-going decision-making rights.
- AG54. In addition, an entity shall consider rights arising from binding arrangements such as call rights, put rights, liquidation rights and rights arising from legislative or executive authority established at the inception of the other entity. When binding arrangements involve activities that are closely related

to the other entity, then these activities are, in substance, an integral part of the other entity's overall activities, even though they may occur outside the legal boundaries of the other entity. Therefore, explicit or implicit decision-making rights embedded in binding arrangements that are closely related to the other entity need to be considered as relevant activities when determining power over the other entity.

- AG55. For some other entities, relevant activities occur only when particular circumstances arise or events occur. The other entity may be designed so that the direction of its activities and the benefits from those activities are predetermined unless and until those particular circumstances arise or events occur. In this case, only the decisions about the other entity's activities when those circumstances or events occur can significantly affect its benefits and thus be relevant activities. The circumstances or events need not have occurred for an entity with the ability to make those decisions to have power. The fact that the right to make decisions is contingent on circumstances arising or an event occurring does not, in itself, make those rights protective.
- AG56. An entity may have an explicit or implicit commitment to ensure that another entity continues to operate as designed. Such a commitment may increase the entity's exposure to variability of benefits and thus increase the incentive for the entity to obtain rights sufficient to give it power. Therefore a commitment to ensure that another entity operates as designed may be an indicator that the entity has power, but does not, by itself, give an entity power, nor does it prevent another party from having power.

Exposure, or Rights, to Variable Benefits from another Entity

- AG57. When assessing whether an entity has control of another entity, the entity determines whether it is exposed, or has rights, to variable benefits from its involvement with the other entity.
- AG58. Variable benefits are benefits that are not fixed and have the potential to vary as a result of the performance of another entity. Variable benefits can be only positive, only negative or both positive and negative (see paragraph 30). An entity assesses whether benefits from another entity are variable and how variable those benefits are on the basis of the substance of the arrangement and regardless of the legal form of the benefits. For example:
- (a) In the context of non-financial benefits an entity may receive benefits as a result of the activities of another entity furthering its objectives. The benefits may be variable benefits for the purpose of this Standard because they may expose the entity to the performance risk of the other entity. If the other entity were unable to perform those activities then the entity might incur additional costs, either from undertaking the activities itself or by providing additional funds or other forms of assistance to enable the other entity to continue providing those activities.

- (b) In the context of financial benefits an entity can hold a bond with fixed interest payments. The fixed interest payments are variable benefits for the purpose of this Standard because they are subject to default risk and they expose the entity to the credit risk of the issuer of the bond. The amount of variability (i.e., how variable those benefits are) depends on the credit risk of the bond. Similarly, fixed performance fees for managing another entity's assets are variable benefits because they expose the entity to the performance risk of the other entity. The amount of variability depends on the other entity's ability to generate sufficient revenue to pay the fee.

AG59. A liquidator would not normally have rights to variable benefits from its involvement with the entity being liquidated.

Link between Power and Benefits

Delegated Power

AG60. It is common for public sector entities to be responsible for carrying out government policy. In some cases they may have the authority to act in their own right, in other cases they may act as an agent for a Minister or another entity. For example:

- (a) A government department, which is authorized by a Minister to act on the Minister's behalf, might act solely as an agent of the responsible Minister in relation to another entity. In such cases the department would not control the other entity and would not consolidate it.
- (b) A government department may operate under a delegation of power from a Minister. The department uses its own discretion in making decisions and taking actions and is not subject to direction from the Minister. In such cases the department is acting in its own right and would need to apply the other requirements of this Standard to determine whether it controlled another entity. The scope of the department's decision-making authority over another entity would be a significant factor in distinguishing whether it is acting as an agent or as a principal.
- (c) An entity may establish a trust to carry out specified activities and appoints the trustee. The trustee is responsible for making decisions about the financing and operating activities of the trust in accordance with the trust deed. If the entity can replace the trustee at its discretion, the entity would need to assess whether it controls the trust given that, for example, it would be exposed, or have rights, to variable benefits in terms of the extent to which its objectives are achieved or furthered through the activities of the trust.

- AG61. An entity may delegate its decision-making authority to an agent on some specific issues or on all relevant activities. When assessing whether it controls another entity, the entity shall treat the decision-making rights delegated to its agent as held by the entity directly. In situations where there is more than one principal, each of the principals shall assess whether it has power over the other entity by considering the requirements in paragraphs AG5–AG56. Paragraphs AG62–AG74 provide guidance on determining whether a decision maker is an agent or a principal.
- AG62. A decision maker shall consider the overall relationship between itself, the other entity being managed (and assessed for control) and other parties involved with that entity. In particular, a decision maker shall consider all the factors below, in determining whether it is an agent:
- (a) The scope of its decision-making authority over the other entity (paragraphs AG64 and AG65);
 - (b) The rights held by other parties (paragraphs AG66–AG69);
 - (c) The remuneration to which it is entitled in accordance with the remuneration agreement(s) (paragraphs AG70–AG72); and
 - (d) The decision maker’s exposure to variability of benefits from other interests that it holds in the other entity (paragraphs AG73 and AG74).

Different weightings shall be applied to each of the factors on the basis of particular facts and circumstances.

- AG63. Determining whether a decision maker is an agent requires an evaluation of all the factors listed in paragraph AG62 unless a single party holds substantive rights to remove the decision maker (removal rights) and can remove the decision maker without cause (see paragraph AG67).

The Scope of the Decision-Making Authority

- AG64. The scope of a decision maker’s decision-making authority is evaluated by considering:
- (a) The activities that are permitted according to the decision-making agreement(s) and specified by law, and
 - (b) The discretion that the decision maker has when making decisions about those activities.
- AG65. A decision maker shall consider the purpose and design of the other entity, the risks to which the other entity was designed to be exposed, the risks it was designed to pass on to the parties involved and the level of involvement the decision maker had in the design of another entity. For example, if a decision maker is significantly involved in the design of the other entity (including in determining the scope of decision-making authority), that involvement may

indicate that the decision maker had the opportunity and incentive to obtain rights that result in the decision maker having the ability to direct the relevant activities.

Rights held by Other Parties

- AG66. Substantive rights held by other parties may affect the decision maker's ability to direct the relevant activities of another entity. Substantive removal or other rights may indicate that the decision maker is an agent.
- AG67. When a single party holds substantive removal rights and can remove the decision maker without cause, this, in isolation, is sufficient to conclude that the decision maker is an agent. If more than one party holds such rights (and no individual party can remove the decision maker without the agreement of other parties) those rights are not, in isolation, conclusive in determining that a decision maker acts primarily on behalf and for the benefit of others. In addition, the greater the number of parties required to act together to exercise rights to remove a decision maker and the greater the magnitude of, and variability associated with, the decision maker's other economic interests (i.e., remuneration and other interests), the less the weighting that shall be placed on this factor.
- AG68. Substantive rights held by other parties that restrict a decision maker's discretion shall be considered in a similar manner to removal rights when evaluating whether the decision maker is an agent. For example, a decision maker that is required to obtain approval from a small number of other parties for its actions is generally an agent. (See paragraphs AG25–AG28 for additional guidance on rights and whether they are substantive).
- AG69. Consideration of the rights held by other parties shall include an assessment of any rights exercisable by another entity's board of directors (or other governing body) and their effect on the decision-making authority (see paragraph AG26(b)).

Remuneration

- AG70. The greater the magnitude of, and variability associated with, the decision maker's remuneration relative to the benefits expected from the activities of the other entity, the more likely the decision maker is a principal.
- AG71. In determining whether it is a principal or an agent the decision maker shall also consider whether the remuneration agreement includes only terms, conditions or amounts that are customarily present in arrangements for similar services and level of skills negotiated on an arm's length basis.
- AG72. A decision maker cannot be an agent unless the conditions set out in paragraph AG74(a) and (b) are present. However, meeting those conditions in isolation is not sufficient to conclude that a decision maker is an agent.

Exposure to Variability of Benefits from Other Interests

- AG73. A decision maker that holds other interests in another entity (e.g., investments in the other entity or provides guarantees with respect to the performance of the other entity), shall consider its exposure to variability of benefits from those interests in assessing whether it is an agent. Holding other interests in another entity indicates that the decision maker may be a principal.
- AG74. In evaluating its exposure to variability of benefits from other interests in the other entity a decision maker shall consider the following:
- (a) The greater the magnitude of, and variability associated with, its economic interests, considering its remuneration and other interests in aggregate, the more likely the decision maker is a principal.
 - (b) Whether its exposure to variability of benefits is different from that of the other entities that receive benefits from the entity being assessed for control and, if so, whether this might influence its actions. For example, this might be the case when a decision maker holds subordinated interests in, or provides other forms of credit enhancement to, another entity.

The decision maker shall evaluate its exposure relative to the total variability of benefits of the other entity. This evaluation is made primarily on the basis of benefits expected from the activities of the other entity but shall not ignore the decision maker's maximum exposure to variability of benefits of the other entity through other interests that the decision maker holds.

Relationship with Other Parties

- AG75. When assessing control, an entity shall consider the nature of its relationship with other parties and whether those other parties are acting on the entity's behalf (i.e., they are "de facto agents"). The determination of whether other parties are acting as de facto agents requires judgment, considering not only the nature of the relationship but also how those parties interact with each other and the entity.
- AG76. Such a relationship need not involve a binding arrangement. Such relationships could also arise from legislative or executive authority that does not meet the definition of a binding arrangement. A party is a de facto agent when the entity has, or those that direct the activities of the entity have, the ability to direct that party to act on the entity's behalf. In these circumstances, the entity shall consider its de facto agent's decision-making rights and its indirect exposure, or rights, to variable benefits through the de facto agent together with its own when assessing control of another entity.

AG77. The following are examples of such other parties that, by the nature of their relationship, might act as de facto agents for the entity:

- (a) The entity's related parties.
- (b) A party that received its interest in the other entity as a contribution or loan from the entity making the assessment of control.
- (c) A party that has agreed not to sell, transfer or encumber its interests in the other entity without the entity's prior approval (except for situations in which the entity and the other party have the right of prior approval and the rights are based on mutually agreed terms by willing independent parties).
- (d) A party that cannot finance its operations without subordinated financial support from the entity.
- (e) Another entity for which the majority of the members of its governing body or for which its key management personnel are the same as those of the entity.
- (f) A party that has a close business relationship with the entity, such as the relationship between a professional service provider and one of its significant clients.

Control of Specified Assets

AG78. An entity shall consider whether it treats a portion of another entity as a deemed separate entity and, if so, whether it controls the deemed separate entity.

AG79. An entity shall treat a portion of another entity as a deemed separate entity if and only if the following condition is satisfied:

Specified assets of the other entity (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the other entity. Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets. In substance, none of the benefits from the specified assets can be used by the remaining portion of the other entity and none of the liabilities of the deemed separate entity are payable from the assets of the remainder of the other entity. Thus, in substance, all the assets, liabilities and equity instruments of that deemed separate entity are ring-fenced from the overall other entity. Such a deemed separate entity is often called a "silo".

AG80. When the condition in paragraph AG79 is satisfied, an entity shall identify the activities that significantly affect the benefits of the deemed separate entity and how those activities are directed in order to assess whether it has power over that portion of the other entity. When assessing control of the deemed

separate entity, the entity shall also consider whether it has exposure or rights to variable benefits from its involvement with that deemed separate entity and the ability to use its power over that portion of the other entity to affect the amount of the benefits from that entity.

- AG81. If the entity controls the deemed separate entity, the entity shall consolidate that portion of the other entity. In that case, other parties exclude that portion of the other entity when assessing control of, and in consolidating, the other entity.

Continuous Assessment

- AG82. An entity shall reassess whether it controls another entity if facts and circumstances indicate that there are changes to one or more of the three elements of control listed in paragraph 20.
- AG83. If there is a change in how power over another entity can be exercised, that change must be reflected in how an entity assesses its power over another entity. For example, changes to decision-making rights can mean that the relevant activities are no longer directed through voting rights, but instead other agreements, such as contracts, give another party or parties the current ability to direct the relevant activities.
- AG84. An event can cause an entity to gain or lose power over another entity without the entity being involved in that event. For example, an entity can gain power over another entity because decision-making rights held by another party or parties that previously prevented the entity from controlling another entity have lapsed.
- AG85. An entity also considers changes affecting its exposure, or rights, to variable benefits from its involvement with another entity. For example, an entity that has power over another entity can lose control of that other entity if the entity ceases to be entitled or have the ability to receive benefits or to be exposed to obligations, because the entity would fail to satisfy paragraph 20(b) (e.g., if a contract to receive performance-related fees is terminated).
- AG86. An entity shall consider whether its assessment that it acts as an agent or a principal has changed. Changes in the overall relationship between the entity and other parties can mean that an entity no longer acts as an agent, even though it has previously acted as an agent, and vice versa. For example, if changes to the rights of the entity, or of other parties, occur, the entity shall reconsider its status as a principal or an agent.
- AG87. An entity's initial assessment of control or its status as a principal or an agent would not change simply because of a change in market conditions (e.g., a change in the other entity's benefits driven by market conditions), unless the change in market conditions changes one or more of the three elements of

control listed in paragraph 20 or changes the overall relationship between a principal and an agent.

Determining Whether an Entity is an Investment Entity

AG88. An entity shall consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. Paragraphs AG89–AG106 describe aspects of the definition of an investment entity in more detail.

Number of Investors

AG89. The definition of an investment entity requires that the entity have one or more investors. An investment entity may have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the economic entity containing the entity, would obtain benefits other than capital appreciation or investment revenue.

AG90. However, in the public sector it is also common for an investment entity to be formed by, or for, a single controlling entity that represents or supports the interests of a wider group of investors (e.g., a pension fund, government investment fund or trust).

Ownership Interests

AG91. An investment entity is typically, but is not required to be, a separate legal entity. The investors in an investment entity will often, but not always, have ownership interests in the form of equity or similar interests (e.g., partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. The definition of an investment entity does not specify that all investors must have the same rights. Having different classes of investors, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, does not preclude an entity from being an investment entity.

AG92. The definition of an investment entity does not specify that the investors must have an ownership interest that meets the definition of net assets/equity in accordance with other applicable IPSASs. An entity that has significant ownership interests in the form of debt that does not meet the definition of net assets/equity may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity's net assets.

Purpose

AG93. The definition of an investment entity requires that the purpose of the entity is to invest solely for returns from capital appreciation, investment revenue

(such as dividends or similar distributions, interest or rental revenue), or both. Documents that indicate what the entity's investment objectives are, such as the entity's mandate, constitution, offering memorandum, publications distributed by the entity and other corporate or partnership documents, will typically provide evidence of an investment entity's purpose. Further evidence may include the manner in which the entity presents itself to other parties; for example, an entity may present its objective as providing medium-term investment for capital appreciation.

AG94. An entity that has additional objectives that are inconsistent with the purpose of an investment entity would not meet the definition of an investment entity. Examples of when this may occur are as follows:

- (a) An investor whose objective is to jointly develop, produce or market products with its investees. The entity will earn returns from the development, production or marketing activity as well as from its investments;
- (b) An investor whose objectives require it to be aligned with the economic, social or environmental policies of another entity. For example, if an entity is required to align its investment policies with other objectives such as owning certain businesses or improving employment outcomes in a jurisdiction; and
- (c) An investor whose individual investment decisions have to be ratified or approved by a controlling entity or which is required to follow the direction of a controlling entity. Such ratifications, approvals or decisions are likely to be inconsistent with the purpose of an investment entity.

AG95. An entity's purpose may change over time. In assessing whether it continues to meet the definition of an investment entity, an entity would need to have regard to any changes in the environment in which it operates and the impact of such changes on its investment strategy.

Demonstrating Purpose through Holding More than One Investment

AG96. An investment entity may have a number of ways in which it can demonstrate that its purpose is to invest funds for capital appreciation, investment revenue or both. One way is by holding several investments to diversify its risk and maximize its returns. An entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments.

AG97. There may be times when the entity holds a single investment. However, holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity. For example, an investment entity may hold only a single investment when the entity:

- (a) Is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire several investments;
- (b) Has not yet made other investments to replace those it has disposed of;
- (c) Is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (e.g., when the required minimum investment is too high for an individual investor); or
- (d) Is in the process of being disestablished.

Investment-Related Services and Activities

- AG98. An investment entity may provide investment-related services (e.g., investment advisory services, investment management, investment support and administrative services), either directly or through a controlled entity, to third parties as well as to its controlling entity or other investors, even if those activities are substantial to the entity, subject to the entity continuing to meet the definition of an investment entity.
- AG99. An investment entity may also participate in the following investment-related activities, either directly or through a controlled entity, if these activities are undertaken to maximize the investment return (capital appreciation or investment revenue) from its investees and do not represent a separate substantial activity or a separate substantial source of revenue to the investment entity:
- (a) Providing management services and strategic advice to an investee; and
 - (b) Providing financial support to an investee, such as a loan, capital commitment or guarantee.
- AG100. If an investment entity has a controlled entity that is not itself an investment entity and whose main purpose and activities are providing investment-related services or activities that relate to the investment entity's investment activities, such as those described in paragraphs AG98–AG99, to the entity or other parties, it shall consolidate that controlled entity in accordance with paragraph 57. If the controlled entity that provides the investment-related services or activities is itself an investment entity, the controlling investment entity shall measure that controlled entity at fair value through surplus or deficit in accordance with paragraph 56.

Exit Strategies

- AG101. An entity's investment plans also provide evidence of its purpose. One feature that differentiates an investment entity from other entities is that an investment entity does not plan to hold its investments indefinitely; it holds them for a

limited period. Because equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity shall have an exit strategy documenting how the entity plans to realize capital appreciation from substantially all of its equity investments and non-financial asset investments. An investment entity shall also have an exit strategy for any debt instruments that have the potential to be held indefinitely, for example perpetual debt investments. The entity need not document specific exit strategies for each individual investment but shall identify different potential strategies for different types or portfolios of investments, including a substantive time frame for exiting the investments. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.

AG102. Exit strategies can vary by type of investment. For investments in private equity securities, examples of exit strategies include an initial public offering, a private placement, a trade sale of a business, distributions (to investors) of ownership interests in investees and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee). For equity investments that are traded in a public market, examples of exit strategies include selling the investment in a private placement or in a public market. For real estate investments, an example of an exit strategy includes the sale of the real estate through specialized property dealers or the open market.

AG103. An investment entity may have an investment in another investment entity that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the investment entity investor need not have an exit strategy for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.

Fair Value Measurement

AG104. An essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis, because using fair value results in more relevant information than, for example, consolidating its controlled entities or using the equity method for its interests in associates or joint ventures. In order to demonstrate that it meets this element of the definition, an investment entity:

- (a) Provides investors with fair value information and measures substantially all of its investments at fair value in its financial statements whenever fair value is required or permitted in accordance with IPSASs; and
- (b) Reports fair value information internally to the entity's key management personnel (as defined in IPSAS 20, *Related Party Disclosures*), who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

AG105. In order to meet the requirement in AG104(a), an investment entity would:

- (a) Elect to account for any investment property using the fair value model in IPSAS 16, *Investment Property*;
- (b) Elect the exemption from applying the equity method in IPSAS 36 for its investments in associates and joint ventures; and
- (c) Measure its financial assets at fair value using the requirements in IPSAS 29.

AG106. An investment entity may have some non-investment assets, such as a head office property and related equipment, and may also have financial liabilities. The fair value measurement element of the definition of an investment entity applies to an investment entity's investments. Accordingly, an investment entity need not measure its non-investment assets or its liabilities at fair value.

Appendix B

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 35.

Objective

- BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in IPSAS 35. As this Standard is based on IFRS 10, *Consolidated Financial Statements* (issued in 2011, including amendments up to December 31, 2014) issued by the IASB, the Basis for Conclusions outlines only those areas where IPSAS 35 departs from the main requirements of IFRS 10, or where the IPSASB considered such departures.

Overview

- BC2. In 2012 the IPSASB commenced work on a project to update those IPSASs that dealt with accounting for interests in controlled entities, associates and joint ventures. In October 2013 the IPSASB issued Exposure Drafts (EDs) 48 to 52 which were collectively referred to as *Interests in Other Entities*. ED 49 *Consolidated Financial Statements* was based on IFRS 10 *Consolidated Financial Statements*, having regard to the relevant public sector modifications in IPSAS 6, *Consolidated and Separate Financial Statements*. In January 2015 the IPSASB issued five new IPSASs, including IPSAS 35. These new IPSASs supersede IPSAS 6, IPSAS 7, *Investments in Associates* and IPSAS 8, *Interests in Joint Ventures*.

Process

- BC3. In developing the Standard the IPSASB had regard to those aspects of IPSAS 6 that had been developed specially to address public sector issues or circumstances that are more prevalent in the public sector than in other sectors. The IPSASB focused on addressing these issues in the Standard. The IPSASB also had regard to the guidance on assessing whether an entity is controlled for the purposes of the *Government Finance Statistics Manual* 2014 (GFSM 2014) with the aim of avoiding unnecessary differences. In developing additional examples that illustrated the public sector environment the IPSASB also considered guidance developed by national standard setters or by bodies with oversight responsibilities for sectors of government.

Alignment with Government Finance Statistics

- BC4. Both at the time of developing ED 49, and as part of the process of finalizing the Standard, the IPSASB considered an analysis of similarities and differences between the definition of control, together with the associated indicators and guidance in GFSM 2014 (and the 2008 System of National Accounts (2008 SNA) with which the GFSM 2014 is harmonized) and the proposed Standard. The IPSASB noted that some of the differences between GFSM and financial reporting are due to their nature and differing objectives. For example, the classification of institutional units into sectors based on their economic

nature of being government units will continue to be a significant difference between macroeconomic statistical reporting and accounting and financial reporting. Furthermore, the distinction between market producers and nonmarket producers in macroeconomic statistics would continue to result in a difference in terms of classification to either the general government sector or the public corporations sector, and therefore the overall classification to the public sector, even if there was exactly the same principle and conceptual guidance on the notion of control.

BC5. During the development of the Standard the IPSASB made a number of efforts to align more closely with guidance in GFSM 2014 or to explain more clearly the nature of differences. Issues in respect of which the IPSASB specifically considered GFSM requirements included:

- (a) Whether to require the consolidation of all controlled entities, as opposed to reporting by sectors of government;
- (b) The similarity between the concept of control in the Standard and the approach taken in GFSM 2014, including consideration of the indicators of control of nonprofit institutions and corporations in 2008 SNA;
- (c) The differences between regulatory control and control for financial reporting purposes; and;
- (d) The rights associated with golden shares.

Some of these matters are discussed in more detail in later sections of this Basis for Conclusions.

Scope (paragraphs 3–11)

Wholly-Owned and Partly-Owned Controlling Entities

BC6. The IPSASB agreed that, consistent with the requirements in IPSAS 6 and IFRS 10, wholly-owned or partly-owned controlling entities that meet certain conditions, and post-employment or other long-term employee benefit plans should not be required to present consolidated financial statements. The IPSASB decided that a controlling entity which itself is a controlled entity should not be required to present consolidated financial statements only if “users of such financial statements are unlikely to exist or their information needs are met by the controlling entity’s consolidated financial statements”. This limitation is intended to protect users where such controlling entities represent key sectors or activities of a government and there are users that need consolidated financial statements for accountability or decision making purposes.

Application of the Consolidation Requirements to all Controlled Entities

- BC7. The IPSASB noted the general principle in both IFRS 10 and IPSAS 6 that a controlling entity should consolidate, on a line by line basis, all of its controlled entities. The IPSASB noted that over recent years the potential scale and complexity of a public sector entity's involvement with other entities (particularly the relationships between a government and other entities) had increased. Government interventions had been a contributing factor to governments (and other public sector entities) having a broad range of interests in other entities, some of which could give rise to control as defined in this Standard. The implications of consolidation when a government has a large number of controlled entities, controlled entities carrying out activities that were formerly regarded as solely private sector activities, and controlled entities where control is intended to be temporary, had led some to query whether consolidation of all controlled entities was justified, having regard to the costs and benefits of doing so.
- BC8. The IPSASB deliberated extensively on the issue of whether all controlled entities should be consolidated, having regard to users' needs. The IPSASB focused on the information provided by consolidated financial statements, whilst noting that users' information needs may also be met through other statements and reports such as (i) separate financial statements of both controlling and controlled entities; (ii) performance reports; and (iii) statistical reports. Although some of the IPSASB's discussions were relevant to any type of public sector entity that is a controlling entity, many of the matters considered were more pertinent at the whole of government level. The IPSASB considered views on the usefulness of consolidation in relation to the following types of controlled entities (whilst noting that these broad categories would not be universally applicable):
- (a) Departments and ministries;
 - (b) Government agencies;
 - (c) [Government Business Enterprises (GBE)] (the term in square brackets is no longer used following the issue of *The Applicability of IPSASs* in April 2016);
 - (d) Financial institutions (excluding government sponsored enterprises); and
 - (e) Other investments (including intentional investments, incidental investments and investment entities). The term "incidental investments" was used to refer to interests acquired in the course of meeting another objective, such as preventing the collapse of a private sector entity.
- BC9. The IPSASB noted that, although there was general agreement that consolidation of controlled departments and ministries and government

agencies is appropriate, some members were less certain that the cost of preparing consolidated financial information was justified for other categories of controlled entities.

BC10. The IPSASB noted arguments in support of requiring consolidation of all controlled entities of a government, including the following:

- (a) Consolidated financial statements provide a panoramic view of a government's activities and current financial position. This panoramic view ensures that users do not lose sight of the risks associated with certain sectors. It shows the performance of the government as a whole.
- (b) Identifying categories of entities which should not be consolidated could be difficult. Such attempts could lead to rules-based standards. For example, there could be difficulties in separately identifying entities rescued from financial distress on a consistent basis across jurisdictions and over time. Similar issues could arise in respect of any separate proposals for GBEs. Although the term GBE was a defined term within IPSASs when this Standard was issued, the IPSASB noted that there were differences in the way this definition is being applied in practice in different jurisdictions. In addition to the issue of clearly identifying any group of entities for which different accounting requirements would be appropriate, the IPSASB noted that similar activities can be conducted by a variety of entity types both within and across jurisdictions. So, although proposals for different accounting treatments might lead to consistent treatment for a group of entities within a jurisdiction, it might not result in comparable accounting for similar activities.
- (c) Consolidation of all controlled entities is an example of like items being accounted for in like ways. Exceptions to consolidation reduce the coherence of the financial statements. Given that there could be a number of entities that could potentially be regarded as warranting separate treatment or disclosure, this could adversely affect the coherence of consolidated financial statements.
- (d) Whole of government financial statements have a different perspective from separate financial statements. Separate financial statements provide information on the activities of the core government.

BC11. The IPSASB also noted arguments that have been raised in opposition to consolidation of certain controlled entities of a government, including the following:

- (a) The consolidation of entities that have activities that differ from the activities of the core government could obscure the presentation of the results and the condition of the government itself. This argument was raised in relation to a variety of controlled entities including manufacturing activities, large financial institutions, temporarily controlled entities and entities with financial objectives as opposed to social objectives.
- (b) Some consider that equity accounting for certain categories of controlled entities provides appropriate information on financial performance subsequent to acquisition without incurring high costs or obscuring information about the core government.
- (c) Some consider that it is inappropriate to consolidate entities that have been rescued from financial distress because they do not represent core government activities and are not intended to be long-term investments.
- (d) Where governments have high numbers of controlled entities the costs of the consolidation process are high and may be perceived to outweigh the benefits of consolidating those entities on a line by line basis.

BC12. Reflecting on these arguments for and against requiring consolidation of all controlled entities the IPSASB had regard to:

- (a) The objectives of financial reporting, as outlined in *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (Conceptual Framework)*;
- (b) The limited availability of evidence on user needs and usefulness of consolidated financial information (particularly on the usefulness of consolidated financial information in respect of specific types of controlled entities);
- (c) The context within which whole of government consolidated financial statements are prepared;
- (d) The interaction between the definition of control and the consolidation requirements in the proposed Standard; and
- (e) The IPSASB's role as an international accounting standard setter.

BC13. With regard to the objectives of financial reporting, the IPSASB noted that Chapter 2 of the *Conceptual Framework* identifies the objectives of financial reporting as being to provide information that is useful for accountability

purposes and for decision-making purposes. Because of the importance of the budget in the public sector (and the importance of demonstrating compliance with the budget) the IPSASB considered an argument that consolidated financial statements should consolidate only those entities that comprise a government's budget entity. However, the IPSASB agreed that a budget entity approach would not be appropriate for general purpose financial reporting because:

- (a) Decisions about which entities are included in a government's budget may be based on factors other than the degree of autonomy of the entity and the extent to which it provides market goods or makes a commercial return.
- (b) Decisions about which entities are included in a government's budget are often related to whether the entity's activity is intended to be self-funding. The exclusion of self-funding entities from a government's budget, essentially allows the offsetting of revenue and expenses for those activities and means that budget sector information does not reflect the substance of all transactions controlled by a government.
- (c) The budget boundary for a jurisdiction is determined within a jurisdiction. If financial reporting were based on budget sectors there would not be standardized and comparable financial reporting by governments in an international context.

BC14. IPSAS 6 required the consolidation of all controlled entities apart from controlled entities where there was evidence that (a) control was intended to be temporary because the controlled entity was held exclusively with a view to its disposal within twelve months from acquisition and (b) management was actively seeking a buyer. Such temporarily controlled entities were required to be accounted for as financial instruments. The IPSASB considered whether this treatment of temporarily controlled entities should also be required in the proposed Standard. The IPSASB noted a number of concerns regarding the requirements in IPSAS 6. These included:

- (a) The difficulty of identifying temporarily controlled entities;
- (b) The difficulty of justifying a different accounting treatment for controlled entities that are held for more than a couple of years (which can occur with some entities that are initially considered to be temporarily controlled);
- (c) The difficulty of disposing of an investment in its current form. A public sector entity may need to retain responsibility for certain risks in order to dispose of its investment in a temporarily controlled entity. Accounting for such entities as financial instruments provides only a partial representation of the risks associated with the investment;

- (d) If a public sector entity is exposed to risks from an investment in a “temporarily” controlled entity, these risks should be reported consistently with the risk exposures from other controlled entities; and
- (e) The provision of additional explanations by the reporting entity can address some of the issues that arise when large temporarily controlled entities are consolidated.

BC15. The IPSASB therefore decided not to require a different accounting treatment for temporarily controlled entities. Respondents to ED 49 generally agreed with this proposal, for similar reasons to the IPSASB. In discussing respondents’ comments the IPSASB acknowledged the arguments made by those that considered there should be an exemption from consolidation for temporarily controlled entities, particularly those acquired by a government to protect the interests of citizens. However, the IPSASB also noted the experience of various jurisdictions in accounting for such situations and that consolidation of such entities had occurred in some jurisdictions. The IPSASB also considered the weight of the support for the removal of the exemption. Respondents noted that such investments can ultimately be held for longer periods than originally envisaged. Some respondents encouraged the IPSASB to consider requiring additional disclosures in respect of entities acquired with a view to disposal. The IPSASB agreed to require disclosure of interests in other entities held for sale in IPSAS 38, *Disclosure of Interests in Other Entities*.

BC16. In considering the existence of research regarding the usefulness of consolidated financial statements in meeting user needs, the IPSASB noted that although an increasing number of governments are applying the accrual basis of accounting, this has been a relatively recent trend and consolidation is often implemented in stages, with core government activities being consolidated first, followed by the consolidation of other categories of entities as time and resources permit. As a result, there are few jurisdictions that currently present consolidated whole of government financial statements, and empirical research on the usefulness of consolidated whole of government financial statements has been limited. Research to date has tended to focus on who uses consolidated financial statements and the overall benefits of consolidated financial statements, as opposed to the usefulness of consolidating certain types of controlled entities or accounting for them in an alternative way. As part of its deliberations the IPSASB did consider alternative ways of accounting for and presenting information on subsets of controlled entities such as temporarily controlled entities. The IPSASB noted the difficulties of consistently identifying categories of controlled entities that might be accounted for differently or subject to additional disclosures.

- BC17. The IPSASB noted that in developing its requirements for investment entities the IASB focused on user needs. Matters considered by the IPSASB in relation to investment entities are discussed later in this Basis for Conclusions.
- BC18. The IPSASB noted that many governments prepared statistical reports which present consolidated financial information in a sectoral approach, breaking down between the general government sectors and public corporation sectors (Non-Financial and Financial). This information is compiled in accordance with statistical guidance in the 2008 SNA, which, in turn, is consistent with guidance in the GFSM 2014 and the European System of Accounts (ESA 2010). The IPSASB considered whether such a statistical approach could be considered as an alternative to the compilation of whole of government accounts based on the IPSAS approach. The IPSASB noted that IPSAS 22, *Disclosure of Financial Information about the General Government Sector* provides guidance on the presentation of such statistical information in consolidated financial statements. However, IPSAS 22 neither requires the provision of such information in consolidated financial statements, nor permits the presentation of such information as an alternative to consolidation of all controlled entities. Although the IPSASB noted that statistical reporting serves an important role and provides information that is comparable across countries, the IPSASB agreed that such information had a different objective and did not fulfill the role of consolidated financial statements in giving an overview of all government activity. The IPSASB also noted that mandating the provision of statistical sector information by governments other than national governments could be difficult. The IPSASB therefore agreed that any changes to IPSAS 22 should not form part of its project to update IPSASs 6 to 8. Although the IPSASB decided not to provide guidance in this Standard on the presentation of information on statistical sectors, it noted that governments may present consolidated financial statements that are disaggregated by statistical sector.
- BC19. ED 49 therefore proposed the consolidation of all controlled entities, other than the exception(s) from consolidation relating to investment entities (discussed separately in this Basis for Conclusions). The IPSASB sought the views of constituents as to whether there are any categories of entities that should not be consolidated, with any proposals for non-consolidation being justified having regard to user needs. Respondents were generally supportive of this proposal, although a number of respondents highlighted implementation difficulties (for example, the costs associated with consolidating a large number of controlled entities). Some respondents also commented on the existence of reporting entities established through legal or administrative means and noted that they may differ from the reporting entity identified in accordance with the proposed Standard. The IPSASB agreed to

acknowledge, in the Standard, the existence of reporting entities established through legal or administrative means.

Investment Entities

- BC20. In October 2012 the IASB issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27). As a result of these amendments IFRS 10 requires that a controlling entity that is an investment entity account for most of its investments at fair value through profit or loss, as opposed to consolidating them. The IPSASB considered the appropriateness of the requirements in IFRS 10 for similar entities in the public sector. The IPSASB first considered which entities might be affected by such requirements. Entities that might meet the definition of an investment entity include some sovereign wealth funds, some pension funds and some funds holding controlling interests in public-private partnership projects (PPP) or private finance initiatives (PFI). The IPSASB noted that any requirements applicable only to investment entities might apply to a relatively small number of public sector entities (having regard to the types of entities that might be investment entities and the fact that these entities might be required to report in accordance with a range of accounting standards, including domestic standards).
- BC21. The IPSASB noted the comments made by respondents to the IASB in relation to the IASB's investment entity proposals and considered that similar arguments would apply in the public sector. Indeed, the IPSASB noted that some types of entities specifically identified by the IASB as potential investment entities (for example, sovereign wealth funds) could be public sector entities applying IPSASs. The IPSASB noted the IASB's focus on user needs in the IASB's deliberations on investment entities. The IPSASB noted that, depending on the reporting framework of the jurisdiction in which they operate, a public sector investment entity might be required to report in accordance with IPSASs, IFRSs, or domestic standards. The IPSASB agreed that the IFRS 10 requirement for an investment entity to account for its investments at fair value appeared to be appropriate in the public sector. The IPSASB also noted that consistent requirements in IPSASs and IFRSs would reduce any opportunity for accounting arbitrage when determining which accounting standards an investment entity should be required to apply.
- BC22. The IPSASB considered whether the definition of an investment entity in IFRS 10 was appropriate in the public sector. The IPSASB agreed that the definition was largely appropriate although it noted that an investment entity will frequently have an external mandate that establishes its purpose (as opposed to the entity asserting its purpose to investors) and amended the definition accordingly. The IPSASB considered that it would be helpful to give additional public sector examples of scenarios in which an entity would not be an investment entity by virtue of having additional objectives.

BC23. The IPSASB considered whether the typical characteristics of an investment entity were appropriate for application in the public sector. The IPSASB noted that IFRS 10 allows for the possibility that an entity may be an investment entity, despite not meeting all the typical characteristics. In such cases the entity is required to explain why it is an investment entity, despite not having all of the typical characteristics of an investment entity. The IPSASB considered that the typical characteristics identified in IFRS 10 were not likely to be typical characteristics in the public sector context. For example, a sovereign wealth fund might:

- (a) Have a single investor (being a Minister or a public sector entity). The fund could argue that it is investing funds on behalf of, or for the benefit of, citizens. IFRS 10, paragraph BC259, explicitly refers to government-owned investment funds and funds wholly owned by pension plans and endowments when explaining why the IASB decided to make this a typical characteristic rather than an essential part of the definition of an investment entity.
- (b) Have investors that are related parties. A fund with a related party investor could nevertheless be acting on behalf of many unrelated beneficiary investors.
- (c) Have ownership interests in a form other than equity or similar interests. The IPSASB noted both that the form of ownership interests in sovereign wealth funds could vary, and that IFRS 10, paragraph BC264, specifically refers to pension funds and sovereign wealth funds when explaining why the IASB decided to make this a typical characteristic rather than an essential part of the definition. IFRS 10, paragraph BC264, states “For example, a pension fund or sovereign wealth fund with a single direct investor may have beneficiaries that are entitled to the net assets of the investment fund, but do not have ownership units.

BC24. Because of the differences between the private and public sector, the IPSASB decided not to identify typical characteristics separately from the definition of an investment entity. The IPSASB noted that much of the discussion in IFRS 10 regarding the typical characteristics of investment entities described ways in which an entity could demonstrate that it met the definition of an investment entity. The IPSASB therefore decided to retain such guidance, but to locate it together with other guidance on the definition of an investment entity. The IPSASB agreed that the characteristic in IFRS 10 that “The individuals or entities that have provided funds to the entity are not related parties of the entity” did not reflect the public sector context and agreed to omit the guidance on that characteristic.

- BC25. Although the IPSASB decided not to identify typical characteristics separately from the definition of an investment entity, the IPSASB considered that most public sector entities classifying themselves as investment entities should be required to disclose information about the judgments and assumptions made. The IPSASB considered that disclosure of these judgments and assumptions would be important for transparency and encourage appropriate use of the investment entity accounting requirements.
- BC26. The IPSASB noted that in comparison with private sector entities which tend to have clear financial objectives, public sector entities can have a broader range of objectives, and these objectives can change over time. A public sector entity's objectives may also change as a result of changes in government policy and changes could lead to an entity that had formerly met the definition of an investment entity ceasing to do so. Having regard to the possibility of changing objectives the IPSASB therefore agreed to highlight the need for an entity to reassess its status on a regular basis.
- BC27. The IPSASB noted that the IFRS 10 investment entity requirements apply to the financial statements of an investment entity itself – they cannot be applied by the controlling entity of any investment entity. IFRS 10 requires that a controlling entity that is not itself an investment entity shall present consolidated financial statements in which all controlled entities are consolidated on a line by line basis. The IPSASB considered whether the public sector context would lead it to place more or less weight on arguments considered by the IASB in relation to this matter, and whether there were any public sector characteristics that would support a differing accounting treatment by the controlling entity of an investment entity.
- BC28. The IPSASB noted that the IASB had concerns that if a non-investment controlling entity were required to retain the fair value treatment used by its controlled investment entities, it could achieve different accounting outcomes by holding controlled entities directly or indirectly through a controlled investment entity. The IPSASB considered that this issue was of less concern in the public sector context. In particular the IPSASB noted that ownership interests through shares or other equity instruments are less common in the public sector. As a consequence, it is less likely that entities within an economic entity in the public sector would hold an ownership investment in the ultimate controlling entity and less likely that they would have ownership investments in other entities within the economic entity.
- BC29. The IPSASB considered what type of information users would find most useful about a controlled investment entity. The IPSASB considered that users would find it most useful if the accounting for investments applied in a controlled investment entity's financial statements were extended to its controlling entity's financial statements. The IPSASB therefore proposed that a controlling entity with a controlled investment entity should be required to present consolidated financial statements in which it (i) measures the

investments of the controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity in accordance with the usual consolidation accounting policies required by the Standard. The IPSASB considered that its proposals reflect the fact that a controlling entity does not manage an investment entity itself on a fair value basis. Rather, it manages the investments of the investment entity on a fair value basis. This approach is also consistent with the accounting by an investment entity for its investments in other entities.

- BC30. At the time that IPSAS 35 was being developed the IASB proposed to clarify aspects of the application of the investment entity requirements. The IASB issued *Investment Entities: Applying the Consolidation Exception* (Amendments to IFRS 10, IFRS 12 and IAS 28) in December 2014. The IPSASB considered that these clarifications were helpful in addressing implementation issues identified by early adopters of the IASB's investment entity requirements and incorporated those aspects of the amendments that were relevant to this Standard.

Control (paragraphs 18–37)

- BC31. The IPSASB agreed that the three requirements for control outlined in IFRS 10 are generally appropriate for the public sector. The IPSASB noted that the IFRS 10 requirements to have power, returns and a link between power and returns is similar to the approach previously taken by the IPSASB in IPSAS 6, although IPSAS 6 required that both power and benefits be present. Consistent with the terminology used in IPSAS 6 the IPSASB decided that the term “benefits” was generally more appropriate than “returns” in the public sector context (as discussed under the subheading “Terminology” below). However, the term “returns” continued to be used in the context of investment entities.
- BC32. The IPSASB took note of the approach taken in Government Finance Statistics in relation to control over an entity. The 2008 SNA, paragraph 4.80, includes eight indicators of control of corporations and five indicators of control of nonprofit institutions and explains that “Although a single indicator could be sufficient to establish control, in other cases a number of indicators may collectively indicate control”. Overall, the direction of the statistical indicators is on the same lines as the approach in this Standard and therefore the practical results of the respective analyses will likely largely coincide. Some of the indicators in GFS are mentioned in the following paragraphs.

Power (paragraphs 23–29)

BC33. The IPSASB decided to modify IFRS 10 to:

- (a) Highlight the range of relevant activities that could occur in the public sector and stress that control of financial and operating policies can demonstrate power over relevant activities;
- (b) Clarify that regulatory control and economic dependence do not give rise to power for the purposes of the Standard; and
- (c) Discuss specific powers that could give rise to control in the public sector, including golden shares, a right to appoint the majority of the board of another entity, and powers obtained through legislation or enabling documents.

Regulatory Control

BC34. The IPSASB agreed that the previous guidance on regulatory control in IPSAS 6 should be incorporated in the Standard. The IPSASB noted that IFRS 10 had been developed for application by profit-oriented entities, few of whom have powers to create or enforce legislation or regulations. By contrast, the nature of government means that regulatory power occurs frequently in the public sector.

BC35. In considering how to incorporate guidance on regulatory control in the Standard the IPSASB noted that (i) the discussion of power in IFRS 10 focuses on the ability to influence the “relevant activities” of the investee, and (ii) power is only one of the three elements that are required for control to exist. The IPSASB decided to place the discussion of regulatory control alongside the discussion of power and relevant activities.

BC36. The IPSASB noted that the discussion of regulation and control in the 2008 SNA is similar to that previously in IPSAS 6. The 2008 SNA states:

Regulation and control. The borderline between regulation that applies to all entities within a class or industry group and the control of an individual corporation can be difficult to judge. There are many examples of government involvement through regulation, particularly in areas such as monopolies and privatized utilities. It is possible for regulatory involvement to exist in important areas, such as in price setting, without the entity ceding control of its general corporate policy. Choosing to enter into or continue to operate in a highly regulated environment suggests that the entity is not subject to control. When regulation is so tight as to effectively dictate how the entity performs its business, then it could be a form of control. If an entity retains unilateral discretion as to whether it will take funding from, interact commercially with, or otherwise deal with a public sector entity, the entity has the ultimate ability to determine its own corporate policy and is not controlled by the public sector entity.

BC37. The IPSASB noted that the 2008 SNA discusses control by a dominant customer. It states:

“In general, if there is clear evidence that the corporation could not choose to deal with non-public sector clients because of public sector influence, then public control is implied.”

Economic Dependence

BC38. IFRS 10 paragraph B40 states that “...in the absence of any other rights, economic dependence of an investee on the investor (such as relations of a supplier with its main customer) does not lead to the investor having power over the investee.” Although the IPSASB agreed that economic dependence, on its own, does not give rise to control, the IPSASB noted that, in the public sector, economic dependence may occur in conjunction with other rights. These other rights need to be assessed to determine if they give rise to control.

BC39. Because of the prevalence of economic dependence in the public sector the IPSASB decided that it was appropriate to discuss ways in which economic dependence can arise and include examples of economic dependence.

Special Voting Rights Attaching to Ownership Interests (Golden Shares)

BC40. The IPSASB agreed that the Standard should acknowledge that special voting rights attaching to ownership interests (often referred to as “golden shares”) will influence assessments of control. The IPSASB noted that such rights are also acknowledged in the GFSM 2014.

Substantive Rights

BC41. Statutory independence is common in the public sector. The IPSASB agreed to illustrate the ways in which statutory independence may influence an investor’s assessments of rights. The Standard notes that the existence of statutory independence of an investee could be seen as a barrier to the investor exercising its rights (paragraph AG26). It also notes that the existence of statutory powers to operate independently does not, of itself, preclude an entity from being controlled by another entity (paragraph 25).

Terminology

BC42. In addition to making changes to reflect the standard terminology in IPSASs, the IPSASB agreed that a number of other changes to the terminology in IFRS 10 were appropriate. Unless noted otherwise in an IPSAS, this discussion of terminology is relevant to IPSASs 34 to 38.

Investor/Investee

BC43. IFRS 10 uses the terms “investor” and “investee” to denote (i) the potential controlling entity, being the entity that is applying the Standard to assess whether control exists and (ii) the potential controlled entity. The IPSASB

considered that these terms were inappropriate in most parts of this Standard because they could be read as implying the existence of a financial instrument representing an ownership interest. Most assessments of control in the public sector do not involve such financial instruments.

- BC44. The IPSASB considered other terms that could be used to describe investors and investees, in the context of the Standard. One option was to refer to an investor as a “potential controlling entity” and an investee as a “potential controlled entity”. The IPSASB considered that these phrases, whilst clear in meaning, would be cumbersome to use throughout the Standard. The IPSASB noted that IPSASs generally refer to the entity applying the Standard as “the entity”. In the case of this Standard, the entity applying the Standard is the entity that is assessing whether or not it controls another entity (referred to as the investor in IFRS 10). The entity applying the Standard is doing so in order to determine whether it controls another entity. The IPSASB therefore decided that, depending on the context, it would refer to the investor as “the entity” and the investee as “another entity”, “other entity”, or “entity being assessed for control”.
- BC45. The IPSASB agreed to retain use of the term “investors” where the Standard is referring to a specific investment and the term is used in accordance with its usual meaning. This was particularly relevant in the parts of the Standard dealing with investment entities.
- BC46. The IPSASB also agreed that the terms “investor” and “investee” are appropriate when referring to interests in joint ventures and associates.

Binding Arrangements

- BC47. The IPSASB agreed to replace most references to “contractual arrangements” in IFRS 10 with references to the term “binding arrangements”. This change acknowledges that in some jurisdictions, entities applying IPSASs may not have the power to enter into contracts but nevertheless may have the authority to enter into binding arrangements. In addition, the IPSASB agreed that binding arrangements, for the purpose of this Standard, should encompass rights that arise from legislative or executive authority. The definition of binding arrangements used in this Standard is intentionally broader than that used in the financial instruments standards, where it is used in relation to rights that are similar to contracts and in respect of willing parties.

Benefits

- BC48. The IPSASB agreed that the term “benefits” is more appropriate than the term “returns” in the public sector, particularly given the existence of control relationships in the absence of a financial investment in the controlled entity. The IPSASB considered that the term “returns” could be regarded as giving an inappropriate emphasis to financial returns, whereas, in the public sector, benefits are more likely to be non-financial than financial. The term “returns” was retained in the context of investment entities.

- BC49. The IPSASB decided to modify IFRS 10 to:
- (a) Highlight that many assessments of control in the public sector involve assessments of non-financial benefits;
 - (b) Note that benefits can have positive or negative aspects; and
 - (c) Include examples of benefits in a public sector context.
- BC50. The IPSASB agreed to locate the examples of benefits in the body of the Standard as it considered that the examples would be particularly useful for an entity making an initial assessment of whether it might control other entities.
- BC51. The definition of control in IPSAS 35 refers to “variable benefits” and this concept is referred to throughout the Standard. The IPSASB considered how the Standard would apply to benefits that appeared to be fixed or constant. The IPSASB noted that the IASB had explicitly considered this issue and had provided examples to show that benefits that appear to be fixed could in fact be variable, because they exposed the entity to performance risk. The IPSASB noted that the IASB examples related to financial benefits and agreed to incorporate an example of a non-financial benefit in paragraph AG58.

Uniform Reporting Dates

- BC52. The IPSASB considered whether to impose a time limit on the difference between the end of the reporting period of the controlling entity and its controlled entities. The IPSASB noted that IFRS 10 requires that the financial statements used in preparing consolidated financial statements have the same reporting date, or where this is impracticable, requires that adjustments be made to the most recent financial statements of the controlled entities. In addition, IFRS 10 limits the difference in dates to three months. The IPSASB noted that there may be instances in the public sector where entities have different reporting dates and it may not be possible to change those dates. The IPSASB agreed not to impose a three month limit on the difference in dates.

Implementation Issues

- BC53. A number of respondents commented on the difficulty of preparing consolidated financial statements, particularly when there are a large number of controlled entities, as in the case of whole of government financial statements. The IPSASB acknowledged these practical difficulties, whilst noting that most jurisdictions presenting consolidated financial statements have faced similar difficulties. In these jurisdictions the consolidating entities used simplifying strategies to cope with the complexity and the consolidation difficulties. Such strategies include:
- (a) Assessing the existence of control for various categories of entities in phases, with an initial focus on entities that are likely to be material.

- (b) Not consolidating (or deferring the consolidation of) controlled entities that are likely to be immaterial.
- (c) Identifying the cost-effective ways of obtaining information about inter-entity balances and transactions.
- (d) Not eliminating immaterial inter-entity transactions and balances.
- (e) Considering whether all disclosures must be made in respect of all entities.

BC54. The IPSASB considered whether to provide specific guidance on the application of materiality when preparing consolidated financial statements but concluded that this would not be appropriate in a financial reporting standard.

Sale or Contribution of Assets between an Investor and its Associate or Joint Venture

BC55. At the time that IPSAS 35 was being developed, the IASB was in the process of seeking feedback on proposals to amend IFRS 10 and IAS 28 so that the requirements for the recognition of a partial gain or loss for transactions between an investor and its associate or joint venture would apply only to the gain or loss resulting from the sale or contribution of assets *that do not constitute a business*, as defined in IFRS 3, *Business Combinations*. The IASB issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28) in September 2014. The IPSASB agreed not to incorporate the requirements introduced by these amendments in IPSAS 35 and IPSAS 36, *Investments in Associates and Joint Ventures*, on the grounds that it would be more appropriate to consider the recognition of full or partial gains and losses in the context of drafting standards-level requirements for public sector combinations.

BC56. At the time the IPSASB developed ED 60, *Public Sector Combinations*, it reconsidered whether to include guidance on how to account for the loss of control of a former controlled entity to an investor's associate or joint venture. The IPSASB reviewed the guidance issued by the IASB in *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28). The effect of the IASB's amendments if adopted in IPSAS 35 would be that a partial gain or loss for transactions between an investor and its associate or joint venture would apply only to the gain or loss resulting from the loss of control of a former controlled entity *that does not contain an operation*. The IPSASB did not identify any public sector reason to depart from the IASB's approach. Consequently, the IPSASB agreed to include this guidance (amended to fit the terminology and definitions in ED 60) in IPSAS 35.

BC57. In December 2015, the IASB deferred the implementation of the guidance in *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28). This was because the IASB was undertaking further research in this area as part of its project on equity accounting, and it did not want to require entities to change their accounting twice in a short period. In deferring the effective date, the IASB continued to allow early application of the guidance as it did not wish to prohibit the application of better financial reporting. The IPSASB reviewed the decision of the IASB to defer the implementation of this guidance. The IPSASB did not identify any public sector reason to depart from the IASB's approach. Consequently, the IPSASB agreed to include this guidance (amended to fit the terminology and definitions in IPSAS 40) in IPSAS 35, to be applied from a date to be determined by the IPSASB.

Revision of IPSAS 35 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

BC58. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

- (a) Removes the standard paragraphs about the applicability of IPSASs to "public sector entities other than GBEs" from the scope section of each Standard;
- (b) Replaces the term "GBE" with the term "commercial public sector entities", where appropriate; and
- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

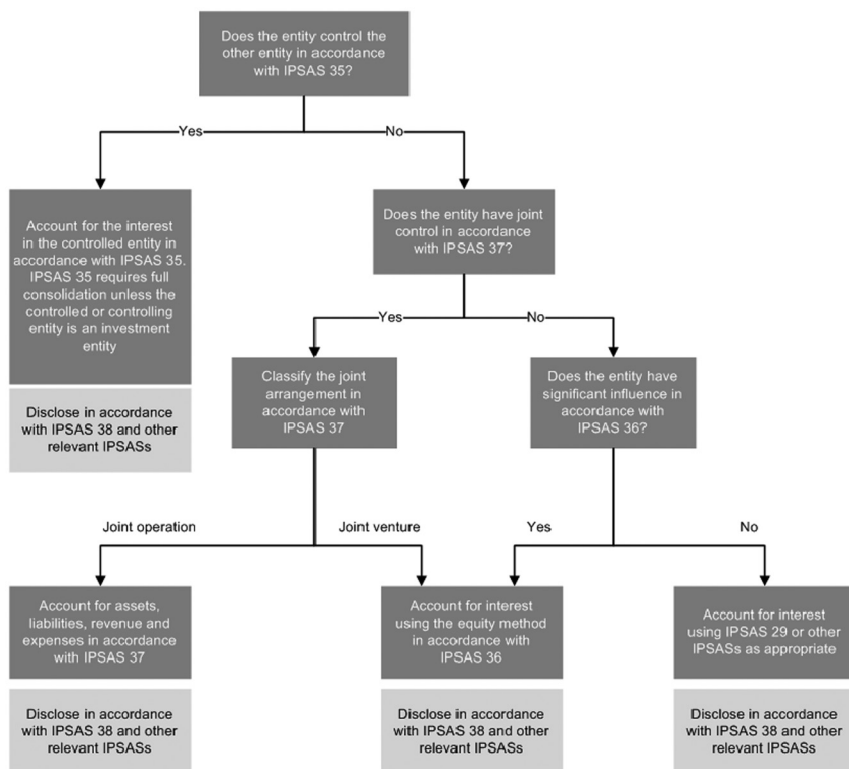
Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 35.

Nature of Relationship with Another Entity

IG1. The diagram below summarizes the accounting for various types of involvement with another entity.

Flowchart 1: Forms of Involvement with Other Parties



Illustrative Examples

These examples accompany, but are not part of, IPSAS 35.

- IE1. The examples in this appendix portray hypothetical situations. Although some aspects of the examples may be present in actual fact patterns, all facts and circumstances of a particular fact pattern would need to be evaluated when applying IPSAS 35.

Power (paragraphs AG9–AG56)

- IE2. The following example illustrates an assessment of whether power exists for the purposes of this Standard.

Example 1

A state government partially funds the activities of a local government. Some of this funding is required to be spent on specified activities. The local government has a council that is elected every four years by the local community. The council decides how to use the local government's resources for the benefit of the local community. The activities of the local government are diverse and include library services, provision of leisure facilities, management of refuse and wastewater, and enforcement of building and health and safety regulations. These activities are the relevant activities of the local government. Many of these activities also coincide with the interests of the state government.

Despite its partial funding of the local government's activities, the state government does not have the power to direct the relevant activities of the local government. The rights of the local government over the relevant activities preclude the state government from having control.

Regulatory Control (paragraph AG12)

- IE3. The following examples illustrate various forms of regulatory control. None of these forms of regulatory control give rise to power over the relevant activities for the purposes of this Standard. However, those examples do not rule out that there may be instances where power over the relevant activities for the purposes of this Standard may derive from regulatory control.

Example 2

A pollution control authority has the power to close down the operations of entities that are not complying with environmental regulations.

The existence of this power does not constitute power over the relevant activities.

Example 3

A city has the power to pass zoning laws to limit the location of fast food outlets or to ban them altogether.

The existence of this power does not constitute power over the relevant activities of the fast food outlets.

Example 4

A central government has the power to impose regulatory control on monopolies. A wholly owned government agency has the power to regulate monopolies that are subject to such regulatory control and has established price ceilings for entities that distribute electricity. The central government does not have an ownership interest in the electricity distributors and does not receive financial benefits from the electricity distributors. Neither the central government, nor the government agency, has control as a result of the power to impose regulatory control. Any other powers would need to be separately assessed.

Example 5

A gaming control board (GCB) is a government agency that regulates casinos and other types of gaming in a state, and enforces state gaming legislation. The GCB is responsible for promulgating rules and regulations that govern the conduct of gaming activities in the state. The rules and regulations stem from legislation. The legislation was passed by the legislature and sets forth the broad policy of the state with regard to gaming; while the rules and regulations provide detailed requirements that must be satisfied by a gaming establishment, its owners, employees, and vendors. The rules and regulations cover a broad range of activity, including licensing, accounting systems, rules of casino games, and auditing.

The GCB also has authority to grant or deny licenses to gaming establishments, their ownership, employees, and vendors. In order to obtain a license, an applicant must demonstrate that they possess good character, honesty and integrity. License application forms typically require detailed personal information. Based upon the type of license being sought, an applicant may also be required to disclose details regarding previous business relationships, employment history, criminal records, and financial stability.

Although the rules and regulations have an impact on how gaming establishments operate, the GCB does not have power over the relevant activities (as defined in this Standard) of the gaming establishments. The regulations apply to all gaming establishments and each establishment has a choice as to whether it wishes to engage in gaming or not. The purpose of the gaming legislation and regulations is to protect the public, rather than to establish a controlling interest in the gaming establishments.

Relevant Activities and Direction of Relevant Activities (paragraphs AG13–AG15)

- IE4. The following examples illustrate assessments of whether an entity has the power to direct the relevant activities of another entity for the purposes of this Standard.

Example 6

Entities A and B, form another entity, entity C, to develop and market a medical product. Entity A is responsible for developing and obtaining regulatory approval of the medical product—that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval. Once the regulator has approved the product, entity B will manufacture and market it—entity B has the unilateral ability to make all decisions about the manufacture and marketing of the product. If all the activities—developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product—are relevant activities, entity A and entity B each needs to determine whether they are able to direct the activities that most significantly affect the benefits from entity C. Accordingly, entity A and B each need to consider whether developing and obtaining regulatory approval or the manufacturing and marketing of the medical product is the activity that most significantly affects the benefits from entity C and whether they are able to direct that activity. In determining which entity has power, entities A and B would consider:

- (a) The purpose and design of entity C;
- (b) The factors that determine the surplus, revenue and value of entity C as well as the value of the medical product;
- (c) The effect of their decision-making authority on entity C's performance with respect to the factors in (b); and
- (d) Their exposure to variability of benefits from entity C.

In this particular example, the entities would also consider:

- (a) The uncertainty of, and effort required in, obtaining regulatory approval (considering their record of successfully developing and obtaining regulatory approval of medical products); and
- (b) Which entity controls the medical product once the development phase is successful.

Example 7

An investment vehicle is created and financed with a debt instrument held by an entity (the debt investor) and equity instruments held by a number of other investors. The equity tranche is designed to absorb the first losses and to receive any residual benefit from the investment vehicle. One of the equity investors who holds 30 per cent of the equity instruments is also the asset manager. The investment vehicle uses its proceeds to purchase a portfolio of financial assets, exposing the investment vehicle to the credit risk associated with the possible default of principal and interest payments of the assets. The transaction is marketed to the debt investor as an investment with minimal exposure to the credit risk associated with the possible default of the assets in the portfolio because of the nature of these assets and because the equity tranche is designed to absorb the first losses of the investment vehicle. The benefits from the investment vehicle are significantly affected by the management of the investment vehicle's asset portfolio, which includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any portfolio assets. All those activities are managed by the asset manager until defaults reach a specified proportion of the portfolio value (i.e., when the value of the portfolio is such that the equity tranche of the investment vehicle has been consumed). From that time, a third-party trustee manages the assets according to the instructions of the debt investor. Managing the investment vehicle's asset portfolio is the relevant activity of the investment vehicle. The asset manager has the ability to direct the relevant activities until defaulted assets reach the specified proportion of the portfolio value; the debt investor has the ability to direct the relevant activities when the value of defaulted assets surpasses that specified proportion of the portfolio value. The asset manager and the debt investor each need to determine whether they are able to direct the activities that most significantly affect the benefits from the investment vehicle, including considering the purpose and design of the investment vehicle as well as each party's exposure to variability of benefits.

Rights that Give an Entity Power over another Entity (paragraphs AG16–AG28)

- IE5. The following examples illustrate assessments of whether an entity has the power to direct the relevant activities of another entity for the purposes of this Standard.

Example 8

A government housing agency establishes a community housing program that provides low-cost housing. The program is operated under an agreement with an incorporated association. The association's only activity is to manage the community housing facility. The association has no ownership instruments.

The relevant activities of the association comprise:

- Reviewing and selecting applicants for housing;
- The day-to-day operation of the housing program;
- Maintaining the houses and common facilities; and
- Improving and extending the housing facilities.

The board of governors of the association has 16 members, with eight appointed by (and subject to removal by) the government housing agency. The chair is appointed by the board from amongst the appointees of the government housing agency, and has a casting vote that is rarely exercised. The board meets regularly and reviews reports received from the association's management. Based on these reports, the board may confirm or override management decisions. In addition, the board makes decisions on major issues such as significant maintenance and investing further capital to build additional housing, after reviewing vacancy levels and the demand for housing.

The government housing agency owns the land on which the housing facilities stand and has contributed capital and operating funds to the association since it was established. The association owns the housing facilities.

The association retains any surplus resulting from the operation of the facilities and under its constitution is unable to provide a direct financial return to the government housing agency. The above fact pattern applies to examples 8A and 8B described below. Each example is considered in isolation.

Example 8A

Based on the facts and circumstances outlined above, the government housing agency controls the association.

The government housing agency has rights that give it the current ability to direct the relevant activities of the association, regardless of whether it chooses to exercise those rights.

The government housing agency appoints eight members of the board of governors, one of whom will become the chair, who has a casting vote. As a result, the government housing agency has power over the association through substantive rights that give it the current ability to direct the relevant activities of the association, regardless of whether the government housing agency chooses to exercise those substantive rights.

The government housing agency also has exposure or rights to variable benefits from its involvement with the association. The government housing agency obtains non-financial benefits through the association furthering its social objective of meeting the need for low-cost community housing. Although not able to receive direct financial benefits, the government housing agency obtains indirect benefits through its ability to direct how the financial returns are to be employed in the community housing program.

The government housing agency also satisfies the final control criterion. Through its appointees on the board, the government housing agency has the ability to use its power to affect the nature or amount of its benefits from the association.

The government housing agency satisfies all three criteria for control and therefore the government housing agency controls the association.

Example 8B

In this example, the facts of Example 8A apply, except that:

- (a) The association's board of governors is elected through a public nomination and voting process that does not give rights to the government housing agency to appoint board members; and
- (b) Decisions made by the association's board are reviewed by the government housing agency, which may offer advice to the association.

Based on the revised facts and circumstances outlined above, the government housing agency does not have substantive rights relating to the association and therefore does not have power over the association.

The government housing agency's social objectives in relation to low-cost community housing are still being achieved and therefore it will still obtain direct non-financial benefits. However, congruence of objectives alone is insufficient to conclude that one entity controls another entity (refer paragraph 36).

The government housing agency does not have power and consequently does not have the ability to use power to affect the nature or amount of the agency's benefits. The government housing agency is unable to satisfy two of the three control criteria and therefore the government housing agency does not control the association.

Example 9

A government has the right to appoint and remove the majority of members of a statutory body. This power has been used by previous governments. The current government has not done so because it does not wish, for political reasons, to be regarded as interfering in the activities of the statutory body. In this case the government still has substantive rights, even though it has chosen not to use them.

Example 10

A local government has a policy that, where it holds land that is surplus to its requirements, consideration should be given to making the land available for affordable housing. The local government establishes terms and conditions to ensure that the housing provided remains affordable and available to meet local housing needs.

In accordance with this policy, the local government sold part of a site to a housing association for CUI to provide 20 affordable homes. The remainder of the site was sold at open market value to a private developer.

The contract between the local government and the housing association specifies what the land can be used for, the quality of housing developments, ongoing reporting and performance management requirements, the process for return of unused land and dispute resolution. The land must be used in a manner consistent with the local government's policy for affordable housing.

The agreement also has requirements regarding the housing association's quality assurance and financial management processes. The housing association must demonstrate that it has the capacity and authority to undertake the development. It must also demonstrate the added value that can be achieved by joining the local government's resources with that of the housing association to address a need within a particular client group in a sustainable way.

The Board of the housing association is appointed by the members of the housing association. The local government does not have a representative on the Board.

Based on the facts and circumstances outlined above, the government housing agency does not hold sufficient power over the association to direct its relevant activities and therefore does not control the association. The local government may receive indirect, non-financial benefits from the association in that the local government's social objectives in relation to low-cost community housing are being furthered by the activities of the housing association. However, congruence of objectives alone is insufficient to conclude that one entity controls another (see paragraph 36). In order to have power over the housing association the local government would need to have the ability to direct the housing association to work with the local government to further the local governments' objectives.

Example 11

An entity being assessed for control has annual shareholder meetings at which decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months. However, shareholders that individually or collectively hold at least 5 per cent of the voting rights can call a special meeting to change the existing policies over the relevant activities, but a requirement to give notice to the other shareholders means that such a meeting cannot be held for at least 30 days. Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings. This includes the approval of material sales of assets as well as the making or disposing of significant investments.

The above fact pattern applies to examples 11A–11D described below. Each example is considered in isolation.

Example 11A

An entity holds a majority of the voting rights in the other entity. The entity's voting rights are substantive because the entity is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before the entity can exercise its voting rights does not stop the entity from having the current ability to direct the relevant activities from the moment the entity acquires the shareholding.

Example 11B

An entity is party to a forward contract to acquire the majority of shares in the other entity. The forward contract's settlement date is in 25 days. The existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract will have been settled. Thus, the entity has rights that are essentially equivalent to the majority shareholder in example 11A above (i.e., the entity holding the forward contract can make decisions about the direction of the relevant activities when they need to be made). The entity's forward contract is a substantive right that gives the entity the current ability to direct the relevant activities even before the forward contract is settled.

Example 11C

An entity holds a substantive option to acquire the majority of shares in the other entity that is exercisable in 25 days and is deeply in the money. The same conclusion would be reached as in example 11B.

Example 11D

An entity is party to a forward contract to acquire the majority of shares in the other entity, with no other related rights over the other entity. The forward contract's settlement date is in six months. In contrast to the examples above, the entity does not have the current ability to direct the relevant activities. The existing shareholders have the current ability to direct the relevant activities because they can change the existing policies over the relevant activities before the forward contract is settled.

Power without a Majority of the Voting Rights and Special Voting Rights Attaching to Ownership Interests (paragraphs AG36–AG37)

- IE6. The following examples illustrate assessments of whether special voting rights attaching to ownership interests in another entity give rise to power for the purposes of this Standard.

Example 12

A central government has privatized a company and, in order to protect its national interests, it has used a “golden share” mechanism. The “golden share” does not have any value or give any percentage rights to the capital of the company. The golden share states that control of the company, or a 24 percent stake in the company cannot be sold without the permission of the central government.

The central government has protective rights, not substantive rights.

Example 13

A central government sold all of its shares in a company, but kept a golden share (with a nominal value of one currency unit). The golden share granted the Secretary of State (as the holder of the share) a 15 percent shareholding in the company, and consequently the ability to block any potential takeover of the business. It also required that the chairman of the board and the chief executive be citizens of the country. The rationale for the golden share was to protect the company from an overseas acquisition, principally on the grounds of national security.

The central government has protective rights, not substantive rights.

Example 14

A central government does not own any shares in defense companies. However it has passed legislation which specifies that, with respect to companies carrying out strategic activities for the defense and national security system, in the event that fundamental interests of national defense or security could be materially affected, the government may:

- (a) Impose specific conditions on the purchase of an interest in any such company – by any person – relating to the security of procurement and of information, the transfer of technologies and export controls;
- (b) Veto the purchase by any person – other than the state (whether directly or indirectly, individually or jointly) – of an interest in the voting share capital in any such company that, given its size, may jeopardize defense or national security; and
- (c) Veto the adoption of resolutions by the shareholders or the board of directors of any such company relating to certain extraordinary transactions (such as mergers, de-mergers, assets disposals, winding up, and bylaws amendments concerning the corporate purpose or equity ownership caps in certain state-controlled companies).

The central government has protective rights, not substantive rights, in respect of these companies.

Control of the Board or Other Governing Body (paragraph AG38)

- IE7. The following example illustrates assessments of whether an entity has control of the board or governing body of another entity for the purposes of this Standard. The existence of such control may provide evidence that an entity has sufficient rights to have power over another entity.

Example 15

A national museum is governed by a board of trustees who are chosen by the government department responsible for funding the museum. The trustees have freedom to make decisions about the operation of the museum.

The department has the power to appoint the majority of the museum's trustees. The department has the potential to exercise power over the museum.

Economic Dependence (paragraphs AG41–AG42)

- IE8. The following examples illustrate assessments of whether dependence on funding from another entity gives rise to power in the context of this Standard.

Example 16

A research institution is one of many institutions that receive the majority of their funding from a central government. The institutions submit proposals and the funding is allocated through a tendering process. The research institution retains the right to accept or decline funding.

The central government does not control the research institution because the research institution can choose to decline funding from the government, seek alternative sources of funding or cease to operate.

Example 17

A catering entity has a binding arrangement to supply food to a government-owned school. The arrangement is between the company and the school. The school contracts generate the majority of the revenue of the catering entity. There are general requirements, set out in regulations, which are applicable to all such arrangements including nutritional standards and policies on procurement. For example, the arrangements specify how much produce must be purchased locally.

Current arrangements are for a period of five years. At the end of this period, if the catering entity wishes to continue supplying school meals it is required to go through a tendering process and compete with other entities for the business.

The school does not control the catering entity because the catering entity can choose to stop supplying school meals, seek other work, or cease to operate.

Example 18

An international donor funds a project in a developing country. The donor uses a small, local agency in the country to run the project. The local agency has its own management board but is highly dependent on the donor for funding. The agency retains the power to turn down funding from the donor.

The international donor does not control the local agency because the agency can choose not to accept funding from the donor and seek alternative sources of funding, or cease to operate.

Voting Rights (paragraphs AG43–AG48)

- IE9. The following examples illustrate assessments of whether an entity with less than a majority of the voting rights in another entity has the practical ability to direct the relevant activities unilaterally, and whether its rights are sufficient to give it power over that other entity for the purposes of this Standard.

Example 19

An entity acquires 48 per cent of the voting rights of another entity. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders have any arrangements to consult any of the others or make collective decisions. When assessing the proportion of voting rights to acquire, on the basis of the relative size of the other shareholdings, the entity determined that a 48 per cent interest would be sufficient to give it control. In this case, on the basis of the absolute size of its holding and the relative size of the other shareholdings, the entity concludes that it has a sufficiently dominant voting interest to meet the power criterion without the need to consider any other evidence of power.

Example 20

Entity A holds 40 per cent of the voting rights of another entity and twelve other investors each hold 5 per cent of the voting rights of the other entity. A shareholder agreement grants Entity A the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities. To change the agreement, a two-thirds majority vote of the shareholders is required. In this case, Entity A concludes that the absolute size of its holding and the relative size of the other shareholdings alone are not conclusive in determining whether it has rights sufficient to give it power. However, Entity A determines that its contractual right to appoint, remove and set the remuneration of management is sufficient to conclude that it has power over the other entity. The fact that Entity A might not have exercised this right or the likelihood of Entity A exercising its right to select, appoint or remove management shall not be considered when assessing whether Entity A has power.

Example 21

Entity A holds 45 per cent of the voting rights of another entity. Two other investors each hold 26 per cent of the voting rights of the other entity. The remaining voting rights are held by three other shareholders, each holding 1 per cent. There are no other arrangements that affect decision-making. In this case, the size of Entity A's voting interest and its size relative to the other shareholdings are sufficient to conclude that Entity A does not have power. Only two other investors would need to co-operate to be able to prevent Entity A from directing the relevant activities of the other entity.

Example 22

An entity holds 35 per cent of the voting rights of another entity. Three other shareholders each hold 5 per cent of the voting rights of the other entity. The remaining voting rights are held by numerous other shareholders, none individually holding more than 1 per cent of the voting rights. None of the shareholders has arrangements to consult any of the others or make collective decisions. Decisions about the relevant activities of the other entity require the approval of a majority of votes cast at relevant shareholders' meetings—75 per cent of the voting rights of the other entity have been cast at recent relevant shareholders' meetings. In this case, the active participation of the other shareholders at recent shareholders' meetings indicates that the entity would not have the practical ability to direct the relevant activities unilaterally, regardless of whether the entity has directed the relevant activities because a sufficient number of other shareholders voted in the same way as the entity.

Potential Voting Rights (paragraphs AG49–AG52)

- IE10. The following examples illustrate assessments of whether potential voting rights are substantive for the purposes of this Standard.

Example 23

Entity A holds 70 per cent of the voting rights of another entity. Entity B has 30 per cent of the voting rights of the other entity as well as an option to acquire half of Entity A's voting rights. The option is exercisable for the next two years at a fixed price that is deeply out of the money (and is expected to remain so for that two-year period). Entity A has been exercising its votes and is actively directing the relevant activities of the other entity. In such a case, Entity A is likely to meet the power criterion because it appears to have the current ability to direct the relevant activities. Although Entity B has currently exercisable options to purchase additional voting rights (that, if exercised, would give it a majority of the voting rights in the other entity), the terms and conditions associated with those options are such that the options are not considered substantive.

Example 24

Entity A and two other investors each hold a third of the voting rights of another entity. The other entity's business activity is closely related to Entity A. In addition to its equity instruments, Entity A also holds debt instruments that are convertible into ordinary shares of the other entity at any time for a fixed price that is out of the money (but not deeply out of the money). If the debt were converted, Entity A would hold 60 per cent of the voting rights of the other entity. Entity A would benefit from realizing synergies if the debt instruments were converted into ordinary shares. Entity A has power over the other entity because it holds voting rights of the other entity together with substantive potential voting rights that give it the current ability to direct the relevant activities.

*Power when Voting or Similar Rights do not have a Significant Effect on Benefits
(paragraphs AG53–AG56)*

- IE11. The following examples illustrate assessments of whether an entity has power in the absence of voting rights or similar rights for the purposes of this Standard.

Example 25

A central government has legislation that governs the establishment of cultural and heritage boards. These boards have a separate legal status and have limited liability. The powers and objectives of the boards, along with their reporting requirements are specified by legislation. The main function of each board is to administer the board's assets, mainly property, for the general benefit of beneficiaries. Boards are permitted to spend money on the promotion of health, education, vocational training, and the social and economic welfare of the beneficiaries. They have limited authority to spend money unless it is for a purpose specifically mentioned in the legislation. Each board must deliver an annual financial report to the government. The beneficiaries (as defined by each board and comprising people from a specified area) elect the members of the board. Trustees are appointed for a three-year term by way of voting by beneficiaries at the annual general meeting. Each board determines its own operating and financial policies and strategy. The activities that have the biggest impact on the achievement of the boards' objectives are the management of property and the distribution of funds to the beneficiaries.

The central government does not control the boards. The government was involved in establishing the legislation that governs the activities of the boards, but does not have rights over the relevant activities of the boards.

Example 26

Five local authorities create a separate company to deliver shared services to participating authorities. The company operates under contract to these local authorities. The company's major objective is the provision of services to these local authorities.

The company is owned by all of the participating local authorities with each owning one share and allowed one vote. The chief executive of each local government is permitted to be a board member of the company. The board of the company is responsible for strategic direction, approval of business cases and monitoring of performance.

For each shared activity there is an advisory group that is responsible for operational management and decision-making in relation to that activity. Each advisory group consists of one representative from each local government.

The benefits of the shared services arrangement are:

- Improved levels and quality of service;
- A co-ordinated and consistent approach to the provision of services;
- Reductions in the cost of support and administrative services;
- Opportunities to develop new initiatives; and
- Economies of scale resulting from a single entity representing many councils in procurement.

If further shared service activities are established that lead to the need for further capital, the company will either issue a new class of equity instrument or will form a controlled entity to hold the interest in the new assets.

The company covers its costs in two ways. It retains a percentage of savings from its bulk purchasing activities and it charges an administrative transaction cost of services provided to the local authorities.

None of the local authorities individually controls the company. In deciding how to account for its interest in the company each local authority would also need to consider whether it is a party to a joint arrangement as defined in IPSAS 37, *Joint Arrangements*.

Example 27

A leisure trust was established as a charity, limited by guarantee, to operate and manage sport and leisure facilities on behalf of a local government. Under the terms of the agreement with the local government, the leisure trust is responsible for the operational management, delivery and development of the city's sports and leisure facilities. The trust is required to operate the existing leisure facilities of the local government. The level of service required, including hours of operation and staffing levels, are specified by the local government. The leisure trust's activities must be consistent with the long-term plan of the local government and a significant portion of the trusts activities are funded by the local government. The leisure trust may not create new facilities nor may it engage in any other activities without the approval of the local government.

If the leisure trust ceases to operate the proceeds must be distributed to another charity with similar purposes. The local government is not responsible for the debts of the leisure trust (its liability is limited to one currency unit).

The local government controls the leisure trust. By specifying in detail the way in which the leisure trust must operate the local government has predetermined the leisure trust's activities and the nature of benefits to the local government.

Example 28

A local government transfers its leisure centers, libraries and theatres into a charitable trust.

In creating the trust the local government expects to benefit from cost savings, increased use of facilities by the public, a more favorable taxation treatment, and better access to funding restricted to charities. The trust can decide the nature and extent of facilities to be provided and can engage in any other charitable purpose. The board of the trust is elected by the community. The local government is entitled to have one representative on the board. The trust is required to retain any surplus and use it for the objectives of the trust.

The local government benefits from the trust's activities but it does not control the trust. The local government cannot direct how the trust uses its resources.

Example 29

Trust A promotes, supports and undertakes programs, actions and initiatives to beautify City A. It receives funding from the local government for various services, including graffiti removal, beautification projects and running environmental events. It reports back to the local government on its performance in delivering these services. If the trust did not exist the local government would need to find some other way to deliver these services. The trust also receives assistance through donations and volunteer work by the local community including local businesses, schools, community groups and individuals.

The trust was originally established by an elected official of the local government.

The governing body of the local government appoints all the trustees (having regard to certain requirements such as balance in gender and location of trustees). There are between five and 12 trustees. The trustees appoint the officers.

Changes to the trust deed must be approved by the trustees and the governing body of the local authority.

If the trust is wound up, surplus assets must be transferred to a similar charitable body in the same geographical area. This transfer of assets is subject to the approval of the local government.

The local government has a mix of rights over the trust including rights to:

- (a) Appoint, reassign or remove members of the trust's key management personnel who have the ability to direct the relevant activities;
- (b) Approve or veto operating and capital budgets relating to the relevant activities of the trust; and
- (c) Veto key changes to the trust, such as the sale of a major asset or of the trust as a whole.

The local government is able to direct the relevant activities (the services) of the trust through its arrangements in such a way that it is able to affect the costs and quality of the services being provided. The local government is exposed to variable returns (both the economic effects of the service and the quality of the service). As it uses its power to affect these returns, the local government controls the trust.

Example 30

Entity A is a public sector body that promotes the construction of new houses, the repair and modernization of existing houses, and the improvement of housing and living conditions. It also facilitates access to housing finance and promotes competition and efficiency in the provision of housing finance.

Entity A established a separate trust which has narrowly defined objectives. The trust's functions are to acquire interests in eligible housing loans and issue mortgage bonds. Entity A guarantees the bonds issued by the trust but does not provide ongoing funding – the trust finances its activities through the revenue from its investments. If the trust is wound up the trust's assets are to be distributed to one or more charitable organizations. Entity A does not have on-going decision-making rights over the trust's activities.

Entity A has power over the relevant activities of the trust because it determined the relevant activities of the trust when it established the trust. Entity A is also exposed to variable benefits both through its exposure to the guaranteed bonds and because the trust's activities, determined by Entity A in establishing the trust, help Entity A to achieve its objectives.

Example 31

A funding agency was established by legislation. It is owned by ten local authorities and the central government. It operates on a for-profit basis. The funding agency will raise debt funding and provide that funding to the participating local authorities. Its primary purpose is to provide more efficient funding costs and diversified funding sources for the local authorities. It may undertake any other activities considered by the board to be reasonably related or incidental to, or in connection with, that business.

The main benefits to the participating local authorities are the reduced borrowing costs. The board of the funding agency may decide to pay dividends but dividend payments are expected to be low.

The board is responsible for the strategic direction and control of the funding agency's activities. The board will comprise between four and seven directors with a majority of independent directors.

There is also a shareholders' council which is made up of ten appointees of the shareholders (including an appointee from the central government). The role of the shareholders' council is to:

- Review the performance of the funding agency and the Board, and report to shareholders on that performance;
- Make recommendations to shareholders as to the appointment, removal, replacement and remuneration of directors; and
- Coordinate shareholders' governance decisions.

The funding agency purchases debt securities in accordance with its lending and/or investment policies, as approved by the board and/or shareholders.

To participate in the funding agency as a principal shareholding authority, each local government made an initial capital investment of CU100,000, provided security against future property taxes and agreed to borrow a set portion of its borrowing needs from the funding agency for a period of three years.

Neither the central government nor the participating local authorities control the funding agency. In deciding how to account for their interest in the funding agency the central government and participating local authorities would also need to consider whether they are parties to a joint arrangement as defined in IPSAS 37.

Example 32

Entity A's only business activity, as specified in its founding documents, is to purchase receivables and service them on a day-to-day basis for Entity B. The servicing on a day-to-day basis includes the collection and passing on of principal and interest payments as they fall due. Upon default of a receivable Entity A automatically puts the receivable to Entity B as agreed separately in a put agreement between Entity A and Entity B. The only relevant activity is managing the receivables upon default because it is the only activity that can significantly affect Entity A's financial performance. Managing the receivables before default is not a relevant activity because it does not require substantive decisions to be made that could significantly affect Entity A's financial performance—the activities before default are predetermined and amount only to collecting cash flows as they fall due and passing them on to Entity B. Therefore, only Entity B's right to manage the assets upon default should be considered when assessing the overall activities of Entity A that significantly affect Entity A's financial performance. In this example, the design of Entity A ensures that Entity B has decision-making authority over the activities that significantly affect the financial performance at the only time that such decision-making authority is required. The terms of the put agreement are integral to the overall transaction and the establishment of Entity A. Therefore, the terms of the put agreement together with the founding documents of Entity A lead to the conclusion that Entity B has power over Entity A even though Entity B takes ownership of the receivables only upon default and manages the defaulted receivables outside the legal boundaries of Entity A.

Exposure, or Rights, to Variable Benefits from another Entity (paragraph AG57)

- IE12. The following examples illustrate assessments of whether an entity receives variable benefits from another entity for the purposes of this Standard.

Example 33

Research has shown that family friendly policies at universities, which include the provision of quality early childhood education services, are critical in attracting and retaining students and staff. This is particularly important for attracting high-level staff and post-graduate students, which in turn help uphold the reputation of the University and its ability to obtain research funding.

The above background information is relevant to examples 33A and 33B described below. Each example is considered in isolation.

Example 33A

University A has established seven childcare centers (although University A receives government funding for its educational programs, the childcare centers have been established by the university, not by the government). The centers operate in University owned buildings. Each center has its own manager, staff and budget. The centers are able to be used by university staff and students only. The University is the licensed provider of childcare services. The University has the right to close centers or relocate them to other properties. Because the childcare center is on university property the staff and parents are required to comply with University health and safety policies. The management team of the childcare center has the ability to determine all other operating policies.

University A receives non-financial benefits from having childcare services available on campus. Although University A is not involved in the day-to-day running of the centers, it has the ability to close the centers or change their hours of operation.

University A controls the childcare centers.

Example 33B

University B has made a building available free of charge for the provision of childcare services on the grounds of the University. The childcare services are provided by an incorporated society. All parents using the childcare center are members of the society. The members appoint the Board of the incorporated society and are in charge of the childcare center's operating and financial policies. The childcare center is able to be used by staff, students and the general public, with students having priority. Because the childcare center is on University property the staff and parents are required to comply with University health and safety policies. The incorporated society is the licensed provider of childcare services. If the incorporated society ceases to operate, its resources must be distributed to a similar non-profit organization. The incorporated society could choose not to use the University's buildings in providing its services.

Although the University receives non-financial benefits from having childcare services available on campus it does not have power to direct the relevant activities of the incorporated society. The members of the incorporated society, being the parents of the children, have the power to direct the relevant activities of the incorporated society. The University does not control the incorporated society.

Link between Power and Benefits

Delegated Power (paragraphs AG60–AG63)

- IE13. The following examples illustrate assessments of whether an entity is acting as a principal or an agent for the purposes of this Standard.

Example 34

A government department may be responsible for monitoring the performance of another public sector entity. The role of the monitoring department is to make sure the other entity's approach is consistent with the government's goals, provide Ministers with quality assurance about delivery and results and assess and notify the Minister of any risks. The department has an explicit agreement with the Minister which sets out its monitoring responsibilities. The department has the authority to request information from the other entity and provides advice to the Minister on any funding requests from that entity. The department also advises the Minister as to whether the other entity should be permitted to undertake certain activities. The department is acting as an agent of the Minister.

Example 35

A provincial government establishes a trust to co-ordinate fundraising efforts for the benefit of health programs and other health initiatives in the region. The trust also invests and manages designated endowment funds. The funds raised are applied to the government-owned hospitals and aged care facilities in the region.

The provincial government appoints all the trustees on the board of the trust and funds the trust's operating costs. The trust is a registered charity and is exempt from income tax.

Based on the following analysis, the provincial government controls the trust:

- (a) The provincial government can give directions to the trustees, and the trustees have the current ability to direct the relevant activities of the trust. The trustees have power over the trust and the provincial government can replace the trustees at its discretion. The trustees' fiduciary obligation to act in the best interest of the beneficiaries does not prevent the provincial government from having power over the trust;
- (b) The provincial government has exposure and rights to variable benefits from involvement with the trust;
- (c) The provincial government can use its power over the trust to affect the nature or amount of the trust's benefits; and
- (d) The activities of the trust are complementary to the activities of the provincial government.

Example 36

A statutory body is established under legislation to deliver services to the community. The statutory body has a governing council that oversees the body's operations and is responsible for its day-to-day operations. The Minister of Health for the provincial government appoints the statutory body's governing council and, subject to the Minister's approval, the statutory body's governing council appoints the chief executive of the body.

The provincial government's Health Department acts as the "system manager" for the provincial public health system. This role includes:

- (a) Strategic leadership, such as the development of provincial-wide health service plans;
- (b) Directions for the delivery of health services, such as entering into service agreements, capital works approval and management of provincial-wide industrial relations, including employment terms and conditions for the statutory body's employees; and
- (c) Monitoring of performance (e.g., quality of health services and financial data) of the authority and taking remedial action when performance does not meet specified performance measures.

The Minister's approval is specifically required for the following major decisions:

- (a) Entering into service agreements with the body;
- (b) Issuing binding health service directives;
- (c) Finalization of health service plans and capital works planning; and
- (d) Employment and remuneration of the statutory body's executive staff.

The Health Department receives all its operating and capital funding from the provincial government.

Based on the facts and circumstances outlined above, the Health Department generally acts as an agent of the Minister in relation to the statutory body. This is evident from the restricted decision-making authority held by the Department. The Health Department does not control the statutory body.

As the Minister appoints the statutory body's governing council and approves the major decisions affecting the body's activities, the Minister has the power to direct the relevant activities of the body. Assuming that the other control criteria (variable returns and link between power and benefits) are satisfied, as would be expected, then the Minister would control the statutory body. As a result, the statutory body would be consolidated in the provincial government's whole of government general purpose financial statements.

Example 37

The facts are the same as in Example 36 except that:

- (a) The Minister has delegated the power to appoint members of the statutory body's governing council to the Health Department's head;
- (b) The appointment of the statutory body's chief executive by the governing council does not require the Minister's approval;
- (c) The Minister has delegated the power to approve the major decisions to the Health Department's head; and
- (d) Assessments of the Health Department's performance encompass the performance of the statutory body.

The Minister could still exercise the powers that have been delegated to the Health Department's head, but in practice, is unlikely to do so.

In this example, the scope of the decision-making authority held by the Health Department has increased significantly as a result of the delegations by the Minister to the Health Department head. As the Health Department acts as a principal under the delegations, the Department has the current ability to direct the relevant activities of the statutory body so as to achieve the health service objectives of the Health Department. As the Health Department also has the ability to use its power over the authority to affect the nature or amount of the Department's benefits, the Department controls the statutory body.

Example 38

The head of the government department related to finance and taxation (the Treasury) is designated by law as the managing trustee for a number of investment funds. The investment funds are funded by designated taxes and are used to deliver federal welfare programs. The Treasury collects most of the designated tax revenue that relates to these funds. Other agencies also collect some of the revenues and forward these to the Treasury.

The Treasury is delegated the responsibility for administering the funds. For each of the funds, the Treasury immediately invests all receipts credited to the fund, and maintains the invested assets in a designated trust fund until money is needed by the relevant agency.

When the relevant agencies determine that monies are needed, the Treasury redeems securities from the funds' investment balances, and transfers the cash proceeds, including interest earned on the investments, to the program accounts for disbursement by the agency. The Treasury provides monthly and other periodic reporting to each agency. The Treasury charges a management fee for its services.

The Treasury does not control the funds.

Example 39

A local government administers ten funds, each relating to a specific district. The funds hold specified assets (such as land, property and investments) that belonged to districts that previously had their own local government but which have since been amalgamated with other districts. The funds receive the revenue associated with the assets and certain taxes such as the property taxes for that district. The rights of the funds to hold these specified assets and receive the specified revenue are set out in legislation. The assets and revenue of the fund may be applied solely for the benefit of the inhabitants of the former districts.

The local government has wide discretion over spending by the funds. Funds must be applied for the benefit of the community in such a manner as using reasonable judgment the local government thinks proper and having regard to the interests of the inhabitants of the former district. The local government may apply the fund to spending which is not covered by council taxation. Expenditure charged to the fund must be for purposes permitted by law.

The funds are controlled by the local government.

Example 40

A sovereign wealth fund (the fund) is a constitutionally established permanent fund, managed by a government corporation. Legislation specifies that the fund is entitled to receive at least 25% of proceeds from oil sales. The fund sets aside a certain share of these revenues to benefit current and future generations of citizens.

The corporation manages the assets of both the fund and certain other state investments and is remunerated for doing so. The corporation may not spend the fund revenue. Decisions on spending fund revenue are made by the Parliament. Each year, the fund's revenue is split between operating expenses and an annual payment to residents that meet certain criteria specified in legislation.

The corporation does not control the sovereign wealth fund. It acts solely as an agent.

Example 41

A decision maker (fund manager) establishes, markets and manages a publicly traded, regulated fund according to narrowly defined parameters set out in the investment mandate as required by its local laws and regulations. The fund was marketed to investors as an investment in a diversified portfolio of equity securities of publicly traded entities. Within the defined parameters, the fund manager has discretion about the assets in which to invest. The fund manager has made a 10 per cent pro rata investment in the fund and receives a market-based fee for its services equal to 1 per cent of the net asset value of the fund. The fees are commensurate with the services provided. The fund manager does not have any obligation to fund losses beyond its 10 per cent investment. The fund is not required to establish, and has not established, an independent board of directors. The investors do not hold any substantive rights that would affect the decision-making authority of the fund manager, but can redeem their interests within particular limits set by the fund.

Although operating within the parameters set out in the investment mandate and in accordance with the regulatory requirements, the fund manager has decision-making rights that give it the current ability to direct the relevant activities of the fund—the investors do not hold substantive rights that could affect the fund manager's decision-making authority. The fund manager receives a market-based fee for its services that is commensurate with the services provided and has also made a pro rata investment in the fund. The remuneration and its investment expose the fund manager to variability of benefits from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal.

In this example, consideration of the fund manager's exposure to variability of benefits from the fund together with its decision-making authority within restricted parameters indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Example 42

A decision maker establishes, markets and manages a fund that provides investment opportunities to a number of investors. The decision maker (fund manager) must make decisions in the best interests of all investors and in accordance with the fund's governing agreements. Nonetheless, the fund manager has wide decision-making discretion. The fund manager receives a market-based fee for its services equal to 1 per cent of assets under management and 20 per cent of all the fund's surplus if a specified level of surplus is achieved. The fees are commensurate with the services provided.

Although it must make decisions in the best interests of all investors, the fund manager has extensive decision-making authority to direct the relevant activities of the fund. The fund manager is paid fixed and performance-related fees that are commensurate with the services provided. In addition, the remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund, without creating exposure to variability of benefits from the activities of the fund that is of such significance that the remuneration, when considered in isolation, indicates that the fund manager is a principal.

The above fact pattern and analysis applies to examples 42A-42C described below. Each example is considered in isolation.

Example 42A

The fund manager also has a 2 per cent investment in the fund that aligns its interests with those of the other investors. The fund manager does not have any obligation to fund losses beyond its 2 per cent investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

The fund manager's 2 per cent investment increases its exposure to variability of benefits from the activities of the fund without creating exposure that is of such significance that it indicates that the fund manager is a principal. The other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. In this example, although the fund manager has extensive decision-making authority and is exposed to variability of benefits from its interest and remuneration, the fund manager's exposure indicates that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Example 42B

The fund manager has a more substantial pro rata investment in the fund, but does not have any obligation to fund losses beyond that investment. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

In this example, the other investors' rights to remove the fund manager are considered to be protective rights because they are exercisable only for breach of contract. Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's investment together with its remuneration could create exposure to variability of benefits from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. The greater the magnitude of, and variability associated with, the fund manager's economic interests (considering its remuneration and other interests in aggregate), the more emphasis the fund manager would place on those economic interests in the analysis, and the more likely the fund manager is a principal.

For example, having considered its remuneration and the other factors, the fund manager might consider a 20 per cent investment to be sufficient to conclude that it controls the fund. However, in different circumstances (i.e., if the remuneration or other factors are different), control may arise when the level of investment is different.

Example 42C

The fund manager has a 20 per cent pro rata investment in the fund, but does not have any obligation to fund losses beyond its 20 per cent investment. The fund has a board of directors, all of whose members are independent of the fund manager and are appointed by the other investors. The board appoints the fund manager annually. If the board decided not to renew the fund manager's contract, the services performed by the fund manager could be performed by other managers in the industry.

Although the fund manager is paid fixed and performance-related fees that are commensurate with the services provided, the combination of the fund manager's 20 per cent investment together with its remuneration creates exposure to variability of benefits from the activities of the fund that is of such significance that it indicates that the fund manager is a principal. However, the investors have substantive rights to remove the fund manager—the board of directors provides a mechanism to ensure that the investors can remove the fund manager if they decide to do so.

In this example, the fund manager places greater emphasis on the substantive removal rights in the analysis. Thus, although the fund manager has extensive decision-making authority and is exposed to variability of benefits of the fund from its remuneration and investment, the substantive rights held by the other investors indicate that the fund manager is an agent. Thus, the fund manager concludes that it does not control the fund.

Example 43

Entity A is created to purchase a portfolio of fixed rate asset-backed securities, funded by fixed rate debt instruments and equity instruments. The equity instruments are designed to provide first loss protection to the debt investors and receive any residual benefits from Entity A. The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default of the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. On formation, the equity instruments represent 10 per cent of the value of the assets purchased. A decision maker (the asset manager) manages the active asset portfolio by making investment decisions within the parameters set out in Entity A's prospectus. For those services, the asset manager receives a market-based fixed fee (i.e., 1 per cent of assets under management) and performance-related fees (i.e., 10 per cent of surplus) if Entity A's surpluses exceed a specified level. The fees are commensurate with the services provided. The asset manager holds 35 per cent of the equity instruments of Entity A. The remaining 65 per cent of the equity instruments, and all the debt instruments of Entity A, are held by a large number of widely dispersed unrelated third party investors. The asset manager can be removed, without cause, by a simple majority decision of the other investors.

The asset manager is paid fixed and performance-related fees that are commensurate with the services provided. The remuneration aligns the interests of the fund manager with those of the other investors to increase the value of the fund. The asset manager has exposure to variability of returns from the activities of the fund because it holds 35 per cent of the equity instruments and from its remuneration.

Although operating within the parameters set out in Entity A's prospectus, the asset manager has the current ability to make investment decisions that significantly affect Entity A's benefits in the form of returns—the removal rights held by the other investors receive little weighting in the analysis because those rights are held by a large number of widely dispersed investors. In this example, the asset manager places greater emphasis on its exposure to variability of returns of the fund from its net asset/equity interest, which is subordinate to the debt instruments. Holding 35 per cent of the equity instruments creates subordinated exposure to losses and rights to returns of Entity A, which are of such significance that it indicates that the asset manager is a principal. Thus, the asset manager concludes that it controls Entity A.

Example 44

A decision maker (the sponsor) sponsors a multi-seller conduit, which issues short-term debt instruments to unrelated third party investors. The transaction was marketed to potential investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. Various transferors sell high quality medium-term asset portfolios to the conduit. Each transferor services the portfolio of assets that it sells to the conduit and manages receivables on default for a market-based servicing fee. Each transferor also provides first loss protection against credit losses from its asset portfolio through over-collateralization of the assets transferred to the conduit. The sponsor establishes the terms of the conduit and manages the operations of the conduit for a market-based fee. The fee is commensurate with the services provided. The sponsor approves the sellers permitted to sell to the conduit, approves the assets to be purchased by the conduit and makes decisions about the funding of the conduit. The sponsor must act in the best interests of all investors.

The sponsor is entitled to any residual benefit from the conduit and also provides credit enhancement and liquidity facilities to the conduit. The credit enhancement provided by the sponsor absorbs losses of up to 5 per cent of all of the conduit's assets, after losses are absorbed by the transferors. The liquidity facilities are not advanced against defaulted assets. The investors do not hold substantive rights that could affect the decision-making authority of the sponsor.

Even though the sponsor is paid a market-based fee for its services that is commensurate with the services provided, the sponsor has exposure to variability of benefits from the activities of the conduit because of its rights to any residual benefits from the conduit and the provision of credit enhancement and liquidity facilities (i.e., the conduit is exposed to liquidity risk by using short-term debt instruments to fund medium-term assets). Even though each of the transferors has decision-making rights that affect the value of the assets of the conduit, the sponsor has extensive decision-making authority that gives it the current ability to direct the activities that most significantly affect the benefits from the conduit (i.e., the sponsor established the terms of the conduit, has the right to make decisions about the assets (approving the assets purchased and the transferors of those assets) and the funding of the conduit (for which new investment must be found on a regular basis)). The right to residual benefits from the conduit and the provision of credit enhancement and liquidity facilities expose the sponsor to variability of benefits from the activities of the conduit that is different from that of the other investors. Accordingly, that exposure

indicates that the sponsor is a principal and thus the sponsor concludes that it controls the conduit. The sponsor's obligation to act in the best interest of all investors does not prevent the sponsor from being a principal.

Accounting requirements: loss of control (paragraphs 52–55A)

IE13A. The following example illustrates the treatment of a sale of an interest in a controlled entity that does not contain an operation.

Example 44A

A controlling entity has a 100 per cent interest in a controlled entity that does not contain an operation. The controlling entity sells 70 per cent of its interest in the controlled entity to an associate in which it has a 20 per cent interest. As a consequence of this transaction, the controlling entity loses control of the controlled entity. The carrying amount of the net assets of the subsidiary is CU100 and the carrying amount of the interest sold is CU70 ($\text{CU70} = \text{CU100} \times 70\%$). The fair value of the consideration received is CU210, which is also the fair value of the interest sold. The investment retained in the former controlled entity is an associate accounted for using the equity method and its fair value is CU90. The gain determined in accordance with paragraphs 54–55, before the elimination required by paragraph 55A, is CU200 ($\text{CU200} = \text{CU210} + \text{CU90} - \text{CU100}$). This gain comprises two parts:

- (a) The gain (CU140) resulting from the sale of the 70 per cent interest in the controlled entity to the associate. This gain is the difference between the fair value of the consideration received (CU210) and the carrying amount of the interest sold (CU70). According to paragraph 55A, the controlling entity recognizes in its surplus or deficit the amount of the gain attributable to the unrelated investors' interests in the existing associate. This is 80 per cent of this gain, that is CU112 ($\text{CU112} = \text{CU140} \times 80\%$). The remaining 20 per cent of the gain ($\text{CU28} = \text{CU140} \times 20\%$) is eliminated against the carrying amount of the investment in the existing associate.
- (b) The gain (CU60) resulting from the remeasurement at fair value of the investment directly retained in the former controlled entity. This gain is the difference between the fair value of the investment retained in the former controlled entity (CU90) and 30 per cent of the carrying amount of the net assets of the controlled entity ($\text{CU30} = \text{CU100} \times 30\%$). According to paragraph 55A, the controlling entity recognizes in its surplus or deficit the amount of the gain attributable to the unrelated investors' interests in the new

associate. This is 56 per cent ($70\% \times 80\%$) of the gain, that is CU34 ($\text{CU34} = \text{CU60} \times 56\%$). The remaining 44 per cent of the gain CU26 ($\text{CU26} = \text{CU60} \times 44\%$) is eliminated against the carrying amount of the investment retained in the former controlled entity.

Investment Entities (paragraphs AG88–AG106)

- IE14. The following examples illustrate assessments of whether an entity is an investment entity for the purposes of this Standard.

Example 45

An entity, Limited Partnership, is formed in 20X1 as a limited partnership with a 10-year life. The offering memorandum states that Limited Partnership's purpose is to invest in entities with rapid growth potential, with the objective of realizing capital appreciation over their life. Entity GP (the general partner of Limited Partnership) provides 1 per cent of the capital to Limited Partnership and has the responsibility of identifying suitable investments for the partnership. Approximately 75 limited partners, who are unrelated to Entity GP, provide 99 per cent of the capital to the partnership.

Limited Partnership begins its investment activities in 20X1. However, no suitable investments are identified by the end of 20X1. In 20X2 Limited Partnership acquires a controlling interest in one entity, ABC Corporation. Limited Partnership is unable to close another investment transaction until 20X3, at which time it acquires equity interests in five additional operating companies. Other than acquiring these equity interests, Limited Partnership conducts no other activities. Limited Partnership measures and evaluates its investments on a fair value basis and this information is provided to Entity GP and the external investors.

Limited Partnership has plans to dispose of its interests in each of its investees during the 10 year stated life of the partnership. Such disposals include the outright sale for cash, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities and the disposal of investments to the public or other unrelated entities.

From the information provided, Limited Partnership meets the definition of an investment entity from formation in 20X1 to 31 December 20X3 because the following conditions exist:

- (a) Limited Partnership has obtained funds from the limited partners and is providing those limited partners with investment management services;

(b) Limited Partnership's only activity is acquiring equity interests in operating companies with the purpose of realizing capital appreciation over the life of the investments. Limited Partnership has identified and documented exit strategies for its investments, all of which are equity investments; and

(c) Limited Partnership measures and evaluates its investments on a fair value basis and reports this financial information to its investors.

In addition, Limited Partnership displays the following characteristics that are relevant in assessing whether it meets the definition of an investment entity:

(a) Limited Partnership is funded by many investors; and

(b) Ownership in Limited Partnership is represented by units of partnership interests acquired through a capital contribution.

Limited Partnership does not hold more than one investment throughout the period. However, this is because it was still in its start-up period and had not identified suitable investment opportunities.

Example 46

High Technology Fund was formed by Technology Corporation to invest in technology start-up companies for capital appreciation. Technology Corporation holds a 70 per cent interest in High Technology Fund and controls High Technology Fund; the other 30 per cent ownership interest in High Technology Fund is owned by 10 investors. Technology Corporation holds options to acquire investments held by High Technology Fund, at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of Technology Corporation. No plans for exiting the investments have been identified by High Technology Fund. High Technology Fund is managed by an investment adviser that acts as agent for the investors in High Technology Fund.

Even though High Technology Fund's purpose is investing for capital appreciation and it provides investment management services to its investors, High Technology Fund is not an investment entity because of the following arrangements and circumstances:

- (a) Technology Corporation, the controlling entity of High Technology Fund, holds options to acquire investments in investments held by High Technology Fund if the assets developed by those entities would benefit the operations of Technology Corporation. This provides a benefit in addition to capital appreciation or investment revenue; and
- (b) The investment plans of High Technology Fund do not include exit strategies for its investments, which are equity investments. The options held by Technology Corporation are not controlled by High Technology Fund and do not constitute an exit strategy.

Example 47

Real Estate Entity was formed to develop, own and operate retail, office and other commercial properties. Real Estate Entity typically holds its property in separate wholly-owned controlled entities, which have no other substantial assets or liabilities other than borrowings used to finance the related investment property. Real Estate Entity and each of its controlled entities report their investment properties at fair value in accordance with IPSAS 16, *Investment Property*. Real Estate Entity does not have a set time frame for disposing of its property investments, but uses fair value to help identify the optimal time for disposal. Although fair value is one performance indicator, Real Estate Entity and its investors use other measures, including information about expected cash flows, rental revenues and expenses, to assess performance and to make investment decisions. The key management personnel of Real Estate Entity do not consider fair value information to be the primary measurement attribute to evaluate the performance of its investments but rather a part of a group of equally relevant key performance indicators.

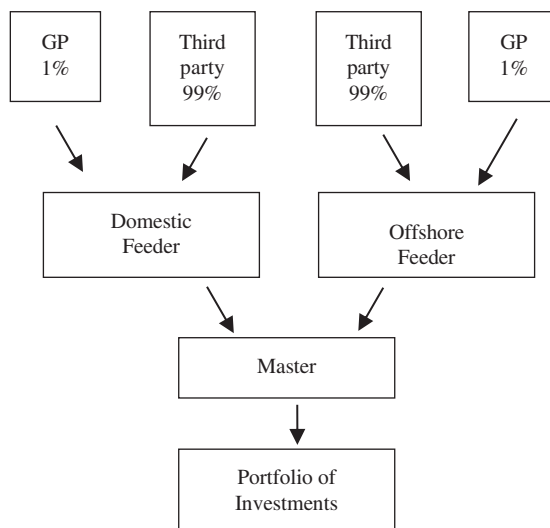
Real Estate Entity undertakes extensive property and asset management activities, including property maintenance, capital expenditure, redevelopment, marketing and tenant selection, some of which it outsources to third parties. This includes the selection of properties for refurbishment, development and the negotiation with suppliers for the design and construction work to be done to develop such properties. This development activity forms a separate substantial part of Real Estate Entity's activities.

Real Estate Entity does not meet the definition of an investment entity because:

- (a) Real Estate Entity has a separate substantial activity that involves the active management of its property portfolio, including lease negotiations, refurbishments and development activities, and marketing of properties to provide benefits other than capital appreciation, investment revenue, or both;
- (b) The investment plans of Real Estate Entity do not include specified exit strategies for its investments. As a result, Real Estate Entity plans to hold those property investments indefinitely; and
- (c) Although Real Estate Entity reports its investment properties at fair value in accordance with IPSAS 16, fair value is not the primary measurement attribute used by management to evaluate the performance of its investments. Other performance indicators are used to evaluate performance and make investment decisions.

Example 48

An entity, Master Fund, is formed in 20X1 with a 10-year life. The equity of Master Fund is held by two related feeder funds. The feeder funds are established in connection with each other to meet legal, regulatory, tax or similar requirements. The feeder funds are capitalized with a 1 per cent investment from the general partner and 99 per cent from equity investors that are unrelated to the general partner (with no party holding a controlling financial interest).



The purpose of Master Fund is to hold a portfolio of investments in order to generate capital appreciation and investment revenue (such as dividends, interest or rental revenue). The investment objective communicated to investors is that the sole purpose of the Master-Feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Master Fund has identified and documented exit strategies for the equity and non-financial investments that it holds. Master Fund holds a portfolio of short and medium term debt investments, some of which will be held until maturity and some of which will be traded but Master Fund has not specifically identified which investments will be held and which will be traded. Master Fund measures and evaluates substantially all of its investments, including its debt investments, on a fair value basis. In addition, investors receive periodic financial information, on a fair value basis, from the feeder funds. Ownership in both Master Fund and the feeder funds is represented through units of equity.

<p>Master Fund and the feeder funds each meet the definition of an investment entity. The following conditions exist:</p> <ul style="list-style-type: none"> (a) Both Master Fund and the feeder funds have obtained funds for the purpose of providing investors with investment management services; (b) The Master-Feeder structure's purpose, which was communicated directly to investors of the feeder funds, is investing solely for capital appreciation and investment revenue and Master Fund has identified and documented potential exit strategies for its equity and non-financial investments; 	<ul style="list-style-type: none"> (c) Although the feeder funds do not have an exit strategy for their interests in Master Fund, the feeder funds can nevertheless be considered to have an exit strategy for their investments because Master Fund was formed in connection with the feeder funds and holds investments on behalf of the feeder funds; and (d) The investments held by Master Fund are measured and evaluated on a fair value basis and information about the investments made by Master Fund is provided to investors on a fair value basis through the feeder funds.
<p>Master Fund and the feeder funds were formed in connection with each other for legal, regulatory, tax or similar requirements. When considered together, they display the following characteristics:</p> <ul style="list-style-type: none"> (a) The feeder funds indirectly hold more than one investment because Master Fund holds a portfolio of investments; (b) Although Master Fund is wholly capitalized by the feeder funds, the feeder funds are funded by many investors who are unrelated to the feeder funds (and to the general partner); and (c) Ownership in the feeder funds is represented by units of equity interests acquired through a capital contribution. 	

Example 49

Government Corporation A was established with the principal activity of providing equity finance to both existing and new enterprises. Its investment objective is to seek capital appreciation and returns. All acquisitions are made on that basis. The strategy of the Corporation is to increase the fair value of investments in order to realize a gain on disposal. Management assesses and monitors fair value of the investments on a regular basis. The Corporation regularly disposes of investments when they reach a certain stage of maturity so as to provide funds for ongoing investment opportunities. Any surplus is distributed to the government in the form of dividends.

The Corporation also provides investment related services to the government regarding the government's policies for assisting entities in financial distress. It acts as an agent in managing and implementing some of the government's business incentive schemes. The Corporation is not exposed to any losses or risks as a result of its involvement with these schemes.

The Corporation is an investment entity. It meets all three aspects of the definition of an investment entity.

Comparison with IFRS 10

IPSAS 35, *Consolidated Financial Statements* is drawn primarily from IFRS 10, *Consolidated Financial Statements* (issued in 2011, including amendments up to December 31, 2014). At the time of issuing this Standard, the IPSASB has not considered the applicability to public sector entities of certain IFRSs referred to in IFRS 10. These standards include:

- IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*; and
- IFRS 9, *Financial Instruments*.

The main differences between IPSAS 35 and IFRS 10 are as follows:

- IPSAS 35 uses different terminology, in certain instances, from IFRS 10. The most significant examples are the use of the terms “economic entity,” “controlling entity,” and “controlled entity”. The equivalent terms in IFRS 10 are “group,” “parent,” and “subsidiary.” In many cases the terms “investor” and “investee” used in IFRS 10 are replaced by references to “an entity”, “another entity” or “an entity being assessed for control”. The terms “investor” and “investee” have been retained in the application guidance on investment entities as they are appropriate in that context.
- IPSAS 35 defines the term “binding arrangement”. This term is broader than the term “contractual arrangement”, which is used in IFRS 10.
- IFRS 10 identifies typical characteristics of an investment entity separately from the definition of an investment entity. IPSAS 35 does not identify such typical characteristics. However, it does discuss some of these characteristics in the context of the definition of an investment entity.
- IPSAS 35 contains more guidance on non-financial benefits.
- IPSAS 35 does not require that a controlling entity, that is not itself an investment entity, shall consolidate all controlled entities. Instead it requires that such a controlling entity shall present consolidated financial statements in which it (i) measures the investments of the controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity in accordance with IPSAS 35.
- IPSAS 35 contains additional illustrative examples that reflect the public sector context.

IPSAS 36—INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 28, *Investments in Associates and Joint Ventures* published by the International Accounting Standards Board (IASB). Extracts from IAS 28 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 36—INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 36, *Investments in Associates and Joint Ventures* was issued in January 2015.

Since then, IPSAS 36 has been amended by the following IPSASs:

- IPSAS 40, *Public Sector Combinations* (issued January 2017)
- *The Applicability of IPSASs* (issued April 2016)
- *Improvements to IPSASs 2015* (issued April 2016)

Table of Amended Paragraphs in IPSAS 36

Paragraph Affected	How Affected	Affected By
4	Amended	Improvements to IPSASs April 2016
6	Deleted	The Applicability of IPSASs April 2016
7	Deleted	The Applicability of IPSASs April 2016
26	Amended	IPSAS 40 January 2017
31	Amended	IPSAS 40 January 2017
33	Amended	IPSAS 40 January 2017
34A	New	IPSAS 40 January 2017
34B	New	IPSAS 40 January 2017
51A	New	The Applicability of IPSASs April 2016
51B	New	IPSAS 40 January 2017
51C	New	IPSAS 40 January 2017

IPSAS 36—INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

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International Public Sector Accounting Standard 36, *Investments in Associates and Joint Ventures*, is set out in paragraphs 1–53. All the paragraphs have equal authority. IPSAS 36 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to prescribe the accounting for investments in associates and joint ventures and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

Scope

2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for investments in associates and joint ventures.**
3. **This Standard shall be applied by all entities that are investors with significant influence over, or joint control of, an investee where the investment leads to the holding of a quantifiable ownership interest.**
4. This Standard provides the basis for accounting for ownership interests in associates and joint ventures. That is, the investment in the other entity confers on the entity the risks and rewards incidental to an ownership interest. This Standard applies only to quantifiable ownership interests. This includes ownership interests arising from investments in the formal equity structure of another entity. A formal equity structure means share capital or an equivalent form of capital, such as units in a property trust. Quantifiable ownership interests may also include ownership interests arising from other investments in which the entity's ownership interest can be measured reliably¹ (for example, interests in a partnership). Where the equity structure of the other entity is poorly defined, it may not be possible to obtain a reliable measure of the ownership interest.
5. Some contributions made by public sector entities may be referred to as an "investment," but may not give rise to an ownership interest. For example, a public sector entity may make a substantial investment in the development of a hospital that is owned and operated by a charity. While such contributions are non-exchange in nature, they allow the public sector entity to participate in the operation of the hospital, and the charity is accountable to the public sector entity for its use of public monies. However, the contributions made by the public sector entity do not constitute an ownership interest, as the charity could seek alternative funding and thereby prevent the public sector entity from participating in the operation of the hospital. Accordingly, the public sector entity is not exposed to the risks, nor does it enjoy the rewards, that are incidental to an ownership interest.
6. [Deleted]
7. [Deleted]

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

Definitions

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

An **associate** is an entity over which the investor has significant influence.

Binding arrangement: For the purposes of this Standard, a binding arrangement is an arrangement that confers enforceable rights and obligations on the parties to it as if it were in the form of a contract. It includes rights from contracts or other legal rights.

Consolidated financial statements are the financial statements of an economic entity in which assets, liabilities, net assets/equity, revenue, expenses and cash flows of the controlling entity and its controlled entities are presented as those of a single economic entity.

The **equity method** is a method of accounting whereby the investment is initially recognized at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets/equity of the associate or joint venture. The investor's surplus or deficit includes its share of the investee's surplus or deficit and the investor's net assets/equity includes its share of changes in the investee's net assets/equity that have not been recognized in the investee's surplus or deficit.

A **joint arrangement** is an arrangement of which two or more parties have joint control.

Joint control is the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A **joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

A **joint venturer** is a party to a joint venture that has joint control of that joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of another entity but is not control or joint control of those policies.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately. The following terms are defined in either IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements*, or IPSAS 37, *Joint Arrangements*: benefits, control,

controlled entity, controlling entity, economic entity, investment entity, joint operation, power and separate financial statements.

Binding Arrangement

9. Binding arrangements can be evidenced in several ways. A binding arrangement is often, but not always, in writing, in the form of a contract or documented discussions between the parties. Statutory mechanisms such as legislative or executive authority can also create enforceable arrangements, similar to contractual arrangements, either on their own, or in conjunction with contracts between the parties.

Significant Influence

10. Whether an investor has significant influence over the investee is a matter of judgment based on the nature of the relationship between the investor and the investee, and on the definition of significant influence in this Standard. This Standard applies only to those associates in which an entity holds a quantifiable ownership interest either in the form of a shareholding or other formal equity structure or in another form in which the entity's interest can be measured reliably.
11. If an entity holds a quantifiable ownership interest and it holds, directly or indirectly (e.g., through controlled entities), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly (e.g., through controlled entities), less than 20 per cent of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.
12. The existence of significant influence by an entity is usually evidenced in one or more of the following ways:
 - (a) Representation on the board of directors or equivalent governing body of the investee;
 - (b) Participation in policy-making processes, including participation in decisions about dividends or similar distributions;
 - (c) Material transactions between the entity and its investee;
 - (d) Interchange of managerial personnel; or
 - (e) Provision of essential technical information.
13. An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar

instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of another entity (i.e., potential voting rights). The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event.

14. In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other binding arrangements whether considered individually or in combination) that affect potential rights, except the intentions of management and the financial ability to exercise or convert those potential rights.
15. An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when an associate becomes subject to the control of another government, a court or an administrator. It could also occur as a result of a binding arrangement.

Equity Method

16. Under the equity method, on initial recognition the investment in an associate or a joint venture is recognized at cost and the carrying amount is increased or decreased to recognize the investor's share of the surplus or deficit of the investee after the date of acquisition. The investor's share of the investee's surplus or deficit is recognized in the investor's surplus or deficit. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's equity that have not been recognized in the investee's surplus or deficit. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognized in net assets/equity of the investor.
17. The recognition of revenue on the basis of distributions received may not be an adequate measure of the revenue earned by an investor on an investment in an associate or a joint venture because the distributions received may bear little relation to the performance of the associate or joint venture. Because the investor has joint control of, or significant influence over, the investee, the investor has an interest in the associate's or joint venture's performance and,

as a result, the return on its investment. The investor accounts for this interest by extending the scope of its financial statements to include its share of the surplus or deficit of such an investee. As a result, application of the equity method provides more informative reporting of the investor's net assets/equity and surplus or deficit.

18. When potential voting rights or other derivatives containing potential voting rights exist, an entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments, unless paragraph 19 applies.
19. In some circumstances, an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives it access to the benefits associated with an ownership interest. In such circumstances, the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the benefits.
20. IPSAS 29, *Financial Instruments: Recognition and Measurement* does not apply to interests in associates and joint ventures that are accounted for using the equity method. When instruments containing potential voting rights in substance currently give access to the benefits associated with an ownership interest in an associate or a joint venture, the instruments are not subject to IPSAS 29. In all other cases, instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with IPSAS 29.
21. **An investment in an associate or a joint venture accounted for using the equity method shall be classified as a non-current asset.**

Application of the Equity Method

22. **An entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or a joint venture using the equity method except when that investment qualifies for exemption in accordance with paragraphs 23–25.**

Exemptions from Applying the Equity Method

23. An entity need not apply the equity method to its investment in an associate or a joint venture if the entity is a controlling entity that is exempt from preparing consolidated financial statements by the scope exception in paragraph 5 of IPSAS 35 or if all of the following apply:
 - (a) The entity itself is a controlled entity and the information needs of users are met by its controlling entity's consolidated financial statements, and, in the case of a partially owned entity, all its other owners, including those not otherwise entitled to vote, have been

informed about, and do not object to, the entity not applying the equity method.

- (b) The entity's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).
- (c) The entity did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization, for the purpose of issuing any class of instruments in a public market.
- (d) The ultimate or any intermediate controlling entity of the entity produces financial statements available for public use that comply with IPSASs, in which controlled entities are consolidated or are measured at fair value in accordance with IPSAS 35.

24. When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through surplus or deficit in accordance with IPSAS 29. An investment entity will, by definition, have made this election.

25. When an entity has an investment in an associate, a portion of which is held indirectly through a venture capital organization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that portion of the investment in the associate at fair value through surplus or deficit in accordance with IPSAS 29 regardless of whether the venture capital organization, or the mutual fund, unit trust and similar entities including investment-linked insurance funds, has significant influence over that portion of the investment. If the entity makes that election, the entity shall apply the equity method to any remaining portion of its investment in an associate that is not held through a venture capital organization, or a mutual fund, unit trust and similar entities including investment-linked insurance funds. When an entity has an investment in an associate, a portion of which is held indirectly through an investment entity, the entity shall measure that portion of the investment at fair value through surplus or deficit in accordance with IPSAS 29.

Discontinuing the Use of the Equity Method

26. **An entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or a joint venture as follows:**
- (a) **If the investment becomes a controlled entity, the entity shall account for its investment in accordance with IPSAS 40, *Public Sector Combinations* and IPSAS 35.**

- (b) **If the retained interest in the former associate or joint venture is a financial asset, the entity shall measure the retained interest at fair value. The fair value of the retained interest shall be regarded as its fair value on initial recognition as a financial asset in accordance with IPSAS 29. If an entity is precluded by IPSAS 29, paragraphs AG113 and AG114 from measuring the retained interest at fair value, the entity shall measure the retained interest at the carrying amount of the investment at the date that it ceases to be an associate or joint venture and that carrying amount shall be regarded as its cost on initial recognition as a financial asset in accordance with IPSAS 29. The entity shall recognize in surplus or deficit any difference between:**
 - (i) **The fair value (or, where relevant, the carrying amount) of any retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and**
 - (ii) **The carrying amount of the investment at the date the equity method was discontinued.**
 - (c) **When an entity discontinues the use of the equity method, the entity shall account for all amounts previously recognized directly in the entity's net assets/equity in relation to that investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities.**
27. **If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.**

Changes in Ownership Interest

28. If an entity's ownership interest in an associate or a joint venture is reduced, but the investment continues to be classified either as an associate or a joint venture respectively, the entity shall transfer directly to accumulated surpluses or deficits the proportion of the gain or loss that had previously been recognized in net assets/equity relating to that reduction in ownership interest if that gain or loss would be required to be transferred directly to accumulated surpluses or deficits on the disposal of the related assets or liabilities.

Equity Method Procedures

29. Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IPSAS 35. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a controlled entity are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

30. An economic entity's share in an associate or a joint venture is the aggregate of the holdings in that associate or joint venture by the controlling entity and its controlled entities. The holdings of the economic entity's other associates or joint ventures are ignored for this purpose. When an associate or a joint venture has controlled entities, associates or joint ventures, the surplus or deficit and net assets taken into account in applying the equity method are those recognized in the associate's or joint venture's financial statements (including the associate's or joint venture's share of the surpluses or deficits and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies (see paragraphs 37–39).
31. Gains and losses resulting from “upstream” and “downstream” transactions involving assets that do not constitute an operation, as defined in IPSAS 40, between an entity (including its consolidated controlled entities) and its associate or joint venture are recognized in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture. “Upstream” transactions are, for example, sales of assets from an associate or a joint venture to the investor. The entity's share in the associate's or the joint venture's gains or losses resulting from these transactions is eliminated. “Downstream” transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture.
32. When downstream transactions provide evidence of a reduction in the net realizable value of the assets to be sold or contributed, or of an impairment loss of those assets, those losses shall be recognized in full by the investor. When upstream transactions provide evidence of a reduction in the net realizable value of the assets to be purchased or of an impairment loss of those assets, the investor shall recognize its share in those losses.
33. The gain or loss resulting from the contribution of non-monetary assets that do not constitute an operation, as defined in IPSAS 40, to an associate or a joint venture in exchange for an equity interest in that associate or joint venture shall be accounted for in accordance with paragraph 31, except when the contribution lacks commercial substance, as that term is described in IPSAS 17, *Property, Plant and Equipment*. If such a contribution lacks commercial substance, the gain or loss is regarded as unrealized and is not recognized unless paragraph 34 also applies. Such unrealized gains and losses shall be eliminated against the investment accounted for using the equity method and shall not be presented as deferred gains or losses in the entity's consolidated statement of financial position or in the entity's statement of financial position in which investments are accounted for using the equity method.
34. If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity recognizes in

full in surplus or deficit the portion of the gain or loss on the contribution relating to the monetary or non-monetary assets received.

- 34A. The gain or loss resulting from a downstream transaction involving assets that constitute an operation, as defined in IPSAS 40, between an entity (including its consolidated controlled entities) and its associate or joint venture is recognized in full in the investor's financial statements.
- 34B. An entity might sell or contribute assets in two or more arrangements (transactions). When determining whether assets that are sold or contributed constitute an operation, as defined in IPSAS 40, an entity shall consider whether the sale or contribution of those assets is part of multiple arrangements that should be accounted for as a single transaction in accordance with the requirements in paragraph 53 of IPSAS 35.
- 35. An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:
 - (a) When an entity has included goodwill relating to an associate or a joint venture in the carrying amount of the investment, amortization of that goodwill is not permitted.
 - (b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as revenue in the determination of the entity's share of the associate or joint venture's surplus or deficit in the period in which the investment is acquired.

Appropriate adjustments to the entity's share of the associate's or joint venture's surplus or deficit after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's surplus or deficit after acquisition are made for impairment losses such as for property, plant and equipment or, where relevant, goodwill.

- 36. **The most recent available financial statements of the associate or joint venture are used by the entity in applying the equity method. When the end of the reporting period of the entity is different from that of an associate or a joint venture the entity either:**
 - (a) **Obtains, for the purpose of applying the equity method, additional financial information as of the same date as the financial statements of the entity; or**

- (b) **Uses the most recent financial statements of the associate or joint venture adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the entity's financial statements.**

37. **The entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.**
38. Except as described in paragraph 39, if an associate or a joint venture uses accounting policies other than those of the entity for like transactions and events in similar circumstances, adjustments shall be made to make the associate's or joint venture's accounting policies conform to those of the entity when the associate's or joint venture's financial statements are used by the entity in applying the equity method.
39. **Notwithstanding the requirements in paragraph 38, if an entity has an interest in an associate or a joint venture that is an investment entity, the entity shall, when applying the equity method, retain the fair value measurement applied by that investment entity associate or joint venture to its interest in controlled entities.**
40. If an associate or a joint venture has outstanding cumulative preference shares that are held by parties other than the entity and are classified as equity, the entity computes its share of surplus or deficit after adjusting for the dividends on such shares, whether or not the dividends have been declared.
41. If an entity's share of the deficit of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognizing its share of further deficits. The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture. Such items may include preference shares and long-term receivables or loans, but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. Deficits recognized using the equity method in excess of the entity's investment in ordinary shares are applied to the other components of the entity's interest in an associate or a joint venture in the reverse order of their seniority (i.e. priority in liquidation).
42. After the entity's interest is reduced to zero, additional deficits are provided for, and a liability is recognized, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture subsequently reports

surpluses, the entity resumes recognizing its share of those surpluses only after its share of the surpluses equals the share of deficits not recognized.

Impairment Losses

43. After application of the equity method, including recognizing the associate's or joint venture's deficits in accordance with paragraph 41, the entity applies IPSAS 29 to determine whether it is necessary to recognize any additional impairment loss with respect to its net investment in the associate or joint venture.
44. The entity also applies IPSAS 29 to determine whether any additional impairment loss is recognized with respect to its interest in the associate or joint venture that does not constitute part of the net investment and the amount of that impairment loss.
45. Whenever application of IPSAS 29 indicates that the investment in an associate or a joint venture may be impaired, an entity applies IPSAS 26, *Impairment of Cash-Generating Assets*, and possibly, IPSAS 21, *Impairment of Non-Cash-Generating Assets*.
46. IPSAS 26 directs an entity to determine the value in use of the cash-generating investment. In determining the value in use of the cash-generating investment in accordance with IPSAS 26, an entity estimates:
 - (a) Its share of the present value of the estimated future cash flows expected to be generated by the associate or joint venture, including the cash flows from the operations of the associate or joint venture and the proceeds from the ultimate disposal of the investment; or
 - (b) The present value of the estimated future cash flows expected to arise from dividends or similar distributions to be received from the investment, and from its ultimate disposal.

Using appropriate assumptions, both methods give the same result.

47. IPSAS 21 requires that, if the recoverable service amount of an asset is less than its carrying amount, the carrying amount shall be reduced to its recoverable service amount. Recoverable service amount is the higher of an asset's fair value, less costs to sell and its value in use. Value in use of a non-cash-generating asset is defined as the present value of the asset's remaining service potential. The present value of the remaining service potential may be assessed using the depreciated replacement cost approach, the restoration cost approach or the service units approach, as appropriate.
48. **The recoverable amount of an investment in an associate or a joint venture shall be assessed for each associate or joint venture, unless the associate or joint venture does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.**

Separate Financial Statements

49. An investment in an associate or a joint venture shall be accounted for in the entity's separate financial statements in accordance with paragraph 12 of IPSAS 34, *Separate Financial Statements*.

Transitional Provisions

50. The transitional provisions for changing from proportionate consolidation to the equity method, or from the equity method to accounting for assets and liabilities in respect of a joint operation are set out in IPSAS 37.

Effective Date

51. An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2017, it shall disclose that fact and apply IPSAS 34, IPSAS 35, IPSAS 37, and IPSAS 38, *Disclosure of Interests in Other Entities*, at the same time.
- 51A. Paragraphs 6 and 7 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.
- 51B. Paragraph 26 was amended by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply this amendment for annual financial statements covering periods beginning on or after January 1, 2019. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2019 it shall disclose that fact and apply IPSAS 40 at the same time.
- 51C. Paragraphs 31 and 33 were amended and paragraphs 34A and 34B added by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments prospectively for annual financial statements covering periods beginning on or after a date to be determined by the IPSASB. Earlier application is permitted. If an entity applies the amendments for a period earlier, it shall disclose that fact and, if it has not already done so, apply IPSAS 40 at the same time.
52. When an entity adopts the accrual basis IPSASs as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public sector Accounting Standards (IPSASs)* for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.

Withdrawal and Replacement of IPSAS 7 (December 2006)

53. This Standard supersedes IPSAS 7, *Investments in Associates* (December 2006). IPSAS 7 remains applicable until IPSAS 36 is applied or becomes effective, whichever is earlier.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 36.

Objective

- BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching its conclusions on IPSAS 36. As this Standard is based on IAS 28, *Investments in Associates and Joint Ventures* (Amended in 2011, including amendments up to December 31, 2014) issued by the IASB, the Basis for Conclusions outlines only those areas where IPSAS 36 departs from the main requirements of IAS 28 (Amended in 2011), or where the IPSASB considered such departures.

Overview

- BC2. In 2012 the IPSASB commenced work on a project to update those IPSASs that dealt with accounting for interests in controlled entities, associates and joint ventures. In October 2013 the IPSASB issued Exposure Drafts (EDs) 48 to 52 which were collectively referred to as *Interests in Other Entities*. ED 50, *Investments in Associates and Joint Ventures*, was based on IAS 28 (Amended in 2011), having regard to the relevant public sector modifications in IPSAS 7, *Investments in Associates* and IPSAS 8, *Interests in Joint Ventures*. In January 2015 the IPSASB issued five new IPSASs, including IPSAS 36. These new IPSASs supersede IPSAS 6, *Consolidated and Separate Financial Statements*, IPSAS 7 and IPSAS 8.
- BC3. As a result of combining the accounting for associates and joint ventures the title of the Standard was changed to *Investments in Associates and Joint Ventures*.
- BC4. In drafting IPSAS 36 the Board did not reconsider all the requirements of IPSAS 7, *Investments in Associates*. The most significant changes resulted from the decision to require the use of the equity method to account for investments in joint ventures and therefore to combine the accounting for investments in associates and joint ventures in one standard. The Board's views on the use of the equity method to account for investments in joint ventures are discussed in the Basis for Conclusions on IPSAS 37.

Scope

Quantifiable Ownership Interests

- BC5. The IPSASB noted that the scope of IPSAS 7 had been limited to investments in associates "where the investment in the associate leads to the holding of an ownership interest in the form of a shareholding or other formal equity structure". In developing IPSAS 7 the IPSASB noted that it is unlikely equity accounting could be applied unless the associate had a formal or other reliably measurable equity structure. The IPSASB reflected on the intention of this

modification and concluded that it was intended to prevent the inappropriate application of that Standard to interests other than ownership interests.

- BC6. In contrast with IPSAS 7 this Standard applies to both associates and joint ventures. Because joint ventures can take many forms, including partnership arrangements which do not have formal equity structures, the scope limitation in IPSAS 7 was not appropriate. The IPSASB decided that the scope of this Standard should be limited to “quantifiable ownership interests”. Respondents supported this proposal, but considered that disclosure of information about an entity’s non-quantifiable ownership interests in other entities would be appropriate. The IPSASB agreed that IPSAS 38, *Disclosure of Interests in Other Entities* should require the disclosure of non-quantifiable ownership interests.

Temporary Joint Control and Significant Influence

- BC7. IPSAS 7 and IPSAS 8, *Interests in Joint Ventures*, did not require application of the equity method or proportionate consolidation when joint control of, or significant influence over, another entity was intended to be temporary. The IPSASB noted that the IASB had removed these exemptions from the equivalent IFRSs in 2003, as a consequence of issuing IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.
- BC8. The IPSASB noted that in developing IPSAS 35, *Consolidated Financial Statements*, it had considered the related issue of whether to incorporate a temporary control exemption in that Standard, and had agreed not to do so. Accordingly the IPSASB decided not to provide exemptions based on temporary joint control or temporary significant influence in IPSAS 36.

Significant Influence

- BC9. The Standard establishes a presumption that an entity has significant influence over an investee if an entity holds an ownership interest in the form of a shareholding or other formal equity structure and holds, directly, or indirectly, (e.g., through controlled entities) 20 per cent or more of the voting power of an investee. The IPSASB noted that the use of 20 percent in establishing a presumption of significant influence came initially from IAS 28 and had also been used in IPSAS 7 (December 2006). In deciding to retain this presumption in the Standard, the IPSASB noted that it was unaware of any public sector reason to use an amount other than 20 per cent.

Uniform Reporting Dates

- BC10. The IPSASB considered whether to impose a time limit on the difference between the end of the reporting period of the entity and associate or joint venture of the entity. The IPSASB noted that IAS 28 requires that the most recent available financial statements of the associate or joint venture be used by an entity in applying the equity method and requires adjustments when

they are not the same. In addition, IAS 28 limits the difference in dates to three months. The IPSASB noted that there may be instances in the public sector where entities have different reporting dates and it may not be possible to change those dates. The IPSASB agreed not to impose a three month limit on the difference in dates.

Investment Entities

BC11. Some respondents to ED 50 requested that the IPSASB clarify the application of the equity method by investment entities and by investors with investments in an associate or a joint venture that is an investment entity. Accordingly the IPSASB:

- (a) Clarified that an investment entity will, by definition, have elected to account for investments in associates and joint ventures at fair value through surplus or deficit in accordance with IPSAS 29; and
- (b) Required that an entity with an interest in an investment entity associate or an investment entity joint venture, shall, when applying the equity method, retain the fair value measurement applied by that investment entity associate or investment entity joint venture to its interests in controlled entities.

BC12. The IPSASB noted that IASB constituents had also sought clarification of some aspects of the accounting for investments in investment entity associates and investment entity joint ventures. The IASB issued ED 2014/2 *Investment Entities—Applying the Consolidation Exception (Proposed amendments to IFRS 10 and IAS 28)* in June 2014 and subsequently issued *Investment Entities: Applying the Consolidation Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)* in December 2014. The IPSASB considered that these clarifications were helpful in addressing implementation issues identified by early adopters of the IASB's investment entity requirements and incorporated those aspects of the amendments that were relevant to this Standard.

Sale or Contribution of Assets between an Investor and its Associate or Joint Venture

BC13. At the time that IPSAS 36 was being developed, the IASB amended IFRS 10 and IAS 28 so that the requirements for the recognition of a partial gain or loss for transactions between an investor and its associate or joint venture would apply only to the gain or loss resulting from the sale or contribution of assets that do not constitute a business, as defined in IFRS 3, *Business Combinations*. The IASB issued *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (Amendments to IFRS 10 and IAS 28)* in September 2014. The IPSASB agreed not to incorporate the requirements introduced by these amendments in IPSAS 35 and IPSAS 36

on the grounds that it would be more appropriate to consider the recognition of full or partial gains and losses in the context of drafting standards-level requirements for public sector combinations.

- BC14. At the time the IPSASB developed ED 60, *Public Sector Combinations*, it reconsidered whether to include guidance on how to account for the sale or contribution of assets between an investor and its associate or joint venture. The IPSASB reviewed the guidance issued by the IASB in *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28). The effect of the IASB's amendments if adopted in IPSAS 36 would be that a partial gain or loss for transactions between an investor and its associate or joint venture would apply only to the gain or loss resulting from the sale or contribution of assets *that do not constitute an operation*. The IPSASB did not identify any public sector reason to depart from the IASB's approach. Consequently, the IPSASB agreed to include this guidance (amended to fit the terminology and definitions in ED 60) in IPSAS 36.
- BC15. In December 2015, the IASB deferred the implementation of the guidance in *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28). This was because the IASB was undertaking further research in this area as part of its project on equity accounting, and it did not want to require entities to change their accounting twice in a short period. In deferring the effective date, the IASB continued to allow early application of the guidance as it did not wish to prohibit the application of better financial reporting. The IPSASB reviewed the decision of the IASB to defer the implementation of this guidance. The IPSASB did not identify any public sector reason to depart from the IASB's approach. Consequently, the IPSASB agreed to include this guidance (amended to fit the terminology and definitions in IPSAS 40) in IPSAS 36, to be applied from a date to be determined by the IPSASB.

Revision of IPSAS 36 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

- BC16. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:
- (a) Removes the standard paragraphs about the applicability of IPSASs to "public sector entities other than GBEs" from the scope section of each Standard;
 - (b) Replaces the term "GBE" with the term "commercial public sector entities", where appropriate; and

- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

Comparison with IAS 28 (Amended in 2011)

IPSAS 36, *Investments in Associates and Joint Ventures* is drawn primarily from IAS 28, *Investments in Associates and Joint Ventures* (Amended in 2011, including amendments up to December 31, 2014). At the time of issuing this Standard, the IPSASB has not considered the applicability to public sector entities of IFRS 9, *Financial Instruments*. References to IFRS 9 in IAS 28 have therefore been replaced by references to the IPSASs dealing with financial instruments.

The main differences between IPSAS 36 and IAS 28 (Amended in 2011) are as follows:

- IPSAS 36 uses different terminology, in certain instances, from IAS 28 (Amended in 2011). The most significant examples are the use of the terms “net assets/equity,” “economic entity,” “controlling entity,” “controlled entity” and “revenue” in IPSAS 36. The equivalent terms in IAS 28 (Amended in 2011) are “equity,” “group,” “parent,” “subsidiary” and “income.”
- IPSAS 36 applies to all investments where the investor has a quantifiable ownership interest. IAS 28 (Amended in 2011) does not contain a similar requirement. However, it is unlikely that equity accounting could be applied unless there was a quantifiable ownership interest.
- Where an entity is precluded by IPSAS 29 from measuring the retained interest in a former associate or joint venture at fair value, IPSAS 36 permits an entity to use carrying amount as the cost on initial recognition of the financial asset. IAS 28 (Amended in 2011) requires that the retained interest be measured at fair value.
- IPSAS 36 requires that an entity with an interest in an associate or a joint venture that is an investment entity, shall, when applying the equity method, retain the fair value measurement applied by that investment entity associate or joint venture to its interest in controlled entities. IAS 28 (Amended in 2011) permits an entity with an interest in an associate or a joint venture that is an investment entity to retain the fair value measurement applied by that investment entity associate or joint venture.

IPSAS 37—JOINT ARRANGEMENTS

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Financial Reporting Standard (IFRS) 11, *Joint Arrangements* published by the International Accounting Standards Board (IASB). Extracts from IFRS 11 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards (IFRS) Foundation.

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IPSAS 37—JOINT ARRANGEMENTS

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 37, *Joint Arrangements* was issued in January 2015.

Since then, IPSAS 37 has been amended by the following IPSASs:

- IPSAS 40, *Public Sector Combinations* (issued January 2017)
- *The Applicability of IPSASs* (issued April 2016)

Table of Amended Paragraphs in IPSAS 37

Paragraph Affected	How Affected	Affected By
5	Deleted	The Applicability of IPSASs April 2016
6	Deleted	The Applicability of IPSASs April 2016
24A	New	IPSAS 40 January 2017
32	Amended	IPSAS 40 January 2017
41A	New	IPSAS 40 January 2017
42A	New	The Applicability of IPSASs April 2016
42B	New	IPSAS 40 January 2017
42C	New	IPSAS 40 January 2017
AG33A	New	IPSAS 40 January 2017
AG33B	New	IPSAS 40 January 2017
AG33C	New	IPSAS 40 January 2017
AG33D	New	IPSAS 40 January 2017

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International Public Sector Accounting Standard 37, *Joint Arrangements*, is set out in paragraphs 1–44. All the paragraphs have equal authority. IPSAS 37 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to establish principles for financial reporting by entities that have an interest in arrangements that are controlled jointly (i.e., joint arrangements).
2. To meet the objective in paragraph 1, this Standard defines joint control and requires an entity that is a party to a joint arrangement to determine the type of joint arrangement in which it is involved by assessing its rights and obligations and to account for those rights and obligations in accordance with that type of joint arrangement.

Scope

3. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in determining the type of joint arrangement in which it is involved and in accounting for the rights and obligations of the joint arrangement.**
4. **This Standard shall be applied by all entities that are a party to a joint arrangement.**
5. [Deleted]
6. [Deleted]

Definitions

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

Binding arrangement: For the purposes of this Standard, a binding arrangement is an arrangement that confers enforceable rights and obligations on the parties to it as if it were in the form of a contract. It includes rights from contracts or other legal rights.

A joint arrangement is an arrangement of which two or more parties have joint control.

Joint control is the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

A joint operator is a party to a joint operation that has joint control of that joint operation.

A **joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

A **joint venturer** is a party to a joint venture that has joint control of that joint venture.

A **party to a joint arrangement** is an entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

A **separate vehicle** is a separately identifiable financial structure, including separate legal entities or entities recognized by statute, regardless of whether those entities have a legal personality.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately. The following terms are defined in IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements* or IPSAS 36, *Investments in Associates and Joint Ventures*: benefits, control, equity method, power, protective rights, relevant activities, separate financial statements and significant influence.

Binding Arrangement

8. Binding arrangements can be evidenced in several ways. A binding arrangement is often, but not always, in writing, in the form of a contract or documented discussions between the parties. Statutory mechanisms such as legislative or executive authority can also create enforceable arrangements, similar to contractual arrangements, either on their own, or in conjunction with contracts between the parties.

Joint Arrangements (see paragraphs AG2–AG33)

9. A joint arrangement is an arrangement of which two or more parties have joint control.
10. A joint arrangement has the following characteristics:
 - (a) The parties are bound by a binding arrangement (see paragraphs AG2–AG4).
 - (b) The binding arrangement gives two or more of those parties joint control of the arrangement (see paragraphs 12–18).
11. A joint arrangement is either a joint operation or a joint venture.

Joint Control

12. Joint control is the sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous

consent of the parties sharing control. The sharing of control may have been agreed by way of a binding arrangement.

13. **An entity that is a party to an arrangement shall assess whether the binding arrangement gives all the parties, or a group of the parties, control of the arrangement collectively. All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the activities that significantly affect the benefits from the arrangement (i.e., the relevant activities).**
14. Once it has been determined that all the parties, or a group of the parties, control the arrangement collectively, joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that control the arrangement collectively.
15. In a joint arrangement, no single party controls the arrangement on its own. A party with joint control of an arrangement can prevent any of the other parties, or a group of the parties, from controlling the arrangement.
16. An arrangement can be a joint arrangement even though not all of its parties have joint control of the arrangement. This Standard distinguishes between parties that have joint control of a joint arrangement (joint operators or joint venturers) and parties that participate in, but do not have joint control of, a joint arrangement.
17. **An entity will need to apply judgment when assessing whether all the parties, or a group of the parties, have joint control of an arrangement. An entity shall make this assessment by considering all facts and circumstances (see paragraphs AG5–AG11).**
18. **If facts and circumstances change, an entity shall reassess whether it still has joint control of the arrangement.**

Types of Joint Arrangement

19. **An entity shall determine the type of joint arrangement in which it is involved. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.**
20. **An entity applies judgment when assessing whether a joint arrangement is a joint operation or a joint venture. An entity shall determine the type of joint arrangement in which it is involved by considering its rights and obligations arising from the arrangement. An entity assesses its rights and obligations by considering the structure and legal form of the arrangement, the terms agreed by the parties or established by legislative or executive authority and, when relevant, other facts and circumstances (see paragraphs AG12–AG33).**

21. Sometimes the parties are bound by a framework agreement that sets up the general terms for undertaking one or more activities. The framework agreement might set out that the parties establish different joint arrangements to deal with specific activities that form part of the agreement. Even though those joint arrangements are related to the same framework agreement, their type might be different if the parties' rights and obligations differ when undertaking the different activities dealt with in the framework agreement. Consequently, joint operations and joint ventures can coexist when the parties undertake different activities that form part of the same framework agreement.
22. **If facts and circumstances change, an entity shall reassess whether the type of joint arrangement in which it is involved has changed.**

Financial Statements of Parties to a Joint Arrangement (see paragraphs AG33A–AG37)

Joint Operations

23. **A joint operator shall recognize in relation to its interest in a joint operation:**
 - (a) **Its assets, including its share of any assets held jointly;**
 - (b) **Its liabilities, including its share of any liabilities incurred jointly;**
 - (c) **Its revenue from the sale of its share of the output arising from the joint operation;**
 - (d) **Its share of the revenue from the sale of the output by the joint operation; and**
 - (e) **Its expenses, including its share of any expenses incurred jointly.**
24. **A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IPSASs applicable to the particular assets, liabilities, revenues and expenses.**
- 24A. **When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes an operation, as defined in IPSAS 40, *Public Sector Combinations*, it shall apply, to the extent of its share in accordance with paragraph 23, all of the principles on acquisition accounting in IPSAS 40, and other IPSASs, that do not conflict with the guidance in this Standard, and disclose the information that is required in those IPSASs in relation to acquisitions. This applies to the acquisition of both the initial interest and additional interests in a joint operation in which the activity of the joint operation constitutes an operation. The accounting for the acquisition of an interest in such a joint operation is specified in paragraphs AG33A–AG33D.**

25. The accounting for transactions such as the sale, contribution or purchase of assets between an entity and a joint operation in which it is a joint operator is specified in paragraphs AG34–AG37.
26. **A party that participates in, but does not have joint control of, a joint operation shall also account for its interest in the arrangement in accordance with paragraphs 23–25 if that party has rights to the assets, and obligations for the liabilities, relating to the joint operation. If a party that participates in, but does not have joint control of, a joint operation does not have rights to the assets, and obligations for the liabilities, relating to that joint operation, it shall account for its interest in the joint operation in accordance with the IPSASs applicable to that interest.**

Joint Ventures

27. **A joint venturer shall recognize its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with IPSAS 36, *Investments in Associates and Joint Ventures*, unless the entity is exempted from applying the equity method as specified in that Standard.**
28. **A party that participates in, but does not have joint control of, a joint venture shall account for its interest in the arrangement in accordance with the IPSASs dealing with financial instruments, being IPSAS 28, *Financial Instruments: Presentation*, IPSAS 29, *Financial Instruments: Recognition and Measurement*, and IPSAS 30, *Financial Instruments: Disclosures*, unless it has significant influence over the joint venture, in which case it shall account for it in accordance with IPSAS 36.**

Separate Financial Statements

29. **In its separate financial statements, a joint operator or joint venturer shall account for its interest in:**
 - (a) **A joint operation in accordance with paragraphs 23–25; and**
 - (b) **A joint venture in accordance with paragraph 12 of IPSAS 34.**
30. **In its separate financial statements, a party that participates in, but does not have joint control of, a joint arrangement shall account for its interest in:**
 - (a) **A joint operation in accordance with paragraph 26; and**
 - (b) **A joint venture in accordance with IPSAS 29, unless the entity has significant influence over the joint venture, in which case it shall apply paragraph 12 of IPSAS 34.**

Transitional Provisions

31. Notwithstanding the requirements of paragraph 33 of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, when this Standard is first applied, an entity need only present the quantitative information required by paragraph 33(f) of IPSAS 3, for the annual period immediately preceding the first annual period for which this Standard is applied (the ‘immediately preceding period’). An entity may also present this information for the current period or for earlier comparative periods, but is not required to do so.

Joint Ventures—Transition from Proportionate Consolidation to the Equity Method

32. When changing from proportionate consolidation to the equity method, an entity shall recognize its investment in the joint venture as at the beginning of the immediately preceding period. That initial investment shall be measured as the aggregate of the carrying amounts of the assets and liabilities that the entity had previously proportionately consolidated, including any purchased goodwill arising from acquisition transactions. If the goodwill previously belonged to a larger cash-generating unit, or to a group of cash-generating units, the entity shall allocate goodwill to the joint venture on the basis of the relative carrying amounts of the joint venture and the cash-generating unit or group of cash-generating units to which it belonged.
33. The opening balance of the investment determined in accordance with paragraph 32 is regarded as the deemed cost of the investment at initial recognition. An entity shall apply paragraphs 43–48 of IPSAS 36 to the opening balance of the investment to assess whether the investment is impaired and shall recognize any impairment loss as an adjustment to accumulated surplus or deficit at the beginning of the immediately preceding period.
34. If aggregating all previously proportionately consolidated assets and liabilities results in negative net assets, an entity shall assess whether it has legal or constructive obligations in relation to the negative net assets and, if so, the entity shall recognize the corresponding liability. If the entity concludes that it does not have legal or constructive obligations in relation to the negative net assets, it shall not recognize the corresponding liability but it shall adjust accumulated surplus or deficit at the beginning of the immediately preceding period. The entity shall disclose this fact, along with its cumulative unrecognized share of losses of its joint ventures as at the beginning of the immediately preceding period and at the date at which this Standard is first applied.
35. An entity shall disclose a breakdown of the assets and liabilities that have been aggregated into the single line investment balance as at the

beginning of the immediately preceding period. That disclosure shall be prepared in an aggregated manner for all joint ventures for which an entity applies the transition requirements referred to in paragraphs 32–36.

36. After initial recognition, an entity shall account for its investment in the joint venture using the equity method in accordance with IPSAS 36.

Joint Operations—Transition from the Equity Method to Accounting for Assets and Liabilities

37. When changing from the equity method to accounting for assets and liabilities in respect of its interest in a joint operation, an entity shall, at the beginning of the immediately preceding period, derecognize the investment that was previously accounted for using the equity method and any other items that formed part of the entity's net investment in the arrangement in accordance with paragraph 41 of IPSAS 36 and recognize its share of each of the assets and the liabilities in respect of its interest in the joint operation, including any goodwill that might have formed part of the carrying amount of the investment.
38. An entity shall determine its interest in the assets and liabilities relating to the joint operation on the basis of its rights and obligations in a specified proportion in accordance with the binding arrangement. An entity measures the initial carrying amounts of the assets and liabilities by disaggregating them from the carrying amount of the investment at the beginning of the immediately preceding period on the basis of the information used by the entity in applying the equity method.
39. Any difference arising from the investment previously accounted for using the equity method together with any other items that formed part of the entity's net investment in the arrangement in accordance with paragraph 41 of IPSAS 36 and the net amount of the assets and liabilities, including any goodwill, recognized shall be:
- (a) Offset against any goodwill relating to the investment with any remaining difference adjusted against accumulated surplus or deficit at the beginning of the immediately preceding period, if the net amount of the assets and liabilities, including any goodwill, recognized is higher than the investment (and any other items that formed part of the entity's net investment) derecognized.
 - (b) Adjusted against accumulated surplus or deficit at the beginning of the immediately preceding period, if the net amount of the assets and liabilities, including any goodwill, recognized is lower than the investment (and any other items that formed part of the entity's net investment) derecognized.

40. **An entity changing from the equity method to accounting for assets and liabilities shall provide a reconciliation between the investment derecognized, and the assets and liabilities recognized, together with any remaining difference adjusted against accumulated surplus or deficit, at the beginning of the immediately preceding period.**

Transitional Provisions in an Entity's Separate Financial Statements

41. **An entity that, in accordance with paragraph 58 of IPSAS 6, *Consolidated and Separate Financial Statements*, was previously accounting in its separate financial statements for its interest in a joint operation as an investment using the equity method, at cost or in accordance with IPSAS 29 shall:**
- (a) **Derecognize the investment and recognize the assets and the liabilities in respect of its interest in the joint operation at the amounts determined in accordance with paragraphs 37–39.**
 - (b) **Provide a reconciliation between the investment derecognized, and the assets and liabilities recognized, together with any remaining difference adjusted in accumulated surplus or deficit, at the beginning of the immediately preceding period.**

Accounting for acquisitions of interests in joint operations

- 41A. **IPSAS 40, *Public Sector Combinations*, issued in January 2017, added paragraphs 24A, 42B, and AG33A–AG33D. An entity shall apply those amendments prospectively for acquisitions of interests in joint operations in which the activities of the joint operations constitute operations, as defined in IPSAS 40, for those acquisitions occurring from the beginning of the first period in which it applies those amendments. Consequently, amounts recognized for acquisitions of interests in joint operations occurring in prior periods shall not be adjusted.**

Effective Date

42. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged. If an entity applies this Standard for a period beginning before January 1, 2017, it shall disclose that fact and apply IPSAS 34, IPSAS 35, IPSAS 36 and IPSAS 38, *Disclosure of Interests in Other Entities*, at the same time.**
- 42A. **Paragraphs 5 and 6 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.**

- 42B. Paragraphs 24A, 41A and AG33A–AG33D were added by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply these amendments prospectively for annual financial statements covering periods beginning on or after January 1, 2019. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2019 it shall disclose that fact and apply IPSAS 40 at the same time.
- 42C. Paragraph 32 was amended by IPSAS 40, *Public Sector Combinations*, issued in January 2017. An entity shall apply this amendment for annual financial statements covering periods beginning on or after January 1, 2019. Earlier application is encouraged. If an entity applies the amendment for a period beginning before January 1, 2019 it shall disclose that fact and apply IPSAS 40 at the same time.
43. When an entity adopts the accrual basis IPSASs as defined in IPSAS 33, *First-time Adoption of Accrual Basis International Public Sector Accounting Standards* (IPSASs), for financial reporting purposes subsequent to this effective date, this Standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption of IPSASs.

Withdrawal and Replacement of IPSAS 8 (December 2006)

44. This Standard supersedes IPSAS 8, *Interests in Joint Ventures* (December 2006). IPSAS 8 remains applicable until IPSAS 37 is applied or becomes effective, whichever is earlier.

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 37.

AG1. The examples in this appendix portray hypothetical situations. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying IPSAS 37.

Joint Arrangements

Binding Arrangement (paragraph 8)

- AG2. Consistent with the definition of binding arrangements in this Standard, this discussion of binding arrangements is also relevant to enforceable arrangements created by legislative or executive authority.
- AG3. When joint arrangements are structured through a separate vehicle (see paragraphs AG19–AG33), the binding arrangement, or some aspects of the binding arrangement, will in some cases be incorporated in the articles, charter or by-laws of the separate vehicle.
- AG4. The binding arrangement sets out the terms upon which the parties participate in the activity that is the subject of the arrangement. The binding arrangement generally deals with such matters as:
- (a) The purpose, activity and duration of the joint arrangement.
 - (b) How the members of the board of directors, or equivalent governing body, of the joint arrangement, are appointed.
 - (c) The decision-making process: the matters requiring decisions from the parties, the voting rights of the parties and the required level of support for those matters. The decision-making process reflected in the binding arrangement establishes joint control of the arrangement (see paragraphs AG5–AG11).
 - (d) The capital or other contributions required of the parties.
 - (e) How the parties share assets, liabilities, revenues, expenses or surplus or deficit relating to the joint arrangement.

Joint Control (paragraphs 12–18)

- AG5. In assessing whether an entity has joint control of an arrangement, an entity shall assess first whether all the parties, or a group of the parties, control the arrangement. IPSAS 35, *Consolidated Financial Statements*, defines control and shall be used to determine whether all the parties, or a group of the parties, are exposed, or have rights, to variable benefits from their involvement with

the arrangement and have the ability to affect those benefits through their power over the arrangement. When all the parties, or a group of the parties, considered collectively, are able to direct the activities that significantly affect the benefits from the arrangement (i.e., the relevant activities), the parties control the arrangement collectively.

- AG6. After concluding that all the parties, or a group of the parties, control the arrangement collectively, an entity shall assess whether it has joint control of the arrangement. Joint control exists only when decisions about the relevant activities require the unanimous consent of the parties that collectively control the arrangement. Assessing whether the arrangement is jointly controlled by all of its parties or by a group of the parties, or controlled by one of its parties alone, can require judgment.
- AG7. Sometimes the decision-making process that is agreed upon by the parties in their binding arrangement implicitly leads to joint control. For example, assume two parties establish an arrangement in which each has 50 per cent of the voting rights and the binding arrangement between them specifies that at least 51 per cent of the voting rights are required to make decisions about the relevant activities. In this case, the parties have implicitly agreed that they have joint control of the arrangement because decisions about the relevant activities cannot be made without both parties agreeing.
- AG8. In other circumstances, the binding arrangement requires a minimum proportion of the voting rights to make decisions about the relevant activities. When that minimum required proportion of the voting rights can be achieved by more than one combination of the parties agreeing together, that arrangement is not a joint arrangement unless the binding arrangement specifies which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement.

Application Examples**Example 1**

Assume that three parties establish an arrangement: A has 50 per cent of the voting rights in the arrangement, B has 30 per cent and C has 20 per cent. The binding arrangement between A, B and C specifies that at least 75 per cent of the voting rights are required to make decisions about the relevant activities of the arrangement. Even though A can block any decision, it does not control the arrangement because it needs the agreement of B. The terms of their binding arrangement requiring at least 75 per cent of the voting rights to make decisions about the relevant activities imply that A and B have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A and B agreeing.

Example 2

Assume an arrangement has three parties: A has 50 per cent of the voting rights in the arrangement and B and C each have 25 per cent. The binding arrangement between A, B and C specifies that at least 75 per cent of the voting rights are required to make decisions about the relevant activities of the arrangement. Even though A can block any decision, it does not control the arrangement because it needs the agreement of either B or C. In this example, A, B and C collectively control the arrangement. However, there is more than one combination of parties that can agree to reach 75 per cent of the voting rights (i.e., either A and B or A and C). In such a situation, to be a joint arrangement the binding arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to decisions about the relevant activities of the arrangement.

Example 3

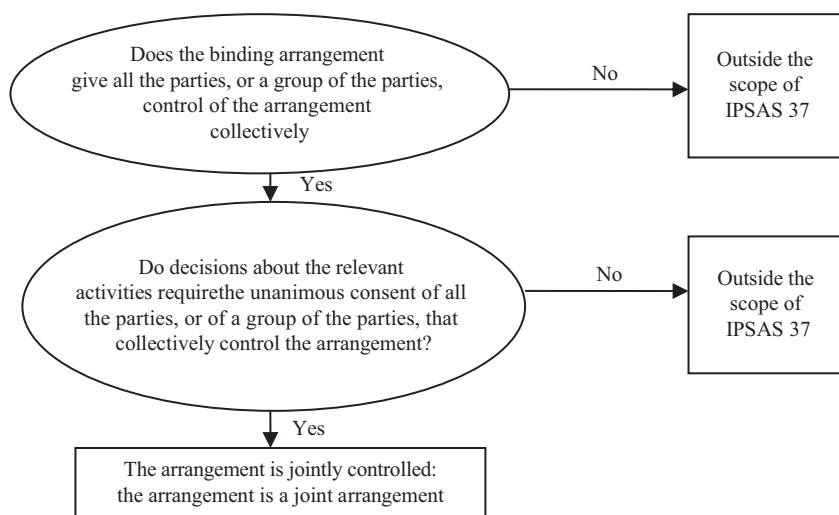
Assume an arrangement in which A and B each have 35 per cent of the voting rights in the arrangement with the remaining 30 per cent being widely dispersed. Decisions about the relevant activities require approval by a majority of the voting rights. A and B have joint control of the arrangement only if the binding arrangement specifies that decisions about the relevant activities of the arrangement require both A and B agreeing.

- AG9. The requirement for unanimous consent means that any party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions (about the relevant activities) without its consent. If the requirement for unanimous consent relates only to decisions that give a party protective rights and not to decisions about

the relevant activities of an arrangement, that party is not a party with joint control of the arrangement.

- AG10. A binding arrangement might include clauses on the resolution of disputes, such as arbitration. These provisions may allow for decisions to be made in the absence of unanimous consent among the parties that have joint control. The existence of such provisions does not prevent the arrangement from being jointly controlled and, consequently, from being a joint arrangement.

Assessing Joint Control



- AG11. When an arrangement is outside the scope of IPSAS 37, *Joint Arrangements*, an entity accounts for its interest in the arrangement in accordance with relevant IPSASs, such as IPSAS 35, IPSAS 36, *Investments in Associates and Joint Ventures* or IPSAS 29, *Financial Instruments: Recognition and Measurement*.

Types of Joint Arrangement (paragraphs 19–22)

- AG12. Joint arrangements are established for a variety of purposes (e.g., as a way for parties to share costs and risks, or as a way to provide the parties with access to new technology or new markets), and can be established using different structures and legal forms.

- AG13. Some arrangements do not require the activity that is the subject of the arrangement to be undertaken in a separate vehicle. However, other arrangements involve the establishment of a separate vehicle.
- AG14. The classification of joint arrangements required by this Standard depends upon the parties' rights and obligations arising from the arrangement in the normal course of operations. This Standard classifies joint arrangements as either joint operations or joint ventures. When an entity has rights to the assets, and obligations for the liabilities, relating to the arrangement, the arrangement is a joint operation. When an entity has rights to the net assets of the arrangement, the arrangement is a joint venture. Paragraphs AG16–AG33 set out the assessment an entity carries out to determine whether it has an interest in a joint operation or an interest in a joint venture.

Classification of a Joint Arrangement

- AG15. As stated in paragraph AG14, the classification of joint arrangements requires the parties to assess their rights and obligations arising from the arrangement. When making that assessment, an entity shall consider the following:
- (a) The structure of the joint arrangement (see paragraphs AG16–AG21).
 - (b) When the joint arrangement is structured through a separate vehicle:
 - (i) The legal form of the separate vehicle (see paragraphs AG22–AG24);
 - (ii) The terms of the binding arrangement (see paragraphs AG25–AG28); and
 - (iii) When relevant, other facts and circumstances (see paragraphs AG29–AG33).

Structure of the Joint Arrangement

Joint Arrangements not Structured Through a Separate Vehicle

- AG16. A joint arrangement that is not structured through a separate vehicle is a joint operation. In such cases, the binding arrangement establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement, and the parties' rights to the corresponding revenues and obligations for the corresponding expenses.
- AG17. The binding arrangement often describes the nature of the activities that are the subject of the arrangement and how the parties intend to undertake those activities together. For example, the parties to a joint arrangement could agree to deliver services or manufacture a product together, with each party being responsible for specific areas and each using its own assets and incurring its own liabilities. The binding arrangement could also specify how the revenues and expenses that are common to the parties are to be shared among them.

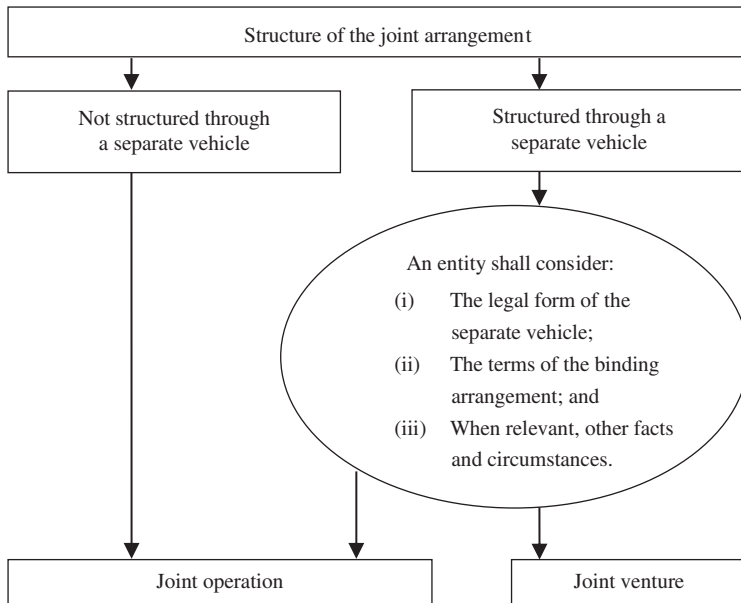
In such a case, each joint operator recognizes in its financial statements the assets and liabilities used for the specific task, and recognizes its share of the revenues and expenses in accordance with the binding arrangement.

- AG18. In other cases, the parties to a joint arrangement might agree, for example, to share and operate an asset together. In such a case, the binding arrangement establishes the parties' rights to the asset that is operated jointly, and how output or revenue from the asset and operating costs are shared among the parties. Each joint operator accounts for its share of the joint asset and its agreed share of any liabilities, and recognizes its share of the output, revenues and expenses in accordance with the binding arrangement.

Joint Arrangements Structured through a Separate Vehicle

- AG19. A joint arrangement in which the assets and liabilities relating to the arrangement are held in a separate vehicle can be either a joint venture or a joint operation.
- AG20. Whether a party is a joint operator or a joint venturer depends on the party's rights to the assets, and obligations for the liabilities, relating to the arrangement, that are held in the separate vehicle.
- AG21. As stated in paragraph AG15, when the parties have structured a joint arrangement in a separate vehicle, the parties need to assess whether the legal form of the separate vehicle, the terms of the binding arrangement and, when relevant, any other facts and circumstances give them:
- (a) Rights to the assets, and obligations for the liabilities, relating to the arrangement (i.e., the arrangement is a joint operation); or
 - (b) Rights to the net assets of the arrangement (i.e., the arrangement is a joint venture).

Classification of a Joint Arrangement: Assessment of the Parties' Rights and Obligations Arising from the Arrangement



The Legal Form of the Separate Vehicle

AG22. The legal form of the separate vehicle is relevant when assessing the type of joint arrangement. The legal form assists in the initial assessment of the parties' rights to the assets and obligations for the liabilities held in the separate vehicle, such as whether the parties have interests in the assets held in the separate vehicle and whether they are liable for the liabilities held in the separate vehicle.

AG23. For example, the parties might conduct the joint arrangement through a separate vehicle, whose legal form causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). In such a case, the assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle indicates that the arrangement is a joint venture. However, the terms agreed by the parties in their binding arrangement (see paragraphs AG25–AG28) and, when relevant, other facts and circumstances (see paragraphs AG29–AG33) can override the assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle.

AG24. The assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle is sufficient to conclude that the arrangement is a joint operation only if the parties conduct the joint arrangement in a separate vehicle whose legal form does not confer separation between the parties and the separate vehicle (i.e., the assets and liabilities held in the separate vehicle are the parties' assets and liabilities).

Assessing the Terms of the Binding Arrangement

- AG25. In many cases, the rights and obligations agreed to by the parties in their binding arrangements are consistent, or do not conflict, with the rights and obligations conferred on the parties by the legal form of the separate vehicle in which the arrangement has been structured.
- AG26. In other cases, the parties use the binding arrangement to reverse or modify the rights and obligations conferred by the legal form of the separate vehicle in which the arrangement has been structured.

Application Example
<p>Example 4</p> <p>Assume that two parties structure a joint arrangement in an incorporated entity. Each party has a 50 per cent ownership interest in the incorporated entity. The incorporation enables the separation of the entity from its owners and as a consequence the assets and liabilities held in the entity are the assets and liabilities of the incorporated entity. In such a case, the assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle indicates that the parties have rights to the net assets of the arrangement.</p> <p>However, the parties modify the features of the corporation through their binding arrangement so that each has an interest in the assets of the incorporated entity and each is liable for the liabilities of the incorporated entity in a specified proportion. Such binding modifications to the features of a corporation can cause an arrangement to be a joint operation.</p>

AG27. The following table compares common terms in binding arrangements of parties to a joint operation and common terms in binding arrangements of parties to a joint venture. The examples of the binding terms provided in the following table are not exhaustive.

Assessing the Terms of the Binding Arrangement		
	Joint Operation	Joint Venture
The terms of the binding arrangement	The binding arrangement provides the parties to the joint arrangement with rights to the assets, and obligations for the liabilities, relating to the arrangement.	The binding arrangement provides the parties to the joint arrangement with rights to the net assets of the arrangement (i.e., it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities, relating to the arrangement).
Rights to assets	The binding arrangement establishes that the parties to the joint arrangement share all interests (e.g., rights, title or ownership) in the assets relating to the arrangement in a specified proportion (e.g., in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The binding arrangement establishes that the assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (i.e., no rights, title or ownership) in the assets of the arrangement.
Obligations for liabilities	The binding arrangement establishes that the parties to the joint arrangement share all liabilities, obligations, costs and expenses in a specified proportion (e.g., in proportion to the parties' ownership interest in the	The binding arrangement establishes that the joint arrangement is liable for the debts and obligations of the arrangement.
		The binding arrangement establishes that the parties to the joint arrangement are liable to the arrangement

Assessing the Terms of the Binding Arrangement		
	Joint Operation	Joint Venture
	arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	only to the extent of their respective investments in the arrangement or to their respective obligations to contribute any unpaid or additional capital to the arrangement, or both.
	The binding arrangement establishes that the parties to the joint arrangement are liable for claims raised by third parties.	The binding arrangement states that creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.

Assessing the Terms of the Binding Arrangement		
	Joint Operation	Joint Venture
Revenues, expenses, surplus or deficit	<p>The binding arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the binding arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly, which could differ from their ownership interest in the joint arrangement. In other instances, the parties might have agreed to share the surplus or deficit relating to the arrangement on the basis of a specified proportion such as the parties' ownership interest in the arrangement. This would not prevent the arrangement from being a joint operation if the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.</p>	<p>The binding arrangement establishes each party's share in the surplus or deficit relating to the activities of the arrangement.</p>

Assessing the Terms of the Binding Arrangement		
	Joint Operation	Joint Venture
Guarantees	The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of such guarantees, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation. The feature that determines whether the joint arrangement is a joint operation or a joint venture is whether the parties have obligations for the liabilities relating to the arrangement (for some of which the parties might or might not have provided a guarantee).	

AG28. When the binding arrangement specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, they are parties to a joint operation and do not need to consider other facts and circumstances (paragraphs AG29–AG33) for the purposes of classifying the joint arrangement.

Assessing Other Facts and Circumstances

AG29. When the terms of the binding arrangement do not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement, the parties shall consider other facts and circumstances to assess whether the arrangement is a joint operation or a joint venture.

AG30. A joint arrangement might be structured in a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The binding terms agreed among the parties might not specify the parties' rights to the assets and obligations for the liabilities, yet consideration of other facts and circumstances can lead to such an arrangement being classified as a joint operation. This will be the case when other facts and circumstances give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement.

AG31. When the activities of an arrangement are primarily designed for the provision of output to the parties, this indicates that the parties have rights to substantially all the service potential or economic benefits of the assets of the arrangement. The parties to such arrangements often ensure their access to the outputs provided by the arrangement by preventing the arrangement from selling output to third parties.

- AG32. The effect of an arrangement with such a design and purpose is that the liabilities incurred by the arrangement are, in substance, satisfied by the cash flows received from the parties through their purchases of the output. When the parties are substantially the only source of cash flows contributing to the continuity of the operations of the arrangement, this indicates that the parties have an obligation for the liabilities relating to the arrangement.

Application Example

Example 5

Assume that two parties structure a joint arrangement in an incorporated entity (entity C) in which each party has a 50 per cent ownership interest. The purpose of the arrangement is to manufacture materials required by the parties for their own, individual manufacturing processes. The arrangement ensures that the parties operate the facility that produces the materials to the quantity and quality specifications of the parties.

The legal form of entity C (an incorporated entity) through which the activities are conducted initially indicates that the assets and liabilities held in entity C are the assets and liabilities of entity C. The binding arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of entity C. Accordingly, the legal form of entity C and the terms of the binding arrangement indicate that the arrangement is a joint venture.

However, the parties also consider the following aspects of the arrangement:

- The parties agreed to purchase all the output produced by entity C in a ratio of 50:50. Entity C cannot sell any of the output to third parties, unless this is approved by the two parties to the arrangement. Because the purpose of the arrangement is to provide the parties with output they require, such sales to third parties are expected to be uncommon and not material.
- The price of the output sold to the parties is set by both parties at a level that is designed to cover the costs of production and administrative expenses incurred by entity C. On the basis of this operating model, the arrangement is intended to operate at a break-even level.

From the fact pattern above, the following facts and circumstances are relevant:

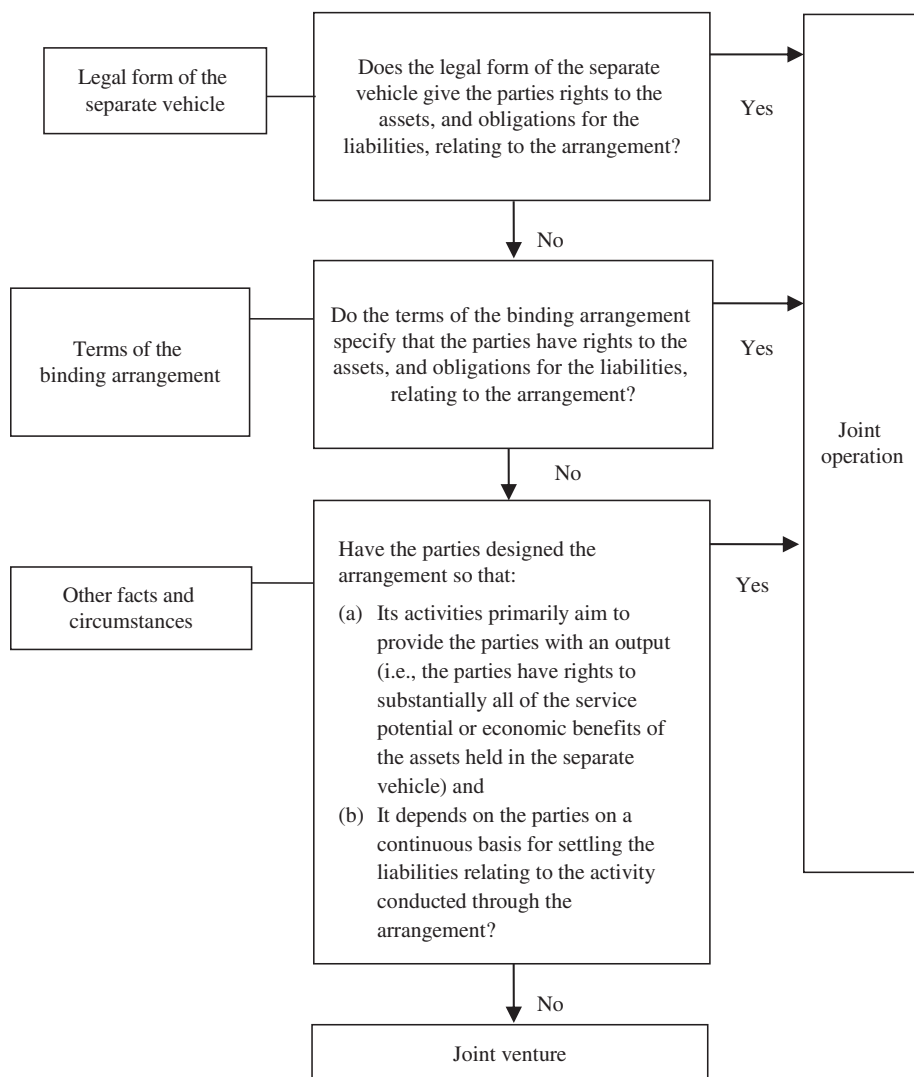
- The obligation of the parties to purchase all the output produced by entity C reflects the exclusive dependence of entity C upon the parties for the generation of cash flows and, thus, the parties have an obligation to fund the settlement of the liabilities of entity C.
- The fact that the parties have rights to all the output produced by entity C means that the parties are consuming, and therefore have rights to, all the service potential or economic benefits of the assets of entity C.

These facts and circumstances indicate that the arrangement is a joint operation. The conclusion about the classification of the joint arrangement in these circumstances would not change if, instead of the parties using their share of the output themselves in a subsequent manufacturing process, the parties sold their share of the output to third parties.

If the parties changed the terms of the binding arrangement so that the arrangement was able to sell output to third parties, this would result in entity C assuming demand, inventory and credit risks. In that scenario, such a change in the facts and circumstances would require reassessment of the classification of the joint arrangement. Such facts and circumstances would indicate that the arrangement is a joint venture.

AG33. The following flow chart reflects the assessment an entity follows to classify an arrangement when the joint arrangement is structured through a separate vehicle:

Classification of a Joint Arrangement Structured Through a Separate Vehicle



Financial Statements of Parties to a Joint Arrangement (paragraphs 23–28)

Accounting for acquisitions of interests in joint operations

AG33A. When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes an operation, as defined in IPSAS 40, it shall apply, to the extent of its share in accordance with paragraph 23, all of the principles on acquisition accounting in IPSAS 40, and other IPSASs, that do not conflict with the guidance in this Standard and disclose the information required by those IPSASs in relation to acquisitions. The principles on acquisition accounting that do not conflict with the guidance in this Standard include but are not limited to:

- (a) Measuring identifiable assets and liabilities at fair value, other than items for which exceptions are given in IPSAS 40 and other IPSASs;
- (b) Recognizing acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with the exception that the costs to issue debt or equity securities are recognized in accordance with IPSAS 28 and IPSAS 29;
- (c) Recognizing the excess of the consideration transferred over the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, if any, as goodwill; and
- (d) Testing for impairment a cash-generating unit to which goodwill has been allocated at least annually, and whenever there is an indication that the unit may be impaired, as required by IPSAS 26, *Impairment of Cash-Generating Assets*, for goodwill acquired in an acquisition.

AG33B. Paragraphs 24A and AG33A also apply to the formation of a joint operation if, and only if, an existing operation, as defined in IPSAS 40, is contributed to the joint operation on its formation by one of the parties that participate in the joint operation. However, those paragraphs do not apply to the formation of a joint operation if all of the parties that participate in the joint operation only contribute assets or groups of assets that do not constitute operations to the joint operation on its formation.

AG33C. A joint operator might increase its interest in a joint operation in which the activity of the joint operation constitutes an operation, as defined in IPSAS 40, by acquiring an additional interest in the joint operation. In such cases, previously held interests in the joint operation are not remeasured if the joint operator retains joint control.

AG33D. Paragraphs 24A and AG33A–AG33C do not apply on the acquisition of an interest in a joint operation when the parties sharing joint control, including the entity acquiring the interest in the joint operation, are under the common

control of the same ultimate controlling party or parties both before and after the acquisition, and that control is not transitory.

Accounting for Sales or Contributions of Assets to a Joint Operation

- AG34. When an entity enters into a transaction with a joint operation in which it is a joint operator, such as a sale or contribution of assets, it is conducting the transaction with the other parties to the joint operation and, as such, the joint operator shall recognize gains and losses resulting from such a transaction only to the extent of the other parties' interests in the joint operation.
- AG35. When such transactions provide evidence of a reduction in the net realizable value of the assets to be sold or contributed to the joint operation, or of an impairment loss of those assets, those losses shall be recognized fully by the joint operator.

Accounting for Purchases of Assets from a Joint Operation

- AG36. When an entity enters into a transaction with a joint operation in which it is a joint operator, such as a purchase of assets, it shall not recognize its share of the gains and losses until it resells those assets to a third party.
- AG37. When such transactions provide evidence of a reduction in the net realizable value of the assets to be purchased or of an impairment loss of those assets, a joint operator shall recognize its share of those losses.

Appendix B

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 37.

Objective

- BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in IPSAS 37. As this Standard is based on IFRS 11, *Joint Arrangements* (issued in 2011, including amendments up to December 31, 2014), issued by the IASB, the Basis for Conclusions outlines only those areas where IPSAS 37 departs from the main requirements of IFRS 11.

Overview

- BC2. In 2012 the IPSASB commenced work on a project to update those IPSASs that dealt with accounting for interests in controlled entities, associates and joint ventures. In October 2013 the IPSASB issued Exposure Drafts (EDs) 48 to 52 which were collectively referred to as *Interests in Other Entities*. ED 51, *Joint Arrangements*, was based on IFRS 11, *Joint Arrangements*, having regard to the relevant public sector modifications in IPSAS 8, *Interests in Joint Ventures*. In January 2015 the IPSASB issued five new IPSASs, including IPSAS 37. These new IPSASs supersede IPSAS 6, *Consolidated and Separate Financial Statements*, IPSAS 7, *Investments in Associates* and IPSAS 8.

Classification of Joint Arrangements

- BC3. IPSAS 37 classifies joint arrangements as joint ventures or joint operations based on whether an entity has (i) rights to assets and obligations for liabilities, or (ii) rights to net assets. This differs from IPSAS 8 which referred to three types of arrangements, being jointly controlled entities, jointly controlled operations and jointly controlled assets. The IPSASB agreed that the classification of joint arrangements in IPSAS 37 should be consistent with IFRS 11.

Elimination of Accounting Option

- BC4. IPSAS 37 requires that a joint venturer account for its interest in a joint venture using the equity method. Previously IPSAS 8 permitted jointly controlled entities to be accounted for using either the equity method or proportionate consolidation. The IPSASB acknowledged the IASB's rationale for removing proportionate consolidation as a method for accounting for interests in joint ventures and agreed that the accounting treatments permitted by IPSAS 37 should be consistent with IFRS 11.
- BC5. The IASB's reasons for removing proportionate consolidation as a method for accounting for interests in joint ventures included the following:

- (a) The equity method is the most appropriate method to account for joint ventures because it is a method that accounts for an entity's interest in the net assets of an investee.
- (b) The approach in IFRS 11 is consistent with the IASB's view of what constitutes the economic substance of an entity's interests in joint arrangements.
- (c) IFRS 11 will require consistent accounting for arrangements with similar rights.
- (d) The IASB did not consider that the elimination of proportionate consolidation would cause a loss of information for users of financial statements (having regard to the disclosure requirements in IFRS 12, *Disclosure of Interests in Other Entities*).

BC6. The IPSASB took the view there were no public sector differences that warranted a different approach to that taken by the IASB.

Acquisition of an Interest in a Joint Operation

BC7. At the time that IPSAS 37 was being developed, the IASB sought feedback on proposals to amend IFRS 11 by adding new guidance on how to account for the acquisition of an interest in a joint operation that constitutes a business, as defined in IFRS 3, *Business Combinations*. The IASB issued *Accounting for Acquisitions of Interests in Joint Operations (Amendments to IFRS 11)* in May 2014. The IPSASB agreed not to incorporate such guidance in IPSAS 37 on the grounds that it would be more appropriate to consider such guidance in the context of drafting standards-level requirements for public sector combinations.

BC8. At the time the IPSASB developed IPSAS 40, *Public Sector Combinations*, it reconsidered whether to include guidance on how to account for the acquisition of an interest in a joint operation that constitutes an operation. The IPSASB reviewed the guidance issued by the IASB in *Accounting for Acquisitions of Interests in Joint Operations (Amendments to IFRS 11)* and did not identify a public sector reason to depart from that guidance. Consequently, the IPSASB agreed to include this guidance (amended to fit the terminology and definitions in IPSAS 40) in IPSAS 37.

Revision of IPSAS 37 as a result of the IPSASB's *The Applicability of IPSASs*, issued in April 2016

BC9. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:

- (a) Removes the standard paragraphs about the applicability of IPSASs to "public sector entities other than GBEs" from the scope section of each Standard;

- (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and
- (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

ILLUSTRATIVE EXAMPLES
CONTENTS

	Paragraph
Construction Services	IE2–IE8
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Illustrative Examples

These examples accompany, but are not part of, IPSAS 37.

- IE1. These examples portray hypothetical situations illustrating the judgments that might be used when applying IPSAS 37 in different situations. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying IPSAS 37.

Example 1 – Construction Services

- IE2. A and B (the parties) are two entities whose activities include the provision of many types of public and private construction services. Entity A is a private sector entity. Entity B is government owned. They set up a binding arrangement to work together for the purpose of fulfilling a contract with a government for the design and construction of a road between two cities. The binding arrangement determines the participation shares of A and B and establishes joint control of the arrangement, the subject matter of which is the delivery of the road. The joint arrangement will have no further involvement once the road has been completed. The road will be transferred to the government at that point.
- IE3. The parties set up a separate vehicle (entity Z) through which to conduct the arrangement. Entity Z, on behalf of A and B, enters into the contract with the government. In addition, the assets and liabilities relating to the arrangement are held in entity Z. The main feature of entity Z's legal form is that the parties, not entity Z, have rights to the assets, and obligations for the liabilities, of the entity.
- IE4. The binding arrangement between A and B additionally establishes that:
- (a) The rights to all the assets needed to undertake the activities of the arrangement are shared by the parties on the basis of their participation shares in the arrangement;
 - (b) The parties have several and joint responsibility for all operating and financial obligations relating to the activities of the arrangement on the basis of their participation shares in the arrangement; and
 - (c) The surplus or deficit resulting from the activities of the arrangement is shared by A and B on the basis of their participation shares in the arrangement.
- IE5. For the purposes of co-ordinating and overseeing the activities, A and B appoint a project manager, who will be an employee of one of the parties. After a specified time, the role of the project manager will rotate to an employee of the other party. A and B agree that the activities will be executed by the employees on a “no gain or loss” basis.

- IE6. In accordance with the terms specified in the contract with the government, entity Z invoices the construction services to the government on behalf of the parties.

Analysis

- IE7. The joint arrangement is carried out through a separate vehicle whose legal form does not confer separation between the parties and the separate vehicle (i.e., the assets and liabilities held in entity Z are the parties' assets and liabilities). This is reinforced by the terms agreed by the parties in their binding arrangement, which state that A and B have rights to the assets, and obligations for the liabilities, relating to the arrangement that is conducted through entity Z. The joint arrangement is a joint operation. It is not a service concession arrangement.
- IE8. A and B each recognize in their financial statements their share of the assets (e.g., property, plant, and equipment, accounts receivable) and their share of any liabilities resulting from the arrangement (e.g., accounts payable to third parties) on the basis of their agreed participation share. Each also recognizes its share of the revenue and expenses resulting from the construction services provided to the government through entity Z.

Example 2 – Service Centre Operated Jointly

- IE9. Two entities (the parties) set up a separate vehicle (entity X) for the purpose of establishing and operating a joint service center. The binding arrangement between the parties establishes joint control of the activities that are conducted in entity X. The main feature of entity X's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the allocation of office space to services, managing the car park, maintaining the center and its equipment, such as lifts, building the reputation of the center and managing the client base for the center.
- IE10. The terms of the binding arrangement are such that:
- (a) Entity X owns the service center. The binding arrangement does not specify that the parties have rights to the service center.
 - (b) The parties are not liable in respect of the debts, liabilities or obligations of entity X. If entity X is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.
 - (c) The parties have the right to sell or pledge their interests in entity X.
 - (d) Each party pays for its share of expenses for operating the service in accordance with its interest in entity X.

Analysis

- IE11. The joint arrangement is carried out through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). In addition, the terms of the binding arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, relating to the arrangement. Instead, the terms of the binding arrangement establish that the parties have rights to the net assets of entity X.
- IE12. On the basis of the description above, there are no other facts and circumstances that indicate that the parties have rights to substantially all the service potential or economic benefits of the assets relating to the arrangement, and that the parties have an obligation for the liabilities relating to the arrangement. The joint arrangement is a joint venture.
- IE13. The parties recognize their rights to the net assets of entity X as investments and account for them using the equity method.

Example 3 – Joint Provision of Assisted Living Services

- IE14. A public sector health care provider (entity X) and a large property developer (entity Y) enter into an agreement to work together to provide assisted living services for the elderly. Entity X and entity Y establish a separate company (entity Z). The legal form of the company confers the rights to the assets and obligations for liabilities to the company itself. The agreement between entity X and entity Y requires all decisions be made jointly. The agreement also confirms:
- (a) Entity X will provide the assisted living services. Entity Y will construct the premises.
 - (b) The assets of the arrangement are owned by entity Z, the company. Neither party will be able to sell, pledge, transfer or otherwise mortgage the assets of entity Z.
 - (c) The liability of the parties is limited to any unpaid capital of entity Z.
 - (d) Each party pays for its share of expenses for operating the service in accordance with its interest in entity Z.
 - (e) Profits of entity Z will be distributed to entity X and entity Y 40:60, being the parties' respective interests in the arrangement.

Analysis

- IE15. The joint arrangement is carried out through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities

of the separate vehicle and not the assets and liabilities of the parties). In addition, the terms of the binding arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, relating to the arrangement. Instead, the terms of the binding arrangement establish that the parties have rights to the net assets of entity Z.

- IE16. On the basis of the description above, there are no other facts and circumstances that indicate that the parties have rights to substantially all the service potential or economic benefits of the assets relating to the arrangement, or that the parties have an obligation for the liabilities relating to the arrangement. The joint arrangement is a joint venture.
- IE17. The parties recognize their rights to the net assets of entity Z as investments and account for them using the equity method.

Variation

- IE18. A public sector health care provider (entity X) and a large property developer (entity Y) enter into an agreement to work together to provide assisted living services for the elderly. The agreement between entity X and entity Y requires all decisions to be made jointly. The agreement confirms:
- (a) Entity X will supply operational assets including office equipment, motor vehicles and furniture and fittings for the assisted living premises.
 - (b) Entity Y will construct the premises and will continue to own the premises. Entity Y will be responsible for the ongoing maintenance of the premises. Entity Y cannot sell the premises without first offering entity X the right to purchase the premises. Entity Y is entitled to 100% of any gain on eventual sale of the premises.
 - (c) The services will be delivered through a new entity, entity Z, established for this purpose.
 - (d) Each party will pay for 50% of the expenses for operating the services.
 - (e) Any profits from providing the assisted living services will be shared equally between entity X and entity Y.
 - (f) Entity X will be responsible for managing staff and for any liabilities arising from personal grievance claims and health and safety issues.
 - (g) Entity Y will be responsible for any liabilities to make good any defects in the premises or alterations to the premises required to meet health and safety codes and changes in those codes.

Analysis of Variation

- IE19. Although the services are delivered through a separate vehicle, entity X and entity Y continue to own the assets used to provide the services. The joint arrangement is a joint operation.
- IE20. Entity X and entity Y each recognize in their financial statements their own assets and liabilities. They also recognize their share of the revenue and expenses resulting from the provision of assisted living services through entity Z.

Example 4 – Joint Manufacturing and Distribution of a Product

- IE21. Entities A and B (the parties) have set up a strategic and operating agreement (the framework agreement) in which they have agreed the terms according to which they will conduct the manufacturing and distribution of a product (product P) in different markets.
- IE22. The parties have agreed to conduct manufacturing and distribution activities by establishing joint arrangements, as described below:
- (a) Manufacturing activity: the parties have agreed to undertake the manufacturing activity through a joint arrangement (the manufacturing arrangement). The manufacturing arrangement is structured in a separate vehicle (entity M) whose legal form causes it to be considered in its own right (i.e., the assets and liabilities held in entity M are the assets and liabilities of entity M and not the assets and liabilities of the parties). In accordance with the framework agreement, the parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement in accordance with their ownership interests in entity M. The parties subsequently sell product P to another arrangement, jointly controlled by the two parties themselves, that has been established exclusively for the distribution of product P as described below. Neither the framework agreement nor the binding arrangement between A and B dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity.
 - (b) Distribution activity: the parties have agreed to undertake the distribution activity through a joint arrangement (the distribution arrangement). The parties have structured the distribution arrangement in a separate vehicle (entity D) whose legal form causes it to be considered in its own right (i.e., the assets and liabilities held in entity D are the assets and liabilities of entity D and not the assets and liabilities of the parties). In accordance with the framework agreement, the distribution arrangement orders its requirements for product P from the parties according to the needs of the different markets where the

distribution arrangement sells the product. Neither the framework agreement nor the binding arrangement between A and B dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.

IE23. In addition, the framework agreement establishes:

- (a) That the manufacturing arrangement will produce product P to meet the requirements for product P that the distribution arrangement places on the parties;
- (b) The commercial terms relating to the sale of product P by the manufacturing arrangement to the parties. The manufacturing arrangement will sell product P to the parties at a price agreed by A and B that covers all production costs incurred. Subsequently, the parties sell the product to the distribution arrangement at a price agreed by A and B.
- (c) That any cash shortages that the manufacturing arrangement may incur will be financed by the parties in accordance with their ownership interests in entity M.

Analysis

IE24. The framework agreement sets up the terms under which parties A and B conduct the manufacturing and distribution of product P. These activities are undertaken through joint arrangements whose purpose is either the manufacturing or the distribution of product P.

IE25. The parties carry out the manufacturing arrangement through entity M whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the binding arrangement dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, when considering the following facts and circumstances the parties have concluded that the manufacturing arrangement is a joint operation:

- (a) The parties have committed themselves to purchasing the whole production of product P manufactured by the manufacturing arrangement. Consequently, A and B have rights to substantially all the service potential or economic benefits of the assets of the manufacturing arrangement.
- (b) The manufacturing arrangement manufactures product P to meet the quantity and quality needs of the parties so that they can fulfill the demand for product P of the distribution arrangement. The exclusive dependence of the manufacturing arrangement upon the parties for

the generation of cash flows and the parties' commitments to provide funds when the manufacturing arrangement incurs any cash shortages indicate that the parties have an obligation for the liabilities of the manufacturing arrangement, because those liabilities will be settled through the parties' purchases of product P or by the parties' direct provision of funds.

- IE26. The parties carry out the distribution activities through entity D, whose legal form confers separation between the parties and the entity. In addition, neither the framework agreement nor the binding arrangement dealing with the distribution activity specifies that the parties have rights to the assets, and obligations for the liabilities, relating to the distribution activity.
- IE27. There are no other facts and circumstances that indicate that the parties have rights to substantially all the service potential or economic benefits of the assets relating to the distribution arrangement or that the parties have an obligation for the liabilities relating to that arrangement. The distribution arrangement is a joint venture.
- IE28. A and B each recognize in their financial statements their share of the assets (e.g., property, plant and equipment, cash) and their share of any liabilities resulting from the manufacturing arrangement (e.g., accounts payable to third parties) on the basis of their ownership interest in entity M. Each party also recognizes its share of the expenses resulting from the manufacture of product P incurred by the manufacturing arrangement and its share of the revenues relating to the sales of product P to the distribution arrangement.
- IE29. The parties recognize their rights to the net assets of the distribution arrangement as investments and account for them using the equity method.

Variation

- IE30. Assume that the parties agree that the manufacturing arrangement described above is responsible not only for manufacturing product P, but also for its distribution to third-party customers.
- IE31. The parties also agree to set up a distribution arrangement like the one described above to distribute product P exclusively to assist in widening the distribution of product P in additional specific markets.
- IE32. The manufacturing arrangement also sells product P directly to the distribution arrangement. No fixed proportion of the production of the manufacturing arrangement is committed to be purchased by, or to be reserved to, the distribution arrangement.

Analysis of Variation

- IE33. The variation has affected neither the legal form of the separate vehicle in which the manufacturing activity is conducted nor the binding terms relating to the parties' rights to the assets, and obligations for the liabilities, relating to the manufacturing activity. However, it causes the manufacturing arrangement to be a self-financed arrangement because it is able to undertake trade on its own behalf, distributing product P to third-party customers and, consequently, assuming demand, inventory and credit risks. Even though the manufacturing arrangement might also sell product P to the distribution arrangement, in this scenario the manufacturing arrangement is not dependent on the parties to be able to carry out its activities on a continuous basis. In this case, the manufacturing arrangement is a joint venture.
- IE34. The variation has no effect on the classification of the distribution arrangement as a joint venture.
- IE35. The parties recognize their rights to the net assets of the manufacturing arrangement and their rights to the net assets of the distribution arrangement as investments and account for them using the equity method.

Example 5 – Bank Operated Jointly

- IE36. Bank A, a government owned bank, and bank B, a privately owned bank, (the parties) agreed to combine certain corporate, investment banking, asset management and service activities by establishing a separate vehicle (bank C). Both parties expect the arrangement to benefit them in different ways. Bank A believes that the arrangement could enable it to achieve its strategic plans to improve its profitability through an enlarged offering of products and services. Bank B expects the arrangement to reinforce its offering in financial savings and market products.
- IE37. The main feature of bank C's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). Banks A and B each have a 40 per cent ownership interest in bank C, with the remaining 20 per cent being listed and widely held. The agreement between bank A and bank B establishes joint control of the activities of bank C.
- IE38. In addition, bank A and bank B entered into an irrevocable agreement under which, even in the event of a dispute, both banks agree to provide the necessary funds in equal amount and, if required, jointly and severally, to ensure that bank C complies with the applicable legislation and banking regulations, and honors any commitments made to the banking authorities. This commitment represents the assumption by each party of 50 per cent of any funds needed to ensure that bank C complies with legislation and banking regulations.

Analysis

- IE39. The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the binding arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of bank C, but it establishes that the parties have rights to the net assets of bank C. The commitment by the parties to provide support if bank C is not able to comply with the applicable legislation and banking regulations is not by itself a determinant that the parties have an obligation for the liabilities of bank C. There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of bank C and that the parties have an obligation for the liabilities of bank C. The joint arrangement is a joint venture.
- IE40. Both banks A and B recognize their rights to the net assets of bank C as investments and account for them using the equity method.

Example 6 – Oil and Gas Exploration, Development and Production Activities

- IE41. Entities A and B (the parties) set up a separate vehicle (entity H) and a Joint Operating Agreement (JOA) to undertake oil and gas exploration, development and production activities in country O. The main feature of entity H's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).
- IE42. Country O has granted entity H permits for the oil and gas exploration, development and production activities to be undertaken in a specific assigned block of land (fields).
- IE43. The agreement and JOA agreed by the parties establish their rights and obligations relating to those activities. The main terms of those agreements are summarized below.

Agreement

- IE44. The board of entity H consists of a director from each party. Each party has a 50 per cent holding in entity H. The unanimous consent of the directors is required for any resolution to be passed.

Joint Operating Agreement (JOA)

- IE45. The JOA establishes an Operating Committee. This Committee consists of one representative from each party. Each party has a 50 per cent participating interest in the Operating Committee.
- IE46. The Operating Committee approves the budgets and work programs relating to the activities, which also require the unanimous consent of the representatives of each party. One of the parties is appointed as operator and is responsible for managing and conducting the approved work programs.
- IE47. The JOA specifies that the rights and obligations arising from the exploration, development and production activities shall be shared among the parties in proportion to each party's holding in entity H. In particular, the JOA establishes that the parties share:
- (a) The rights and the obligations arising from the exploration and development permits granted to entity H (e.g., the permits, rehabilitation liabilities, any royalties and taxes payable);
 - (b) The production obtained; and
 - (c) All costs associated with all work programs.
- IE48. The costs incurred in relation to all the work programs are covered by cash calls on the parties. If either party fails to satisfy its monetary obligations, the other is required to contribute to entity H the amount in default. The amount in default is regarded as a debt owed by the defaulting party to the other party.

Analysis

- IE49. The parties carry out the joint arrangement through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The parties have been able to reverse the initial assessment of their rights and obligations arising from the legal form of the separate vehicle in which the arrangement is conducted. They have done this by agreeing terms in the JOA that entitle them to rights to the assets (e.g., exploration and development permits, production, and any other assets arising from the activities) and obligations for the liabilities (e.g., all costs and obligations arising from the work programs) that are held in entity H. The joint arrangement is a joint operation.
- IE50. Both entity A and entity B recognize in their financial statements their own share of the assets and of any liabilities resulting from the arrangement on the basis of their agreed participating interest. On that basis, each party also recognizes its share of the revenue (from the sale of their share of the production) and its share of the expenses.

Example 7 – Liquefied Natural Gas Arrangement

- IE51. Entity A owns an undeveloped gas field that contains substantial gas resources. Entity A determines that the gas field will be economically viable only if the gas is sold to customers in overseas markets. To do so, a liquefied natural gas (LNG) facility must be built to liquefy the gas so that it can be transported by ship to the overseas markets.
- IE52. Entity A enters into a joint arrangement with entity B in order to develop and operate the gas field and the LNG facility. Under that arrangement, entities A and B (the parties) agree to contribute the gas field and cash, respectively, to a new separate vehicle, entity C. In exchange for those contributions, the parties each take a 50 per cent ownership interest in entity C. The main feature of entity C's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties).
- IE53. The binding arrangement between the parties specifies that:
- (a) Entities A and B must each appoint two members to the board of entity C. The board of directors must unanimously agree the strategy and investments made by entity C.
 - (b) Day-to-day management of the gas field and LNG facility, including development and construction activities, will be undertaken by the staff of entity B in accordance with the directions jointly agreed by the parties. Entity C will reimburse B for the costs it incurs in managing the gas field and LNG facility.
 - (c) Entity C is liable for taxes and royalties on the production and sale of LNG as well as for other liabilities incurred in the ordinary course of business, such as accounts payable, site restoration and decommissioning liabilities.
 - (d) Entities A and B have equal shares in the surplus from the activities carried out in the arrangement and, as such, are entitled to equal shares of any dividends or similar distributions made by entity C.
- IE54. The binding arrangement does not specify that either party has rights to the assets, or obligations for the liabilities, of entity C.
- IE55. The board of entity C decides to enter into a financing arrangement with a syndicate of lenders to help fund the development of the gas field and construction of the LNG facility. The estimated total cost of the development and construction is CU1,000 million.¹

¹ In this example monetary amounts are denominated in 'currency units (CU)'.

IE56. The lending syndicate provides entity C with a CU700 million loan. The arrangement specifies that the syndicate has recourse to entities A and B only if entity C defaults on the loan arrangement during the development of the field and construction of the LNG facility. The lending syndicate agrees that it will not have recourse to entities A and B once the LNG facility is in production because it has assessed that the cash inflows that entity C should generate from LNG sales will be sufficient to meet the loan repayments. Although at this time the lenders have no recourse to entities A and B, the syndicate maintains protection against default by entity C by taking a lien on the LNG facility.

Analysis

- IE57. The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the binding arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of entity C, but they establish that the parties have rights to the net assets of entity C. The recourse nature of the financing arrangement during the development of the gas field and construction of the LNG facility (i.e., entities A and B providing separate guarantees during this phase) does not, by itself, impose on the parties an obligation for the liabilities of entity C (i.e., the loan is a liability of entity C). Entities A and B have separate liabilities, which are their guarantees to repay that loan if entity C defaults during the development and construction phase.
- IE58. There are no other facts and circumstances that indicate that the parties have rights to substantially all the service potential or economic benefits of the assets of entity C and that the parties have an obligation for the liabilities of entity C. The joint arrangement is a joint venture.
- IE59. The parties recognize their rights to the net assets of entity C as investments and account for them using the equity method.

Example 8—Accounting for acquisitions of interests in joint operations in which the activity constitutes an operation

- IE60. Municipalities A, B and C have joint control of Joint Operation D whose activity constitutes an operation, as defined in IPSAS 40, *Public Sector Combinations*.
- IE61. Municipality E acquires municipality A's 40 per cent ownership interest in Joint Operation D at a cost of CU300 and incurs acquisition-related costs of CU50.
- IE62. The binding arrangement between the parties that Municipality E joined as part of the acquisition establishes that Municipality E's shares in several assets and liabilities differ from its ownership interest in Joint Operation D. The following table sets out Municipality E's share in the assets and liabilities

related to Joint Operation D as established in the binding arrangement between the parties:

<i>Municipality E's share in the assets and liabilities related to Joint Operation D</i>	
Property, plant and equipment	48%
Intangible assets (excluding goodwill)	90%
Accounts receivable	40%
Inventory	40%
Retirement benefit obligations	15%
Accounts payable	40%
Contingent liabilities	56%

Analysis

- IE63. Municipality E recognizes in its financial statements its share of the assets and liabilities resulting from the contractual arrangement (see paragraph 23).
- IE64. It applies the principles on acquisition accounting in IPSAS 40 and other IPSASs for identifying, recognizing, measuring and classifying the assets acquired, and the liabilities assumed, on the acquisition of the interest in Joint Operation D. This is because Municipality E acquired an interest in a joint operation in which the activity constitutes an operation (see paragraph 24A).
- IE65. However, Municipality E does not apply the principles on acquisition accounting in IPSAS 40 and other IPSASs that conflict with the guidance in this Standard. Consequently, in accordance with paragraph 23, Municipality E recognizes, and therefore measures, in relation to its interest in Joint Operation D, only its share in each of the assets that are jointly held and in each of the liabilities that are incurred jointly, as stated in the binding arrangement. Municipality E does not include in its assets and liabilities the shares of the other parties in Joint Operation D.
- IE66. IPSAS 40 requires the acquirer to measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values with limited exceptions; for example, a reacquired right recognized as an intangible asset is measured on the basis of the remaining term of the related binding arrangement regardless of whether market participants would consider

potential renewals of binding arrangements when measuring its fair value. Such measurement does not conflict with this Standard and thus those requirements apply.

- IE67. Consequently, Municipality E determines the fair value, or other measure specified in IPSAS 40, of its share in the identifiable assets and liabilities related to Joint Operation D. The following table sets out the fair value or other measure specified by IPSAS 40 of Municipality E's shares in the identifiable assets and liabilities related to Joint Operation D:

<i>Fair value or other measure specified by IPSAS 40 for Municipality E's shares in the identifiable assets and liabilities of Joint Operation D (CU)</i>	
Property, plant and equipment	138
Intangible assets (excluding goodwill)	72
Accounts receivable	84
Inventory	70
Retirement benefit obligations	(12)
Accounts payable	(48)
Contingent liabilities	(52)
Deferred tax liability (see the international or national standard dealing with income taxes)	(24)
Net assets	228

- IE68. In accordance with IPSAS 40, the excess of the consideration transferred over the amount allocated to Municipality E's shares in the net identifiable assets is recognized as goodwill:

Consideration transferred	CU300
Municipality E's shares in the identifiable assets and liabilities relating to its interest in the joint operation	<u>CU228</u>
Goodwill	<u>CU72</u>

- IE69. Acquisition-related costs of CU50 are not considered to be part of the consideration transferred for the interest in the joint operation. They are recognized as expenses in surplus or deficit in the period that the costs are incurred and the services are received (see paragraph 111 of IPSAS 40).

Example 9—Contributing the right to use know-how to a joint operation in which the activity constitutes an operation

- IE70. Entities A and B are two entities whose activities are the construction of high performance batteries for diverse applications.
- IE71. In order to develop batteries for electric vehicles they set up a binding arrangement (Joint Operation Z) to work together. Entities A and B share joint control of Joint Operation Z. This arrangement is a joint operation in which the activity constitutes an operation, as defined in IPSAS 40.
- IE72. After several years, the joint operators (Entities A and B) concluded that it is feasible to develop a battery for electric vehicles using Material M. However, processing Material M requires specialist know-how and thus far, Material M has only been used in electricity generation.
- IE73. In order to get access to existing know-how in processing Material M, Entities A and B arrange for Entity C to join as another joint operator by acquiring an interest in Joint Operation Z from Entities A and B and becoming a party to the binding arrangements.
- IE74. Entity C's activity so far has been solely the generation of electricity. It has long-standing and extensive knowledge in processing Material M.
- IE75. In exchange for its share in Joint Operation Z, Entity C pays cash to Entities A and B and grants the right to use its know-how in processing Material M for the purposes of Joint Operation Z. In addition, Entity C seconds some of its employees who are experienced in processing Material M to Joint Operation Z. However, Entity C does not transfer control of the know-how to Entities A and B or Joint Operation Z because it retains all the rights to it. In particular, Entity C is entitled to withdraw the right to use its know-how in processing Material M and to withdraw its seconded employees without any restrictions or compensation to Entity A and B or Joint Operation Z if it ceases its participation in Joint Operation Z.

- IE76. The fair value of Entity C's know-how on the date of the acquisition of the interest in the joint operation is CU1,000. Immediately before the acquisition, the carrying amount of the know-how in the financial statements of Entity C was CU300.

Analysis

- IE77. Entity C has acquired an interest in Joint Operation Z in which the activity of the joint operation constitutes an operation, as defined in IPSAS 40.
- IE78. In accounting for the acquisition of its interest in the joint operation, Entity C applies all the principles on acquisition accounting in IPSAS 40 and other IPSASs that do not conflict with the guidance in this Standard (see paragraph 24A). Entity C therefore recognizes in its financial statements its share of the assets and liabilities resulting from the binding arrangement (see paragraph 23).
- IE79. Entity C granted the right to use its know-how in processing Material M to Joint Operation Z as part of joining Joint Operation Z as a joint operator. However, Entity C retains control of this right because it is entitled to withdraw the right to use its know-how in processing Material M and to withdraw its seconded employees without any restrictions or any compensation to Entities A and B or Joint Operation Z if it ceases its participation in Joint Operation Z.
- IE80. Consequently, Entity C continues to recognize the know-how in processing Material M after the acquisition of the interest in Joint Operation Z because it retains all the rights to it. This means that Entity C will continue to recognize the know-how based on its carrying amount of CU300. As a consequence of retaining control of the right to use the know-how that it granted to the joint operation, Entity C has granted the right to use the know-how to itself. Consequently, Entity C does not remeasure the know-how, and it does not recognize a gain or loss on the grant of the right to use it.

Comparison with IFRS 11

IPSAS 37, *Joint Arrangements*, is drawn primarily from IFRS 11, *Joint Arrangements* (issued in 2011, including amendments up to December 31, 2014). At the time of issuing this Standard, the IPSASB has not considered the applicability to public sector entities of IFRS 9, *Financial Instruments*. References to IFRS 9 in IFRS 11 are therefore replaced by references to the IPSASs dealing with financial instruments.

The main differences between IPSAS 37 and IFRS 11 are as follows:

- IPSAS 37 uses different terminology, in certain instances, from IFRS 11. The most significant examples are the use of the terms “controlling entity”, “surplus or deficit” and “accumulated surplus or deficit” in IPSAS 37. The equivalent terms in IFRS 11 are, “parent,” “profit or loss” and “retained earnings.”
- IPSAS 35 defines the term “binding arrangement”. This term is broader than the term “contractual arrangement”, which is used in IFRS 11.
- IPSAS 37 contains additional illustrative examples that reflect the public sector context.

IPSAS 38—DISCLOSURE OF INTERESTS IN OTHER ENTITIES

Acknowledgment

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Financial Reporting Standard (IFRS) 12, *Disclosures of Interests in Other Entities* published by the International Accounting Standards Board (IASB). Extracts from IFRS 12 are reproduced in this publication of the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) with the permission of the International Financial Reporting Standards Foundation.

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IPSAS 38—DISCLOSURE OF INTERESTS IN OTHER ENTITIES

History of IPSAS

This version includes amendments resulting from IPSASs issued up to January 31, 2018.

IPSAS 38, *Disclosure of Interests in Other Entities* was issued in January 2015.

Since then, IPSAS 38 has been amended by the following IPSASs:

- IPSAS 39, *Employee Benefits* (issued July 2016)
- *The Applicability of IPSASs* (issued April 2016)

Table of Amended Paragraphs in IPSAS 38

Paragraph Affected	How Affected	Affected By
4	Amended	IPSAS 39 July 2016
5	Deleted	The Applicability of IPSASs April 2016
6	Deleted	The Applicability of IPSASs April 2016
61A	New	The Applicability of IPSASs April 2016
61B	New	IPSAS 39 July 2016

IPSAS 38—DISCLOSURE OF INTERESTS IN OTHER ENTITIES

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International Public Sector Accounting Standard 38, *Disclosure of Interests in Other Entities*, is set out in paragraphs 1–62. All the paragraphs have equal authority. IPSAS 38 should be read in the context of its objective, the Basis for Conclusions, the *Preface to International Public Sector Accounting Standards*, and the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Objective

1. The objective of this Standard is to require an entity to disclose information that enables users of its financial statements to evaluate:
 - (a) The nature of, and risks associated with, its interests in controlled entities, unconsolidated controlled entities, joint arrangements and associates, and structured entities that are not consolidated; and
 - (b) The effects of those interests on its financial position, financial performance and cash flows.

Scope

2. **An entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in disclosing information about its interests in controlled entities, unconsolidated controlled entities, joint arrangements and associates, and structured entities that are not consolidated.**
3. **This Standard shall be applied by an entity that has an interest in any of the following:**
 - (a) **Controlled entities;**
 - (b) **Joint arrangements (i.e., joint operations or joint ventures);**
 - (c) **Associates; or**
 - (d) **Structured entities that are not consolidated.**
4. **This Standard does not apply to:**
 - (a) **Post-employment benefit plans or other long-term employee benefit plans to which IPSAS 39, *Employee Benefits* applies.**
 - (b) **An entity's separate financial statements to which IPSAS 34, *Separate Financial Statements*, applies. However:**
 - (i) **If an entity has interests in structured entities that are not consolidated and prepares separate financial statements as its only financial statements, it shall apply the requirements in paragraphs 40–48 when preparing those separate financial statements.**
 - (ii) **An investment entity that prepares financial statements in which all of its controlled entities are measured at fair value through surplus or deficit in accordance with paragraph 56 of IPSAS 35 shall present the disclosures relating to investment entities required by this Standard.**

- (c) **An interest held by an entity that participates in, but does not have joint control of, a joint arrangement unless that interest results in significant influence over the arrangement or is an interest in a structured entity.**
- (d) **An interest in another entity that is accounted for in accordance with IPSAS 29, *Financial Instruments: Recognition and Measurement*. However, an entity shall apply this Standard:**
 - (i) **When that interest is an interest in an associate or a joint venture that, in accordance with IPSAS 36, *Investments in Associates and Joint Ventures*, is measured at fair value through surplus or deficit; or**
 - (ii) **When that interest is an interest in a structured entity that is not consolidated.**

5. [Deleted]

6. [Deleted]

Definitions

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

Binding arrangement: For the purposes of this Standard, a binding arrangement is an arrangement that confers enforceable rights and obligations on the parties to it as if it were in the form of a contract. It includes rights from contracts or other legal rights.

An **interest in another entity**, for the purpose of this Standard, refers to involvement by way of binding arrangements or otherwise that exposes an entity to variability of benefits from the performance of the other entity. An interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees. It includes the means by which an entity has control or joint control of, or significant influence over, another entity. An entity does not necessarily have an interest in another entity solely because of a typical funder/recipient or customer/supplier relationship.

Paragraphs AG7–AG9 provide further information about interests in other entities.

Paragraphs AG57–AG59 of IPSAS 35, *Consolidated Financial Statements* explain variability of benefits.

Revenue from a structured entity, for the purpose of this Standard, includes, but is not limited to, recurring and non-recurring fees, interest, dividends or similar distributions, gains or losses on the remeasurement or derecognition of interests in structured entities and gains or losses from the transfer of assets and liabilities to the structured entity.

A structured entity is:

- (a) In the case of entities where administrative arrangements or legislation are normally the dominant factors in deciding who has control of an entity, an entity that has been designed so that administrative arrangements or legislation are not the dominant factors in deciding who controls the entity, such as when binding arrangements are significant to determining control of the entity and relevant activities are directed by means of binding arrangements; or
- (b) In the case of entities where voting or similar rights are normally the dominant factor in deciding who has control of an entity, an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of binding arrangements.

Paragraphs AG20–AG23 provide further information about structured entities.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are reproduced in the *Glossary of Defined Terms* published separately. The following terms are defined in either IPSAS 34, *Separate Financial Statements*, IPSAS 35, *Consolidated Financial Statements*, IPSAS 36, *Investments in Associates and Joint Ventures* or IPSAS 37, *Joint Arrangements*: associate, consolidated financial statements, control, controlled entity, controlling entity, economic entity, equity method, investment entity, joint arrangement, joint control, joint operation, joint venture, non-controlling interest, relevant activities, separate financial statements, separate vehicle and significant influence.

Binding Arrangement

8. Binding arrangements can be evidenced in several ways. A binding arrangement is often, but not always, in writing, in the form of a contract or documented discussions between the parties. Statutory mechanisms such as legislative or executive authority can also create enforceable arrangements, similar to contractual arrangements, either on their own or in conjunction with contracts between the parties.

Disclosing Information about Interests in Other Entities

9. **To meet the objective in paragraph 1, an entity shall disclose:**
 - (a) **The significant judgments and assumptions it has made in determining:**
 - (i) **The nature of its interest in another entity or arrangement;**
 - (ii) **The type of joint arrangement in which it has an interest (paragraphs 12–14); and**
 - (iii) **That it meets the definition of an investment entity, if applicable (paragraph 15); and**
 - (b) **Information about its interests in:**
 - (i) **Controlled entities (paragraphs 17–26);**
 - (ii) **Joint arrangements and associates (paragraphs 35–39);**
 - (iii) **Structured entities that are not consolidated (paragraphs 40–48);**
 - (iv) **Non-quantifiable ownership interests (paragraphs 49–50); and**
 - (v) **Controlling interests acquired with the intention of disposal (paragraphs 51–57).**
10. **If the disclosures required by this Standard, together with disclosures required by other IPSASs, do not meet the objective in paragraph 1, an entity shall disclose whatever additional information is necessary to meet that objective.**
11. **An entity shall consider the level of detail necessary to satisfy the disclosure objective in paragraph 1 and how much emphasis to place on each of the requirements in this Standard. It shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics (see paragraphs AG2–AG6).**

Significant Judgments and Assumptions

12. **An entity shall disclose the methodology used to determine:**
 - (a) **That it has control of another entity as described in paragraphs 18 and 20 of IPSAS 35;**
 - (b) **That it has joint control of an arrangement or significant influence over another entity; and**

- (c) **The type of joint arrangement (i.e., joint operation or joint venture) when the arrangement has been structured through a separate vehicle.**
13. **The disclosures required by paragraph 12 shall be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete. The use of such cross-referencing may be subject to jurisdictional restrictions.**
 14. **To comply with paragraph 12, an entity shall disclose, for example, the factors considered in determining that:**
 - (a) **It controls a specific entity (or similar category of entities) where the interest in the other entity is not evidenced by the holding of equity or debt instruments;**
 - (b) **It does not control another entity (or category of entities) even though it holds more than half of the voting rights of the other entity (or entities);**
 - (c) **It controls another entity (or category of entities) even though it holds less than half of the voting rights of the other entity (or entities);**
 - (d) **It is an agent or a principal (see paragraphs AG60–AG74 of IPSAS 35);**
 - (e) **It does not have significant influence even though it holds 20 per cent or more of the voting rights of another entity; and**
 - (f) **It has significant influence even though it holds less than 20 per cent of the voting rights of another entity.**

Investment Entity Status

15. **When a controlling entity determines that it is an investment entity in accordance with IPSAS 35, the investment entity shall disclose information about significant judgments and assumptions it has made in determining that it is an investment entity. An investment entity is not required to disclose this information if it has all of the characteristics in paragraph 61 of IPSAS 35.**
16. **When an entity becomes, or ceases to be, an investment entity, it shall disclose the change of investment entity status and the reasons for the change. In addition, an entity that becomes an investment entity shall disclose the effect of the change of status on the financial statements for the period presented, including:**

- (a) The total fair value, as of the date of change of status, of the controlled entities that cease to be consolidated;
- (b) The total gain or loss, if any, calculated in accordance with paragraph 64 of IPSAS 35; and
- (c) The line item(s) in surplus or deficit in which the gain or loss is recognized (if not presented separately).

Interests in Controlled Entities

17. An entity shall disclose information that enables users of its consolidated financial statements:
 - (a) To understand:
 - (i) The composition of the economic entity; and
 - (ii) The interest that non-controlling interests have in the economic entity's activities and cash flows (paragraph 19); and
 - (b) To evaluate:
 - (i) The nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the economic entity (paragraph 20);
 - (ii) The nature of, and changes in, the risks associated with its interests in consolidated structured entities (paragraphs 21–24);
 - (iii) The consequences of changes in its ownership interest in a controlled entity that do not result in a loss of control (paragraph 25); and
 - (iv) The consequences of losing control of a controlled entity during the reporting period (paragraph 26).
18. When the financial statements of a controlled entity used in the preparation of consolidated financial statements are as of a date or for a period that is different from that of the consolidated financial statements (see paragraph 46 of IPSAS 35) an entity shall disclose:
 - (a) The date of the end of the reporting period of the financial statements of that controlled entity; and
 - (b) The reason for using a different date or period.

The Interest that Non-controlling Interests have in the Economic Entity's Activities and Cash Flows

19. **An entity shall disclose for each of its controlled entities that have non-controlling interests that are material to the reporting entity:**
- (a) **The name of the controlled entity;**
 - (b) **The domicile and legal form of the controlled entity and the jurisdiction in which it operates;**
 - (c) **The proportion of ownership interests held by non-controlling interests;**
 - (d) **The proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held;**
 - (e) **The surplus or deficit allocated to non-controlling interests of the controlled entity during the reporting period;**
 - (f) **Accumulated non-controlling interests of the controlled entity at the end of the reporting period; and**
 - (g) **Summarized financial information about the controlled entity (see paragraph AG10).**

The Nature and Extent of Significant Restrictions

20. **An entity shall disclose:**
- (a) **Significant restrictions in binding arrangements (e.g., statutory, contractual and regulatory restrictions) on its ability to access or use the assets and settle the liabilities of the economic entity, such as:**
 - (i) **Those that restrict the ability of a controlling entity or its controlled entities to transfer cash or other assets to (or from) other entities within the economic entity.**
 - (ii) **Guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the economic entity.**
 - (b) **The nature and extent to which protective rights of non-controlling interests can significantly restrict the entity's ability to access or use the assets and settle the liabilities of the economic entity (such as when a controlling entity is obliged to settle liabilities of a controlled entity before settling its own liabilities, or approval of non-controlling interests is required either to access the assets or to settle the liabilities of a controlled entity).**

- (c) **The carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.**

Nature of the Risks Associated with an Entity's Interests in Consolidated Structured Entities

21. **An entity shall disclose the terms of any binding arrangements that could require the controlling entity or its controlled entities to provide financial support to a consolidated structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support).**
22. **If during the reporting period a controlling entity or any of its controlled entities has, without having an obligation under a binding arrangement to do so, provided financial or other support to a consolidated structured entity (e.g., purchasing assets of, or instruments issued by, the structured entity), the entity shall disclose:**
 - (a) **The type and amount of support provided, including situations in which the controlling entity or its controlled entities assisted the structured entity in obtaining financial support; and**
 - (b) **The reasons for providing the support.**
23. **If during the reporting period a controlling entity or any of its controlled entities has, without having an obligation under a binding arrangement to do so, provided financial or other support to a previously unconsolidated structured entity and that provision of support resulted in the entity controlling the structured entity, the entity shall disclose an explanation of the relevant factors in reaching that decision.**
24. **An entity shall disclose any current intentions to provide financial or other support to a consolidated structured entity, including intentions to assist the structured entity in obtaining financial support.**

Consequences of Changes in a Controlling Entity's Ownership Interest in a Controlled Entity that do not Result in a Loss of Control

25. **An entity shall present a schedule that shows the effects on the net assets/equity attributable to owners of the controlling entity of any changes in its ownership interest in a controlled entity that do not result in a loss of control.**

Consequences of Losing Control of a Controlled Entity During the Reporting Period

26. **An entity shall disclose the gain or loss, if any, calculated in accordance with paragraph 52 of IPSAS 35 and:**
 - (a) **The portion of that gain or loss attributable to measuring any investment retained in the former controlled entity at its fair value at the date when control is lost; and**
 - (b) **The line item(s) in surplus or deficit in which the gain or loss is recognized (if not presented separately).**

Interests in Unconsolidated Controlled Entities (Investment Entities)

27. **An investment entity that, in accordance with IPSAS 35 is required to apply the exception to consolidation and instead account for its investment in a controlled entity at fair value through surplus or deficit shall disclose that fact.**
28. **For each unconsolidated controlled entity, an investment entity shall disclose:**
 - (a) **The controlled entity's name;**
 - (b) **The domicile and legal form of the controlled entity and the jurisdiction in which it operates; and**
 - (c) **The proportion of ownership interest held by the investment entity and, if different, the proportion of voting rights held.**
29. **If an investment entity is the controlling entity of another investment entity, the controlling entity shall also provide the disclosures in paragraph 28(a)–(c) for investments that are controlled by its controlled investment entity. The disclosure may be provided by including, in the financial statements of the controlling entity, the financial statements of the controlled entity (or controlled entities) that contain the above information.**
30. **An investment entity shall disclose:**
 - (a) **The nature and extent of any significant restrictions arising from binding arrangements (e.g., resulting from borrowing arrangements, regulatory requirements or contractual arrangements) on the ability of an unconsolidated controlled entity to transfer funds to the investment entity in the form of cash dividends, or similar distributions, or to repay loans or advances made to the unconsolidated controlled entity by the investment entity; and**

- (b) Any current commitments or intentions to provide financial or other support to an unconsolidated controlled entity, including commitments or intentions to assist the controlled entity in obtaining financial support.
31. If, during the reporting period, an investment entity or any of its controlled entities has, without having an obligation arising from a binding arrangement to do so, provided financial or other support to an unconsolidated controlled entity (e.g., purchasing assets of, or instruments issued by, the controlled entity or assisting the controlled entity in obtaining financial support), the entity shall disclose:
- (a) The type and amount of support provided to each unconsolidated controlled entity; and
 - (b) The reasons for providing the support.
32. An investment entity shall disclose the terms of any binding arrangements that could require the entity or its unconsolidated controlled entities to provide financial support to an unconsolidated, controlled, structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or to provide financial support).
33. If during the reporting period an investment entity or any of its unconsolidated controlled entities has, without having an obligation arising from a binding arrangement to do so, provided financial or other support to an unconsolidated, structured entity that the investment entity did not control, and if that provision of support resulted in the investment entity controlling the structured entity, the investment entity shall disclose an explanation of the relevant factors in reaching the decision to provide that support.
34. A controlling entity that controls an investment entity and is not itself an investment entity, shall disclose in its consolidated financial statements, the information required by paragraphs 27 to 33 in respect of such unconsolidated controlled entities.

Interests in Joint Arrangements and Associates

35. An entity shall disclose information that enables users of its financial statements to evaluate:
- (a) The nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates (paragraphs 36 and 38); and

- (b) **The nature of, and changes in, the risks associated with its interests in joint ventures and associates** (paragraph 39).

Nature, Extent and Financial Effects of an Entity's Interests in Joint Arrangements and Associates

36. An entity shall disclose:

- (a) **For each joint arrangement and associate that is material to the reporting entity:**
- (i) **The name of the joint arrangement or associate;**
 - (ii) **The nature of the entity's relationship with the joint arrangement or associate (by, for example, describing the nature of the activities of the joint arrangement or associate and whether they are strategic to the entity's activities);**
 - (iii) **The domicile and legal form of the joint arrangement or associate and the jurisdiction in which it operates; and**
 - (iv) **The proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).**
- (b) **For each joint venture and associate that is material to the reporting entity:**
- (i) **Whether the investment in the joint venture or associate is measured using the equity method or at fair value;**
 - (ii) **Summarized financial information about the joint venture or associate as specified in paragraphs AG12 and AG13; and**
 - (iii) **If the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, if there is a quoted market price for the investment.**
- (c) **Financial information as specified in paragraph AG16 about the entity's investments in joint ventures and associates that are not individually material:**
- (i) **In aggregate for all individually immaterial joint ventures; and**
 - (ii) **In aggregate for all individually immaterial associates. This aggregated information is to be disclosed separately from the aggregated information on joint ventures.**

- 37. An investment entity need not provide the disclosures required by paragraphs 36(b)–36(c).**

38. An entity shall also disclose:

- (a) The nature and extent of any significant restrictions (e.g., resulting from borrowing arrangements, regulatory requirements or binding arrangements between investors with joint control of, or significant influence over, a joint venture or an associate) on the ability of joint ventures or associates to transfer funds to the entity in the form of cash dividends or similar distributions, or to repay loans or advances made by the entity.
- (b) When the financial statements of a joint venture or associate used in applying the equity method are as of a date or for a period that is different from that of the entity:
 - (i) The date of the end of the reporting period of the financial statements of that joint venture or associate; and
 - (ii) The reason for using a different date or period.
- (c) The unrecognized share of losses of a joint venture or associate, both for the reporting period and cumulatively, if the entity has stopped recognizing its share of losses of the joint venture or associate when applying the equity method.

Risks Associated with an Entity's Interests in Joint Ventures and Associates

39. An entity shall disclose:

- (a) Commitments that it has relating to its joint ventures separately from the amount of other commitments as specified in paragraphs AG17–AG19; and
- (b) In accordance with IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, unless the probability of loss is remote, contingent liabilities incurred relating to its interests in joint ventures or associates (including its share of contingent liabilities incurred jointly with other investors with joint control of, or significant influence over, the joint ventures or associates), separately from the amount of other contingent liabilities.

Interests in Structured Entities that are not Consolidated

40. An entity shall disclose information that enables users of its financial statements:

- (a) To understand the nature and extent of its interests in structured entities that are not consolidated (paragraphs 43–45); and
- (b) To evaluate the nature of, and changes in, the risks associated with its interests in structured entities that are not consolidated (paragraphs 46–48).

41. The information required by paragraph 40(b) includes information about an entity's exposure to risk from involvement that it had with structured entities that are not consolidated in previous periods (e.g., sponsoring the structured entity), even if the entity no longer has any involvement by way of binding arrangement with the structured entity at the reporting date.
42. An investment entity need not provide the disclosures required by paragraph 40 for a structured entity that it controls but which is not consolidated, and for which it presents the disclosures required by paragraphs 27–33.

Nature of Interests

43. **An entity shall disclose qualitative and quantitative information about its interests in structured entities that are not consolidated, including, but not limited to, the nature, purpose, size and activities of the structured entity and how the structured entity is financed.**
44. **If an entity has sponsored a structured entity that is not consolidated for which it does not provide information required by paragraph 46 (e.g., because it does not have an interest in the entity at the reporting date), the entity shall disclose:**
 - (a) **How it has determined which structured entities it has sponsored;**
 - (b) **Revenue from those structured entities during the reporting period, including a description of the types of revenue presented; and**
 - (c) **The carrying amount (at the time of transfer) of all assets transferred to those structured entities during the reporting period.**
45. **An entity shall present the information in paragraph 44(b) and (c) in tabular format, unless another format is more appropriate, and classify its sponsoring activities into relevant categories (see paragraphs AG2–AG6).**

Nature of Risks

46. **An entity shall disclose in tabular format, unless another format is more appropriate, a summary of:**
 - (a) **The carrying amounts of the assets and liabilities recognized in its financial statements relating to its interests in structured entities that are not consolidated;**
 - (b) **The line items in the statement of financial position in which those assets and liabilities are recognized;**

- (c) **The amount that best represents the entity's maximum exposure to loss from its interests in structured entities that are not consolidated, including how the maximum exposure to loss is determined. If an entity cannot quantify its maximum exposure to loss from its interests in structured entities that are not consolidated it shall disclose that fact and the reasons; and**
 - (d) **A comparison of the carrying amounts of the assets and liabilities of the entity that relate to its interests in structured entities that are not consolidated and the entity's maximum exposure to loss from those entities.**
47. **If during the reporting period an entity has, without having an obligation under a binding arrangement to do so, provided financial or other support to a structured entity that is not consolidated in which it previously had or currently has an interest (for example, purchasing assets of, or instruments issued by, the structured entity), the entity shall disclose:**
- (a) **The type and amount of support provided, including situations in which the entity assisted the structured entity in obtaining financial support; and**
 - (b) **The reasons for providing the support.**
48. **An entity shall disclose any current intentions to provide financial or other support to a structured entity that is not consolidated, including intentions to assist the structured entity in obtaining financial support. Such current intentions include intentions to provide support as a result of obligations under binding arrangements and intentions to provide support where the entity has no obligation under a binding arrangement.**

Non-quantifiable Ownership Interests

49. **An entity shall disclose information that enables users of its financial statements to understand the nature and extent of any non-quantifiable ownership interests in other entities.**
50. **To the extent that this information has not already been provided in accordance with this Standard, an entity shall disclose, in respect of each non-quantifiable ownership interest that is material to the reporting entity:**
- (a) **The name of the entity in which it has an ownership interest; and**
 - (b) **The nature of its ownership interest in the entity.**

Controlling Interests Acquired with the Intention of Disposal

51. **An entity, other than an investment entity, shall disclose information regarding its interest in a controlled entity when, at the point at which control arose, the entity had the intention of disposing of that interest and, at the reporting date, it has an active intention to dispose of that interest.**
52. There are a number of situations in which a public sector entity may obtain control of another entity, but where the entity has an active intention to dispose of all or part of its controlling interest in the near future.
53. Because of a government's broad responsibility for the economic well-being of a jurisdiction it may intervene to prevent the consequences of failure of an entity, such as a financial institution. Such interventions may lead to a government obtaining control of another entity, although it has no intention of maintaining control over that entity. Rather, its intention may be to sell, or otherwise dispose of, its interest in the controlled entity. If the other entity needs to be restructured to facilitate disposal the restructuring can occur over a period of one or more years and the government may retain some residual assets or liabilities at the end of the process. The consolidation of such controlled entities for the reporting periods in which control is present, can have a significant impact on the consolidated financial statements. The obtaining of control as a result of interventions to prevent failure is most likely to occur in the context of governments, but could also occur in the case of individual public sector entities.
54. A public sector entity may also acquire a controlling interest in another entity, with the intention of disposing of all or part of that interest, in implementing a government's policy objectives. For example, a government may direct an entity to acquire certain interests in other entities for the purpose of redistribution.
55. **An entity shall disclose the following information in the notes in respect of each controlled entity referred to in paragraph 51:**
 - (a) **The name of the controlled entity and a description of its key activities;**
 - (b) **The rationale for the acquisition of the controlling interest and the factors considered in determining that control exists;**
 - (c) **The impact on the consolidated financial statements of consolidating the controlled entity including the effect on assets, liabilities, revenue, expenses and net assets/equity; and**
 - (d) **The current status of the approach to disposal, including the expected method and timing of disposal.**

56. **The disclosures required by paragraph 55 shall be provided at each reporting date until the entity disposes of the controlling interest or ceases to have the intention to dispose of that interest. In the period in which the entity disposes of the controlling interest or ceases to have the intention to dispose of the controlling interest it shall disclose:**
- (a) **The fact that there has been a disposal or change of intention; and**
 - (b) **The effect of the disposal or change of intention on the consolidated financial statements.**
57. **Where other disclosures required by this Standard or other IPSASs would provide information relevant to paragraphs 55 or 56 a cross-reference to those other disclosures shall be provided.**

Transitional Provisions

58. An entity is encouraged to provide information required by this Standard earlier than annual periods beginning on or after January 1, 2017. Providing some of the disclosures required by this Standard does not compel the entity to comply with all the requirements of this Standard or to apply IPSAS 34, IPSAS 35, IPSAS 36, and IPSAS 37 early.
59. The disclosure requirements of this Standard need not be applied for any period presented that begins before the annual period immediately preceding the first annual period for which this Standard is applied.
60. The disclosure requirements of paragraphs 40–56 and the corresponding guidance in paragraphs AG20–AG25 of this Standard need not be applied for any period presented that begins before the first annual period for which this Standard is applied.

Effective Date

61. **An entity shall apply this Standard for annual financial statements covering periods beginning on or after January 1, 2017. Earlier application is encouraged.**
- 61A. **Paragraphs 5 and 6 were deleted by *The Applicability of IPSASs*, issued in April 2016. An entity shall apply those amendments for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendments for a period beginning before January 1, 2018, it shall disclose that fact.**
- 61B. **Paragraph 4 was amended by IPSAS 39, *Employee Benefits*, issued in July 2016. An entity shall apply that amendment for annual financial statements covering periods beginning on or after January 1, 2018. Earlier application is encouraged. If an entity applies the amendment**

for a period beginning before January 1, 2018 it shall disclose that fact and apply IPSAS 39 at the same time.

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

Appendix A

Application Guidance

This Appendix is an integral part of IPSAS 38.

AG1. The examples in this appendix portray hypothetical situations. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying this Standard.

Aggregation (paragraph 11)

AG2. An entity shall decide, in the light of its circumstances, how much detail it provides to satisfy the information needs of users, how much emphasis it places on different aspects of the requirements and how it aggregates the information. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring information as a result of too much aggregation.

AG3. An entity may aggregate the disclosures required by this Standard for interests in similar entities if aggregation is consistent with the disclosure objective and the requirement in paragraph AG4, and does not obscure the information provided. An entity shall disclose how it has aggregated its interests in similar entities.

AG4. An entity shall present information separately for interests in:

- (a) Controlled entities;
- (b) Joint ventures;
- (c) Joint operations;
- (d) Associates; and
- (e) Structured entities that are not consolidated.

AG5. In determining whether to aggregate information, an entity shall consider quantitative and qualitative information about the different risk and benefit characteristics of each entity it is considering for aggregation and the significance of each such entity to the reporting entity. The entity shall present the disclosures in a manner that clearly explains to users of financial statements the nature and extent of its interests in those other entities.

AG6. Examples of aggregation levels within the classes of entities set out in paragraph AG4 that might be appropriate are:

- (a) Nature of activities (e.g., a research and development entity, a revolving credit card securitization entity).

- (b) Industry classification.
- (c) Geography (e.g., country or region).

Interests in Other Entities

- AG7. An interest in another entity refers to involvement by way of binding arrangements or otherwise that exposes the reporting entity to variability of benefits from the performance of the other entity. Consideration of the purpose and design of the other entity may help the reporting entity when assessing whether it has an interest in that entity and, therefore, whether it is required to provide the disclosures in this Standard. That assessment shall include consideration of the risks that the other entity was designed to create and the risks the other entity was designed to pass on to the reporting entity and other parties.
- AG8. A reporting entity is typically exposed to variability of benefits from the performance of another entity by holding instruments (such as equity or debt instruments issued by the other entity) or having another involvement that absorbs variability. For example, assume a structured entity holds a loan portfolio. The structured entity obtains a credit default swap from another entity (the reporting entity) to protect itself from the default of interest and principal payments on the loans. The reporting entity has involvement that exposes it to variability of benefits from the performance of the structured entity because the credit default swap absorbs variability of benefits, in the form of returns, of the structured entity.
- AG9. Some instruments are designed to transfer risk from a reporting entity to another entity. Such instruments create variability of benefits for the other entity but do not typically expose the reporting entity to variability of benefits from the performance of the other entity. For example, assume a structured entity is established to provide investment opportunities for investors who wish to have exposure to entity Z's credit risk (entity Z is unrelated to any party involved in the arrangement). The structured entity obtains funding by issuing to those investors notes that are linked to entity Z's credit risk (credit-linked notes) and uses the proceeds to invest in a portfolio of risk-free financial assets. The structured entity obtains exposure to entity Z's credit risk by entering into a credit default swap (CDS) with a swap counterparty. The CDS passes entity Z's credit risk to the structured entity in return for a fee paid by the swap counterparty. The investors in the structured entity receive higher benefits that reflect both the structured entity's return from its asset portfolio and the CDS fee. The swap counterparty does not have involvement with the structured entity that exposes it to variability of benefits from the performance of the structured entity because the CDS transfers variability to the structured entity, rather than absorbing variability of benefits of the structured entity.

Summarized Financial Information for Controlled Entities, Joint Ventures and Associates (paragraphs 19 and 36)

- AG10. For each controlled entity that has non-controlling interests that are material to the reporting entity, an entity shall disclose:
- (a) Dividends or similar distributions paid to non-controlling interests; and
 - (b) Summarized financial information about the assets, liabilities, surplus or deficit and cash flows of the controlled entity that enables users to understand the interest that non-controlling interests have in the economic entity's activities and cash flows. That information might include but is not limited to, for example, current assets, non-current assets, current liabilities, non-current liabilities, revenue and surplus or deficit.
- AG11. The summarized financial information required by paragraph AG10(b) shall be the amounts before inter-entity eliminations.
- AG12. For each joint venture and associate that is material to the reporting entity, an entity shall disclose:
- (a) Dividends or similar distributions received from the joint venture or associate; and
 - (b) Summarized financial information for the joint venture or associate (see paragraphs AG14 and AG15) including, but not necessarily limited to:
 - (i) Current assets;
 - (ii) Non-current assets;
 - (iii) Current liabilities;
 - (iv) Non-current liabilities;
 - (v) Revenue;
 - (vi) Tax expense;
 - (vii) Pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to discontinuing operations; and
 - (viii) Surplus or deficit.
- AG13. In addition to the summarized financial information required by paragraph AG12, an entity shall disclose for each joint venture that is material to the reporting entity the amount of:
- (a) Cash and cash equivalents included in paragraph AG12(b)(i);
 - (b) Current financial liabilities (excluding taxes and transfers payable, payables under exchange transactions and provisions) included in paragraph AG12(b)(iii);

- (c) Non-current financial liabilities (excluding taxes and transfers payable, payables under exchange transactions and provisions) included in paragraph AG12(b)(iv);
- (d) Depreciation and amortization;
- (e) Interest revenue;
- (f) Interest expense; and
- (g) Income tax expense.

AG14. The summarized financial information presented in accordance with paragraphs AG12 and AG13 shall be the amounts included in the IPSAS financial statements of the joint venture or associate (and not the entity's share of those amounts). If the entity accounts for its interest in the joint venture or associate using the equity method:

- (a) The amounts included in the IPSAS financial statements of the joint venture or associate shall be adjusted to reflect adjustments made by the entity when using the equity method, such as fair value adjustments made at the time of acquisition and adjustments for differences in accounting policies.
- (b) The entity shall provide a reconciliation of the summarized financial information presented to the carrying amount of its interest in the joint venture or associate.

AG15. An entity may present the summarized financial information required by paragraphs AG12 and AG13 on the basis of the joint venture's or associate's financial statements if:

- (a) The entity measures its interest in the joint venture or associate at fair value in accordance with IPSAS 36; and
- (b) The joint venture or associate does not prepare IPSAS financial statements and preparation on that basis would be impracticable or cause undue cost.

In that case, the entity shall disclose the basis on which the summarized financial information has been prepared.

AG16. An entity shall disclose, in aggregate, the carrying amount of its interests in all individually immaterial joint ventures or associates that are accounted for using the equity method. An entity shall also disclose separately the aggregate amount of its share of those joint ventures' or associates':

- (a) Revenue.
- (b) Tax expense.
- (c) Pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to discontinuing operations.

- (d) Surplus or deficit.
- (e) An entity provides the disclosures separately for joint ventures and associates.

Commitments for Joint Ventures (paragraph 39(a))

AG17. An entity shall disclose total commitments it has made but not recognized at the reporting date (including its share of commitments made jointly with other investors with joint control of a joint venture) relating to its interests in joint ventures. Commitments are those that may give rise to a future outflow of cash or other resources.

AG18. Unrecognized commitments that may give rise to a future outflow of cash or other resources include:

- (a) Unrecognized commitments to contribute funding or resources as a result of, for example:
 - (i) The constitution or acquisition agreements of a joint venture (that, for example, require an entity to contribute funds over a specific period).
 - (ii) Capital-intensive projects undertaken by a joint venture.
 - (iii) Unconditional purchase obligations, comprising procurement of equipment, inventory or services that an entity is committed to purchasing from, or on behalf of, a joint venture.
 - (iv) Unrecognized commitments to provide loans or other financial support to a joint venture.
 - (v) Unrecognized commitments to contribute resources to a joint venture, such as assets or services.
 - (vi) Other non-cancellable unrecognized commitments relating to a joint venture.
- (b) Unrecognized commitments to acquire another party's ownership interest (or a portion of that ownership interest) in a joint venture if a particular event occurs or does not occur in the future.

AG19. The requirements and examples in paragraphs AG17 and AG18 illustrate some of the types of disclosure required by paragraph 27 of IPSAS 20, *Related Party Disclosures*.

Interests in Structured Entities that are not Consolidated (paragraphs 40–48)

Structured Entities

AG20. A structured entity is an entity that has been designed so that the conventional ways in which an entity is controlled are not the dominant factors in deciding

who controls the entity. In the case of entities such as departments or ministries where administrative arrangements or legislation are often the dominant factors in deciding who has control of an entity, a structured entity is an entity that has been designed so that administrative arrangements or legislation are not the dominant factor in deciding who controls the entity. In the case of entities where voting or similar rights are normally the dominant factor in deciding who has control of an entity (which may be the case for some entities with profit objectives), a structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity. Although binding arrangements frequently occur between public sector entities, binding arrangements are not normally the dominant factor in determining who controls an entity. Therefore the use of binding arrangements to determine the relevant activities of an entity may indicate the existence of a structured entity. Depending on the context a structured entity could be (i) an entity for which most of the activities are predetermined, with the relevant activities limited in scope but directed through binding arrangements or (ii) an entity for which any voting rights relate to administrative tasks only and the relevant activities are directed by means of binding arrangements.

AG21. A structured entity often has some or all of the following features or attributes:

- (a) Restricted activities.
- (b) A narrow and well-defined objective, such as to carry out research and development activities, provide a source of capital or funding to an entity or provide investment opportunities for investors by passing on risks and rewards associated with the assets of the structured entity to investors.
- (c) Insufficient net assets/equity to permit the structured entity to finance its activities without subordinated financial support.
- (d) Financing in the form of multiple contractually linked instruments to investors that create concentrations of credit or other risks (tranches).

AG22. Examples of entities that are regarded as structured entities include, but are not limited to:

- (a) A partnership between a government and a private sector entity that is not a joint venture, being a partnership established and directed by binding arrangements.
- (b) Securitization vehicles.
- (c) Asset-backed financings.
- (d) Some investment funds.

AG23. The mere fact that a government provides funding to another entity does not make that entity a structured entity. Nor is an entity that is controlled by voting rights a structured entity simply because, for example, it receives funding from third parties following a restructuring.

Nature of Risks from Interests in Structured Entities that are not Consolidated (paragraphs 46–48)

- AG24. In addition to the information required by paragraphs 46–48, an entity shall disclose additional information that is necessary to meet the disclosure objective in paragraph 40(b).
- AG25. Examples of additional information that, depending on the circumstances, might be relevant to an assessment of the risks to which an entity is exposed when it has an interest in a structured entity that is not consolidated are:
- (a) The terms of an arrangement that could require the entity to provide financial support to a structured entity that is not consolidated (e.g., liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or provide financial support), including:
 - (i) A description of events or circumstances that could expose the reporting entity to a loss.
 - (ii) Whether there are any terms that would limit the obligation.
 - (iii) Whether there are any other parties that provide financial support and, if so, how the reporting entity's obligation ranks with those of other parties.
 - (b) Losses incurred by the entity during the reporting period relating to its interests in structured entities that are not consolidated.
 - (c) The types of revenue the entity received during the reporting period from its interests in structured entities that are not consolidated.
 - (d) Whether the entity is required to absorb losses of a structured entity that is not consolidated before other parties, the maximum limit of such losses for the entity, and (if relevant) the ranking and amounts of potential losses borne by parties whose interests rank lower than the entity's interest in the structured entity that is not consolidated.
 - (e) Information about any liquidity arrangements, guarantees or other commitments with third parties that may affect the fair value or risk of the entity's interests in structured entities that are not consolidated.
 - (f) Any difficulties a structured entity that is not consolidated has experienced in financing its activities during the reporting period.
 - (g) In relation to the funding of a structured entity that is not consolidated, the forms of funding (e.g., commercial paper or medium-term notes) and their weighted-average life. That information might include maturity analyses of the assets and funding of a structured entity if the structured entity has longer-term assets funded by shorter-term funding.

Appendix B

Amendments to Other IPSASs

[Deleted]

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 38, Disclosure of Interests in Other Entities.

Objective

BC1. This Basis for Conclusions summarizes the IPSASB's considerations in reaching the conclusions in IPSAS 38. As this Standard is based on IFRS 12, *Disclosure of Interests in Other Entities* (issued in 2011, including amendments up to December 31, 2014), issued by the IASB, the Basis for Conclusions outlines only those areas where IPSAS 38 departs from the main requirements of IFRS 12.

Overview

BC2. In 2012 the IPSASB commenced work on a project to update those IPSASs that dealt with accounting for interests in controlled entities, associates and joint ventures. In October 2013 the IPSASB issued Exposure Drafts (EDs) 48 to 52 which were collectively referred to as *Interests in Other Entities*. ED 52, *Disclosure of Interests in Other Entities*, was based on IFRS 12, *Disclosure of Interests in Other Entities*, having regard to the relevant public sector modifications to the disclosure requirements in IPSAS 6, *Consolidated and Separate Financial Statements*, IPSAS 7, *Investments in Associates*, and IPSAS 8, *Interests in Joint Ventures*. In January 2015 the IPSASB issued five new IPSASs, including IPSAS 38. These new IPSASs supersede IPSAS 6, IPSAS 7, and IPSAS 8.

Significant Judgments and Assumptions (paragraphs 12 to 14)

BC3. The IPSASB noted that paragraph 7 of IFRS 12 requires that an entity disclose information about significant judgments and assumptions it has made in determining the nature of its interest in another entity (for example, control, joint control or significant influence). Although the IPSASB agreed that users need information about how an entity has made these judgments, it noted that a public sector entity could be required to make many judgments and assumptions in relation to particular entities, and that the disclosure of such judgments and assumptions and changes in such judgments from period to period could result in unnecessary detail. The IPSASB also noted that, in the public sector, decisions about the reporting entity may be made having regard to frameworks developed in conjunction with other parties such as legislative bodies or oversight committees. The assessments made in respect of the classification of certain types of entities as controlled entities, jointly controlled entities, or entities subject to significant influence may be recorded in public documents other than the financial statements. The IPSASB therefore agreed to require that an entity disclose the methodology used to decide the existence or absence of control, joint control of an arrangement or

significant influence, either in the financial statements themselves or by way of reference to another publicly available document.

Definition of Structured Entity (paragraphs 7 and AG20 to AG23)

- BC4. The IPSASB noted that the definition of “structured entity” in IFRS 12 focusses on voting or similar rights, which tend to occur less frequently or have less significance in the public sector than in the private sector. However, the IPSASB agreed that it was still appropriate to refer to voting or similar rights in the definition of a structured entity because voting or similar rights may be the predominant way in which a public sector entity establishes control over another entity. The IPSASB decided to modify the definition of a structured entity to highlight that they occur when the conventional ways in which an entity is controlled are not the dominant factors in deciding who controls the entity and encompass the broader range of circumstances that occur in the public sector.
- BC5. The IPSASB identified administrative arrangements and statutory provisions (legislation) as common means by which control may be determined for many public sector entities. Accordingly, the IPSASB took the view that the reference to “similar rights” in the definition of structured entity should encompass administrative arrangements and statutory provisions. Thus, the ED proposed that entities for which administrative arrangements or statutory provisions are dominant factors in determining control of the entity would not be structured entities. The IPSASB considers that the disclosures required of structured entities are appropriate, but that in order to be useful they need to be focused on a limited class of entities (consistent with the intention of the IASB’s requirements in relation to entities applying IFRS 12).
- BC6. Some respondents to ED 52 were concerned that the definition of a structured entity could be read as suggesting that an entity was operating in an unauthorized way or in contravention of laws. The IPSASB noted that this was not its intention and reviewed the definition of structured entities to see if any clarification was required. The IPSASB noted that the definition does not suggest that a structured entity would not be required to comply with relevant statutes or administrative arrangements. Rather the definition allows for the possibility that a small group of entities may have been established under different arrangements from the arrangements commonly used to establish similar entities.

Investment Entities (paragraphs 27 to 34)

- BC7. The IPSASB considered the investment entity disclosures required by IFRS 12 and concluded that those disclosures were particularly appropriate in the public sector context. The IPSASB noted that, as a consequence of the requirements in IPSAS 35 most public sector entities with investment entities would be required to make these disclosures.

- BC8. The IPSASB considered whether a non-investment controlling entity accounting for investment entities at fair value should be required to make any additional disclosures. The IPSASB considered that the disclosures required in relation to investment entities were appropriate and should also be provided in the consolidated financial statements of a controlling entity with investment entities.

Non-quantifiable Ownership Interests (paragraphs 49 and 50)

- BC9. The scope of IPSAS 36, *Investments in Associates and Joint Ventures*, is limited to “quantifiable ownership interests”. The IPSASB noted that respondents supported this proposal, but considered that disclosure of information about an entity’s non-quantifiable ownership interests in other entities would be appropriate. The IPSASB agreed to require, in this Standard, disclosure of information about non-quantifiable ownership interests.

Controlling Interests Acquired with the Intention of Disposal (paragraphs 50 to 57)

- BC10. Some respondents to ED 52 proposed that the IPSASB require disclosures about temporary control (either by developing a standard based on IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, or by adding disclosures to this Standard). The IPSASB considered, and rejected, the idea of requiring disclosure of all controlled investments held for sale on the grounds that it was too broad. Nevertheless, the IPSASB agreed that some disclosure about controlling interests intended to be held for a limited time could be of interest to users. For example, the IPSASB considered that users would be interested in information about interventions to prevent the consequences of the failure of an entity, or acquisitions of entities which will subsequently be redistributed to achieve policy objectives. The IPSASB agreed that its objective was to require disclosure of information about controlling interests where there was an active intention to dispose of the interest, both at the time of the acquisition and at the reporting date.
- BC11. In considering the information to be disclosed the IPSASB agreed that the requirements should be general in nature. The IPSASB acknowledged that the circumstances in which a controlling interest is acquired or disposed of could vary widely (for example, a controlling interest might be acquired by virtue of providing guarantees). In addition, entities might wish to provide information about the transactions or events giving rise to such controlling interests, and the IPSASB did not wish to be unnecessarily prescriptive about the type of information that should be provided. The IPSASB therefore agreed to require disclosures to assist users to understand the impact of consolidating such controlling interests on the consolidated financial statements by reference to the effect on the main aspects of the financial statements.

- BC12. The IPSASB acknowledged that the expected method of disposal might be under consideration at the reporting date and that plans might change from one period to another. It also acknowledged that disposal might occur in stages. The IPSASB therefore agreed to require disclosure of the “current status of the approach to disposal”.
- BC13. The IPSASB considered whether to limit the disclosures to situations where control was expected to exist for a specified time period, such as one or two years. The IPSASB decided not to specify a time period. It considered that limiting the disclosures to controlling interests and situations where there was still an active intention to dispose of the interest would lead to informative disclosures without overwhelming readers with too much detail.

Revision of IPSAS 38 as a result of the IPSASB’s *The Applicability of IPSASs*, issued in April 2016

- BC14. The IPSASB issued *The Applicability of IPSASs* in April 2016. This pronouncement amends references in all IPSASs as follows:
- (a) Removes the standard paragraphs about the applicability of IPSASs to “public sector entities other than GBEs” from the scope section of each Standard;
 - (b) Replaces the term “GBE” with the term “commercial public sector entities”, where appropriate; and
 - (c) Amends paragraph 10 of the *Preface to International Public Sector Accounting Standards* by providing a positive description of public sector entities for which IPSASs are designed.

The reasons for these changes are set out in the Basis for Conclusions to IPSAS 1.

Comparison with IFRS 12

IPSAS 38, *Disclosure of Interests in Other Entities* is drawn primarily from IFRS 12, *Disclosure of Interests in Other Entities* (issued in 2011, including amendments up to December 31, 2014). At the time of issuing this Standard, the IPSASB has not considered the applicability to public sector entities of IFRS 9, *Financial Instruments*. References to IFRS 9 in IFRS 12 are therefore replaced by references to the IPSASs dealing with financial instruments.

The main differences between IPSAS 38 and IFRS 12 are as follows:

- IPSAS 38 uses different terminology, in certain instances, from IFRS 12. The most significant examples are the use of the terms “net assets/equity,” “economic entity,” “controlling entity,” “controlled entity,” “revenue” in IPSAS 38. The equivalent terms in IFRS 12 are “equity,” “group,” “parent,” “subsidiary” and “income.”
- The definition of a structured entity in IPSAS 38 acknowledges the differing ways in which control may be obtained in the public sector.
- IPSAS 38 requires that a controlling entity that controls an investment entity, and is not itself an investment entity, disclose information in respect of unconsolidated investment entities. IFRS 12 does not require such disclosures by a controlling entity that controls an investment entity, and is not itself an investment entity because IFRS 10 requires that such a controlling entity consolidate controlled investment entities.
- IPSAS 38 requires the disclosure of information about non-quantifiable ownership interests. IFRS 12 does not specify such disclosures.
- IPSAS 38 requires the disclosure of information about interests in entities that were acquired with the intention of disposal and which are still held for disposal. IFRS 12 does not specify such disclosures. However, IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* requires disclosures about non-current assets held for sale.

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