

Accounting Alert

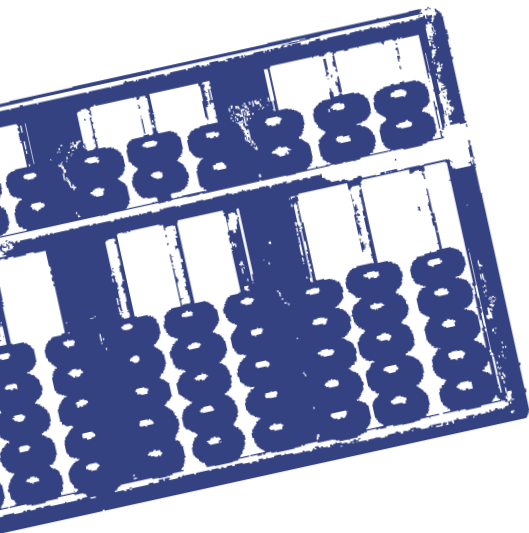
Special edition

Analysis of the latest financial reporting developments

In this issue:

Proposed Standards on Financial instruments

ED NZ IAS-32 and ED NZ IAS-39 can be obtained from the Institute's website: www.icanz.co.nz



For more information visit:

- IASplus.com – a Deloitte website detailing IFRS “as it happens” as well as reporting on the current and proposed output of the IASB.
- deloitte.co.nz for New Zealand based publications including this Accounting Alert.

Proposed Standards on Financial instruments

The Financial Reporting Standards Board (FRSB) has issued *ED NZ IAS-32 Financial Instruments: Presentation and Disclosure* (ED NZ IAS-32) and *ED NZ IAS-39: Financial Instruments: Recognition and Measurement* (ED NZ IAS-39).

This Accounting Alert provides an overview of ED NZ IAS-32 and ED NZ IAS-39 and some action points to consider in relation to these standards on first time adoption of NZ International Financial Reporting Standards.

Overview

ED NZ IAS-32 prescribes the presentation and disclosure requirements for financial instruments including:

- clarifying the liability and equity classification of financial instruments
- prescribing conditions under which assets and liabilities may be set-off
- requiring disclosure of fair value for each class of financial assets and liabilities.

ED NZ IAS-39 addresses the recognition, derecognition and measurement of financial assets and financial liabilities, including derivatives and embedded derivatives, with special rules for hedge accounting. It will fill a major gap in New Zealand's current reporting framework, given that the recognition and measurement of financial instruments has not previously been the subject of a financial reporting standard in New Zealand.

Submissions on ED NZ IAS-32 and ED NZ IAS-39 are due 30 April 2004.

Background

ED NZ IAS-32 and ED NZ IAS-39 have been issued based on the corresponding standards IAS-32 and IAS-39 issued by the International Accounting Standards Board (IASB) in December 2003

Proposed Amendments

The IASB made some further amendments to IAS-32 and IAS-39 after the New Zealand exposure drafts were issued. The FRSB will incorporate the following changes in the New Zealand standards when these are finalised.

IFRS-2: Share Based Payment contains a consequential amendment to IAS-39 of the addition of a scope exclusion for financial instruments, contracts and obligations within the scope of IFRS-2.

IFRS-4 Insurance Contracts has consequential amendments to the scope of IAS-32 and IAS-39:

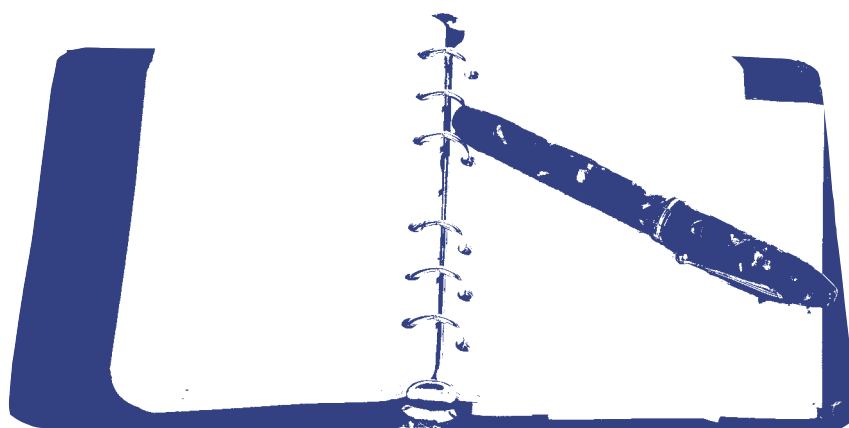
- (i) to amend the definition of insurance contracts (insurance contracts are outside the scope of IAS-39)
- (ii) to delete the scope exclusion for derivatives based on climatic, geological or other physical variables
- (iii) to clarify which financial guarantee contracts are within the scope of IAS-39 and which are within the scope of IFRS-4
- (iv) to clarify that derivatives that are embedded in insurance contracts are within the scope of IAS-39
- (v) to exempt financial instruments with a discretionary participation feature from the requirements on liability and equity classification.

The IASB has also issued an amendment to IAS-39 in March 2004 - *'Financial Instruments: Recognition and Measurement – Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk'*

This amendment:

- permits fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk (commonly referred to as 'macro hedging') than as currently outlined in ED NZ IAS-39
- adds related Application Guidance and an Illustrative Example.

In February 2004, the IASB announced that it had agreed to propose amending IAS-39 to narrow the circumstances in which an entity will have the option to designate an individual financial asset or financial liability as one to be measured at fair value with changes in fair value recognised in profit or loss. The proposal will also include several other clarifications to IAS-39 for matters recently raised. An exposure draft is expected to be issued by the IASB in the second quarter in 2004.



ED NZ IAS-32 and ED NZ IAS-39

Scope

ED NZ IASs 32 and 39 should be applied to all types of financial instruments unless scoped out from one or both of the Standards.

The following financial instruments are, according to specific provisions, scoped out of both ED NZ IAS-32 and ED NZ IAS-39:

- interests in subsidiaries, associates, and joint ventures accounted for under (proposed) NZ IAS-27, NZ IAS-28, or NZ IAS-31; however ED NZ IASs 32 and 39 apply in cases where under NZ IAS-27, NZ IAS-28, or NZ IAS-31 such interests are to be accounted for under ED NZ IAS-39 – for example, derivatives on an interest in a subsidiary, associate, or joint venture;
- employers' rights and obligations under employee benefit plans to which (proposed) NZ IAS-19 applies;
- contracts for contingent consideration in a business combination (acquirer only);
- contracts requiring payment based on climatic, geological, or other physical variable, except derivatives embedded in such contracts are subject to ED NZ IAS-39;
- rights and obligations under insurance contracts, except ED NZ IAS-39 does apply to financial instruments that take the form of an insurance (or reinsurance) contract but that principally involve the transfer of financial risks and derivatives embedded in insurance contracts.

In addition, ED NZ IAS-39 does not apply to financial instruments that meet the definition of own equity under ED NZ IAS-32.

Leases

ED NZ IAS-32 applies to lease receivables and payables. ED NZ IAS-39 applies to those financial instruments only in limited respects:

- It applies to lease receivables with respect to the derecognition and impairment provisions.
- It applies to lease payables with respect to the derecognition provisions.

ED NZ IAS-39 applies to derivatives embedded in leases.

Financial guarantees

ED NZ IAS-32 applies to all financial guarantees.

Guarantees that provide for payments to be made in response to changes in a specified variable (price, rate, or index) are derivatives within the scope of ED NZ IAS-39.

Guarantees are only excluded from ED NZ IAS-39 if they provide for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due.

Loan commitments

ED NZ IAS-32 applies to all loan commitments.

Loan commitments are outside the scope of ED NZ IAS-39 if they cannot be settled net in cash or another financial instrument, they are not designated as financial liabilities at fair value through profit or loss, and the entity does not have a past practice of selling the loans that resulted from the commitment shortly after origination.

Contracts to buy or sell non-financial items

Contracts to buy or sell non-financial items are within the scope of ED NZ IASs 32 and 39 if they can be settled net in cash or another financial asset and are not entered into and 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.



Definition includes those contracts indexed to or settled in an entity's own "equity" instruments that do not meet the definition of equity.

The ability to designate any financial asset or financial liability at fair value through profit or loss on initial recognition may be restricted.

An entity is permitted to classify in 'loans and receivables' loans that are purchased provided that they are not quoted in an active market.

Definition of a Financial Asset

ED NZ IAS-32 defines a financial asset as cash, a contractual right to receive cash or another financial asset, a contractual right to exchange financial assets or liabilities with another entity under conditions that are potentially favourable, or an equity instrument of another entity.

The definition also includes those contracts where an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable.

A contract that will or may be settled in the entity's own equity instruments is a financial asset if it is:

- a non-derivative for which the entity is or may be obliged to receive a variable number of its own equity instruments; or
- 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 instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Classification of Financial Assets

ED NZ IAS-39 requires financial assets to be classified in one of the following categories:

- Financial assets at fair value through profit or loss.
- Available-for-sale financial assets.
- Loans and receivables.
- Held-to-maturity investments.

Those categories are used to determine how a particular financial asset is recognised and measured in the financial statements.

Financial assets at fair value through profit or loss. This category has two subcategories. The first includes any financial asset that is designated on initial recognition as one to be measured at fair value with fair value changes in profit or loss. The second category includes financial assets that are held for trading. All derivatives (except those designated hedging instruments) and financial assets acquired or held for the purpose of selling in the short term or for which there is a recent pattern of short-term profit taking are held for trading.

The ability to designate any financial asset at fair value through profit or loss on initial recognition may be restricted as noted above under Proposed Amendments on page 1.

Available-for-sale financial assets (AFS) are any non-derivative financial assets designated on initial recognition as available for sale. AFS assets are measured at fair value in the balance sheet. Fair value changes on AFS assets are recognised directly in equity, through the statement of changes in equity, except for interest on AFS assets (which is recognised in income on an effective yield basis), impairment losses, and foreign exchange gains or losses. The cumulative gain or loss that was recognised in equity is recognised in profit or loss when an available-for-sale financial asset is derecognised.

Loans and receivables are non-derivative financial assets with fixed or determinable payments, originated or acquired, that are not quoted in an active market, not held for trading, and not designated on initial recognition as assets at fair value through profit or loss or as available-for-sale. Loans and receivables for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, should be classified as available-for-sale. Loans and receivables are measured at amortised cost.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments that an entity intends and is able to hold to maturity and that do not meet the definition of loans and receivables and are not designated on initial recognition as assets at fair value through profit or loss or as available for sale. Held-to-maturity investments are measured at amortised cost.



If an entity sells a held-to-maturity investment other than in insignificant amounts or as a consequence of a non-recurring, isolated event beyond its control that could not be reasonably anticipated, all of its other held-to-maturity investments must be reclassified as available-for-sale for the current and next two financial reporting years.

Definition of a Financial Liability

A financial liability is any liability that is:

- a 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 unfavourable; or
- a contract that will or may be settled in the entity's own equity instruments where the contract is either a non-derivative for which the entity may have to deliver a variable number of own equity instruments, or a derivative that will be settled other than by exchange of a fixed amount of a financial asset for a fixed number of the entity's own equity instruments.

Classification of Financial Liabilities

ED NZ IAS-39 recognises two classes of financial liabilities:

- Financial liabilities at fair value through profit or loss.
- Other financial liabilities measured at amortised cost using the effective interest method.

A financial liability at fair value through profit or loss is either:

- a financial liability classified as held for trading; or
- a financial liability that is designated by the entity as a liability at fair value through profit or loss upon initial recognition.

The ability to designate any financial liability as a liability at fair value through profit or loss upon initial recognition may be restricted as noted above under Proposed Amendments.

Classification as debt or equity

The fundamental principle of ED NZ IAS-32 is that an instrument should be classified as either a liability or an equity instrument according to its substance based on the definitions of a financial liability and an equity instrument, and not according to its legal form.

ED NZ IAS-32 defines an equity instrument as any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

A financial liability is defined above. Based on the definition, the following instruments are financial liabilities of the issuer:

- A financial instrument that provides for mandatory redemption by the issuer or gives the holder the right to require the issuer to redeem the instrument (such as mandatorily redeemable preferred shares)
- A financial instrument that gives the holder the right to put that instrument back to the issuer for cash or another financial asset (e.g. units in some unit trusts, certain shares in co-operative companies)
- An instrument where the choice of settlement in cash or another financial asset is contingent on the outcome of circumstances beyond the control of both the issuer and the holder.

Derivatives on own shares

A derivative 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. A derivative on own equity that gives the issuer or the holder a choice over how it is settled, such as settlement net in cash or net in shares, is a financial asset or liability unless all of the settlement alternatives would result in equity classification.

Units in a unit trust that can be redeemed for cash will be classified as liabilities under ED-NZ IAS-32.

On initial recognition, a financial instrument should be measured at fair value. A gain or loss should not be immediately recognised unless there is evidence of observable market data supporting a fair value different to the consideration paid or received.



Compound financial instruments

In the case of compound financial instruments, which have both a liability and equity component, such component parts are required to be split with each part accounted for and presented separately according to its substance.

ED NZ IAS-32 requires the issuer's liability on a compound instrument, such as a convertible bond, to be recorded initially at fair value, with the residual value to be assigned to the equity component.

Interest, dividends, losses, and gains

Interest, dividends, losses, and gains relating to a financial liability are to be recognised as income or expense in profit or loss. Distributions to holders of equity instruments as well as transaction costs for an equity transaction (other than costs of issuing an equity instrument that are directly attributable to the acquisition of a business) are to be accounted for within equity.

Treasury shares

If an entity reacquires its own shares (with these being held by the entity or another member of the consolidated group), the cost of those instruments is to be deducted from equity.

No gain or loss is to be recorded in profit or loss on the purchase, sale, issue, or cancellation of an entity's own equity instruments.

Measurement

Initially, financial assets and liabilities should be measured at fair value (including transaction costs, for assets and liabilities not measured at fair value through profit or loss).

Subsequently, financial assets and liabilities (including derivatives) should be measured at fair value, with the following exceptions:

- Loans and receivables, held-to-maturity investments, and non-derivative financial liabilities should be measured at amortised cost using the effective interest method.
- Investments in equity investments with no reliable fair value measurement (and related derivatives) should be measured at cost.
- Financial assets and liabilities that are designated as a hedged item or hedging instrument are subject to measurement under the hedge accounting requirements of ED NZ IAS-39.
- Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition, or that are accounted for using the continuing involvement method, are subject to particular measurement requirements.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. ED NZ IAS-39 provides a hierarchy to be used in determining the fair value for a financial instrument:

- Quoted market prices in an active market are the best evidence of fair value and should be used, where they exist, to measure the financial instrument.
- If a market for a financial instrument is not active, an entity establishes fair value by using a valuation technique that makes maximum use of market inputs and includes recent arm's length market transactions, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models. An acceptable valuation technique incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments.
- If there is no active market for an equity instrument and the range of reasonable fair values is significant and these estimates cannot be made reliably, then an entity must measure the equity instrument at cost less impairment.

Amortised cost is calculated using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

Impairment losses are recognised as incurred – it is not appropriate to recognise, in advance, expected future losses.

Financial assets that are not carried at fair value through profit and loss are subject to an impairment test.

A financial asset or group of assets is impaired and impairment losses are incurred only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset.

The amount of the loss for an asset carried at amortised cost is measured as the difference between the asset's carrying amount and the present value of future estimated cash flows discounted at the financial asset's original effective interest rate.

Individual assets that are individually assessed and for which no impairment exists are grouped with financial assets with similar credit risk statistics and collectively assessed for impairment.

The following table has a summary of the measurement requirements.

	Fair Value	Amortised Cost	Impairment
Assets			
Fair Value through Profit or Loss	✓ Profit or Loss		
Available for sale	✓ Equity		✓
Held to maturity		✓	✓
Loans and receivables		✓	✓
Liabilities			
Trading	✓ Profit or Loss		
Other		✓	
Derivatives	✓ Profit or Loss or equity		

Recognition and Derecognition

Initial recognition

ED NZ IAS-39 requires recognition of a financial asset or a financial liability when, and only when, the entity becomes a party to the contractual provisions of the instrument, subject to the following provisions in respect of regular way purchases.

Regular way purchases or sales of a financial asset

A regular way purchase or sale of financial assets is recognised and derecognised using either trade date or settlement date accounting. The method used is to be applied consistently for all purchases and sales of financial assets that belong to the same category of financial asset as defined in ED NZ IAS-39 (note that for this purpose assets held for trading form a different category from assets designated at fair value through profit or loss). The choice of method is an accounting policy.

Derecognition of a financial asset

The basic premise for the derecognition model in ED NZ IAS-39 is to determine whether the asset under consideration for derecognition is:

- an asset in its entirety; or
- specifically identified cash flows from an asset; or
- a fully proportionate share of the cash flows from an asset; or
- a fully proportionate share of specifically identified cash flows from a financial asset.

Once the asset under consideration for derecognition has been determined, an assessment is made as to whether the asset has been transferred, and if so, whether the transfer of that asset is subsequently eligible for derecognition.

In determining whether an asset qualifies for derecognition, the evaluation of the transfer of the risks and rewards inherent in the asset takes priority over the assessment as to whether control over that asset has been passed or not.

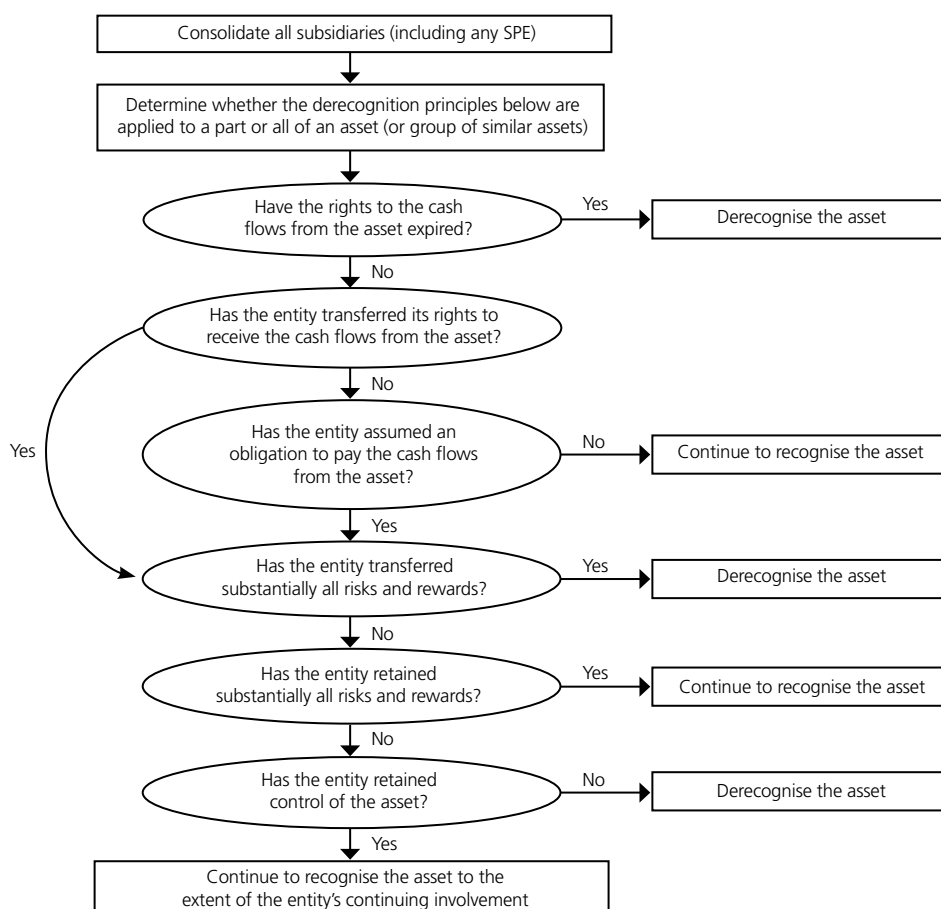
An asset is transferred if either the entity has transferred the contractual rights to receive the cash flows, or the entity has retained the contractual rights to receive the cash flows from the asset, but has assumed a contractual obligation to pass those cash flows on under an arrangement that meets the following three conditions:

- the entity has no obligation to pay amounts to the eventual recipient unless it collects equivalent amounts on the original asset,
- the entity is prohibited from selling or pledging the original asset (other than as security to the eventual recipient), and
- the entity has an obligation to remit those cash flows without material delay.

Once an entity has determined that the asset has been transferred, it then determines whether or not it has transferred substantially all of the risks and rewards of ownership of the asset. If substantially all the risks and rewards have been transferred, the asset is derecognised. If substantially all the risks and rewards have been retained, derecognition of the asset is precluded.

If the entity has neither retained nor transferred substantially all of the risks and rewards of the asset, then the entity must assess whether it has relinquished control of the asset or not. If the entity does not control the asset then derecognition is appropriate; however if the entity has retained control of the asset, then the entity continues to recognise the asset to the extent to which it has a continuing involvement in the asset.

These various derecognition steps are summarised below in a decision tree.



Derecognition of a financial liability

A financial liability should be removed from the balance sheet when, and only when, it is extinguished, that is, when the obligation specified in the contract is either discharged, cancelled, or expired.

Where there has been an exchange between an existing borrower and lender of debt instruments with substantially different terms, or there has been a substantial modification of the terms of an existing financial liability, this transaction is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. A gain or loss from extinguishment of the original financial liability is recognised in the income statement.

In substance defeasance is not permitted under ED NZ IAS-39.

Derivatives

ED NZ IAS-39 defines a derivative as a financial instrument or other contract within the scope of the standard:

- whose value changes in response to an underlying (e.g. interest rate);
- that requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; and
- that is settled at a future date.

Contracts to buy or sell financial items are always within the scope of ED NZ IAS-39. Contracts to buy or sell non-financial items are outside the scope of ED NZ IAS-39 if they were entered into and continue to be held for the purpose of the receipt or delivery of non-financial items in accordance with the entity's expected purchase, sale, or usage requirements; otherwise they are within the scope.

Contracts to buy or sell non-financial items are inside the scope if net settlement occurs. The following situations constitute net settlement:

- the terms of the contract permit either counterparty to settle net;
- there is a past practice of net settling similar contracts;
- there is a past practice, for similar contracts, of taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price, or from a dealer's margin; or
- the non-financial item is readily convertible to cash.

Derivatives must always be recognised at fair value on the balance sheet. Unless the derivative is a hedging instrument in a cash flow or net investment hedge, changes in fair value are recognised in the income statement.

Embedded derivatives

An embedded derivative is a feature within a contract, such that the cash flows associated with that feature behave in a similar fashion to a stand-alone derivative. In the same way that derivatives must be accounted for at fair value on the balance sheet with changes recognised in the income statement, so must some embedded derivatives. ED NZ IAS-39 requires that an embedded derivative be separated from its host contract and accounted for as a derivative when:

- the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the entire instrument is not measured at fair value with changes in fair value recognised in the income statement.

Certain embedded derivatives are accounted for separately from the host contract.

If an embedded derivative is separated, the host contract is accounted for under the appropriate standard (for instance, under ED NZ IAS-39 if the host is a financial instrument). Appendix A to ED NZ IAS-39 provides examples of embedded derivatives that are closely related to their hosts, and of those that are not. Examples of embedded derivatives that are not closely related to their hosts (and therefore must be separately accounted for) include:

- the equity conversion option in debt convertible to ordinary shares (from the perspective of the holder only);
- commodity indexed interest or principal payments in host debt contracts;
- cap and floor options in host debt contracts that are in-the-money when the instrument was issued;
- currency derivatives in purchase or sale contracts for non-financial items where the foreign currency is not that of either counterparty to the contract, is not the currency in which the related good or service is routinely denominated in commercial transactions around the world, and is not the currency that is commonly used in such contracts in the economic environment in which the transaction takes place.

Hedge Accounting

ED NZ IAS-39 permits hedge accounting under certain circumstances provided that the hedging relationship is:

- formally designated and documented, including the entity's risk management objective and strategy for undertaking the hedge, identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the entity will assess the hedging instrument's effectiveness; and
- expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk as designated and documented, and effectiveness can be reliably measured.

Hedging instruments

All derivative contracts with an external counterparty may be designated as hedging instruments except for some written options.

An external non-derivative financial asset or liability may not be designated as a hedging instrument except as a hedge of foreign currency risk.

A proportion of the hedging instrument may be designated as the hedging instrument. Generally, specific cash flows inherent in a derivative cannot be designated in a hedge relationship while other cash flows are excluded. However, the intrinsic value and the time value of an option contract may be separated, with only the intrinsic value being designated. Similarly, the interest element and the spot price of a forward can also be separated, with the spot price being the designated risk.

Hedged items

A hedged item can be:

- a single recognised asset or liability, firm commitment, highly probable transaction, or a net investment in a foreign operation;
- a group of assets, liabilities, firm commitments, highly probable forecast transactions, or net investments in foreign operations with similar risk characteristics;
- a held-to-maturity investment for foreign currency or credit risk (but not for interest risk or prepayment risk);
- a portion of the cash flows or fair value of a financial asset or financial liability; or
- a non-financial item for foreign currency risk only or the risk of changes in fair value of the entire item.



Hedges of firm commitments are fair value hedges, except that the foreign exchange risk component of the commitment may be designated a cash flow hedge.

Entities have a choice of whether to apply basis adjustment for hedges of forecast transactions resulting in the recognition of a non-financial asset or liability.

Hedge accounting is not permitted for hedges of a net position, that is, the net of a financial asset and financial liability. Instead it is possible to designate in a hedging relationship a portion of the gross assets or liabilities, or forecast cash flows that give rise to the net exposure, provided the hedge meets the other hedge accounting criteria.

The amendment to IAS-39 issued by the IASB in March 2004 will permit fair value hedge accounting to be used more readily for a portfolio hedge of interest rate risk than as currently outlined in ED NZ IAS-39.

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.

Effectiveness

ED NZ IAS-39 requires hedge effectiveness to be assessed both prospectively and retrospectively. A hedge is regarded as highly effective if, at inception and, at a minimum, at each reporting date, the changes in the fair value or cash flows of the hedged item attributable to the hedged risk are expected to be almost fully offset by the changes in the fair value or cash flows of the hedging instrument on a prospective basis, and on a retrospective basis where actual results are within a range of 80% to 125%.

All hedge ineffectiveness is recognised immediately in the income statement.

Categories of hedges

A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or a previously unrecognised firm commitment to buy or sell an asset at a fixed price or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. The gain or loss from the change in fair value of the hedging instrument is recognised immediately in profit or loss. At the same time the carrying amount of the hedged item is adjusted for the corresponding gain or loss with respect to the hedged risk, which is also recognised immediately in net profit or loss.

A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised 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 profit or loss. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity and recycled to the income statement when the hedged cash transaction affects profit or loss. If the hedged cash flows result in the recognition of a non-financial asset or liability, the entity can choose to adjust the basis of the asset or liability for the amount deferred in equity. This option has the status of an accounting policy and must be applied consistently to all such hedges.

A hedge of a net investment in a foreign operation as defined in (proposed) NZ IAS-21 is accounted for similarly to a cash flow hedge.

Discontinuation of hedge accounting

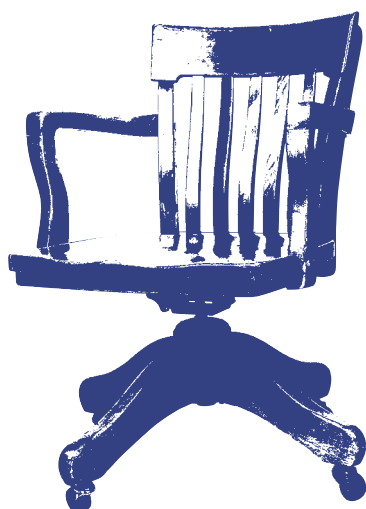
Hedge accounting must be discontinued prospectively if:

- the hedging instrument expires or is sold, terminated, or exercised;
- the hedge no longer meets the hedge accounting criteria
– for example it is no longer effective;
- for cash flow hedges the forecast transaction is no longer expected to occur; or
- the entity revokes the hedge designation.

If hedge accounting ceases for a cash flow hedge relationship because the forecast transaction is no longer expected to occur, gains and losses deferred in equity must be taken to the income statement immediately. If the transaction is still expected to occur and the hedge relationship ceases, the amounts accumulated in equity will be retained in equity until the hedged item affects profit or loss.

If a hedged financial instrument that is measured at amortised cost has been adjusted for the gain or loss attributable to the hedged risk in a fair value hedge, from the moment the hedge relationship is discontinued, this adjustment is amortised to profit or loss based on a

Currently designation of own debt as a liability at fair value through profit and loss is permitted, but disclosure is required of (a) the change in fair value not attributable to changes in the benchmark interest rate and (b) the difference between the carrying amount and the amount contractually due on maturity. This designation may ultimately be prohibited – refer Proposed Amendments on page 1.



recalculated effective interest rate on this date such that the adjustment is fully amortised by the maturity of the instrument.

Offsetting a financial asset and financial liability

Offsetting of a financial asset and financial liability is appropriate only when the entity:

- currently has a legally enforceable right to set off the recognised amounts; and
- intends to either settle on a net basis or to realise the asset and settle the liability simultaneously.

Disclosure

The standard requires a description of the entity's financial risk management objectives and policies including its hedging policies.

For each class of financial instrument an entity must disclose:

- information about extent and nature of instruments including significant terms; and
- accounting policies and methods adopted, including recognition criteria and measurement principles

In addition, for each class of financial asset or financial liability, an entity must disclose:

- specified information regarding exposure to interest rate risk and credit risk;
- fair value of that class, except in the case of unquoted equity investments or derivatives linked to such equity investments that are measured at cost under ED NZ IAS-39 because their fair value cannot be measured reliably (in which case further specified disclosures are necessary); and
- specified information about the methods and significant assumptions applied in determining fair values, including information relating to the use of quoted market prices and valuation techniques.

Other disclosure requirements include:

- in respect of all hedges: a description of the hedge and a description of the financial instrument designated as the hedging instrument and the nature of the risk being hedged;
- additional disclosures about cash flow hedges;
- details of transfers of financial assets where the entity continues to recognise all of the asset or continues to recognise the asset to the extent of the entity's continuing involvement;
- carrying amount of financial assets accepted or pledged as collateral;
- existence of any multiple embedded derivative features in issued compound financial instruments;
- for financial assets and financial liabilities carried at fair value through profit or loss, the amount of the change in fair value not attributable to changes in the benchmark interest rate and the difference between the carrying amount and amount contractually due on maturity;
- reasons for any reclassification of financial assets from measurement at fair value to measurement at cost;
- material items of income, expense, and gains and losses resulting from financial assets or financial liabilities whether recognised in profit or loss or in equity;
- nature and amount of any impairment losses recognised;
- defaults and breaches in relation to loan agreements.

First-time adopters of IFRS in 2005 are not required to restate their 2004 comparatives to comply with ED NZ IASs 32 and 39.

Many of the transitional provisions represent amendments to (proposed) NZ IFRS-1: First-time Adoption of IFRS.

Transition and Effective Date (ED NZ IAS-39)

Comparative financial statements

In 2005 financial statements only, an entity may elect for the prior-year comparative information to still be prepared under their existing GAAP. If this election is taken the entity must:

- disclose this fact together with the basis used to prepare this information; and
- disclose the nature of the main adjustments that would make the information comply with ED NZ IAS-32 and ED NZ IAS-39. The entity need not quantify those adjustments. However, the entity must treat any adjustment between the balance sheet at the comparative period's reporting date and the balance sheet at the start of the first IFRS reporting period as arising from a change in accounting policy and give the appropriate disclosures.

Transition

On initial adoption, subject to the guidance below, ED NZ IAS-39 should be applied retrospectively, with the opening balance of retained earnings for the earliest period presented and all other comparative amounts adjusted as if the standard had always been in use, except where restating the information would be impracticable, in which case the entity must disclose that fact and indicate the extent to which the information was restated.

Derecognition

With respect to derecognition the entity may either apply the ED NZ IAS-39 requirements prospectively, or apply the ED NZ IAS-39 requirements retrospectively from a date of the entity's choosing, provided that the information needed to apply ED NZ IAS-39 to assets and liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Designation upon transition

On initial adoption of the standard an entity may designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss or as available for sale.

Hedging

If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge, but the hedge does not meet the conditions for hedge accounting in ED NZ IAS-39, the entity must apply the rules on discontinuation of hedge accounting. Transactions entered into before the date of transition to IFRSs may not be retrospectively designated as hedges.

The designation and documentation of a hedge relationship must be completed on or before the date of transition to IFRSs if the hedge relationship is to qualify for hedge accounting from that date.

Fair value hedges

With respect to fair value hedges, if under previous GAAP the hedged item was not adjusted, the entity should adjust the carrying amount of the hedged item on transition with the adjustment amounting to 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 that was not recognised under previous GAAP; and
- b. that portion of the cumulative change in the fair value of the hedging instrument that reflects the designated hedged risk.

Cash flow hedges

Under New Zealand GAAP, an entity may have deferred gains and losses on a cash flow hedge of a forecast transaction. If, at the date of transition to IFRS, the hedged forecast transaction is highly probable, or is not highly probable but still expected to occur, the entire deferred gain or loss is recognised in equity. Any net cumulative gain or loss that is reclassified to equity on initial application of ED NZ IAS-39 remains in equity until (a) the forecast transaction subsequently results in the recognition of a non-financial asset or

A full inventory of financial instruments should be performed.

non-financial liability, (b) the forecast transaction affects profit or loss, or (c) circumstances subsequently change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss that had been recognised directly in equity is recognised in profit or loss. If the hedging instrument is still held, but the hedge does not qualify as a cash flow hedge under ED NZ IAS-39, hedge accounting is no longer appropriate starting from the date of transition to IFRS.

An entity may not adjust the carrying amount of non-financial assets and non-financial liabilities to exclude gains and losses related to cash flow hedges that were included in the carrying amount before the beginning of the financial year in which ED NZ IAS-39 is first applied.

Action Points

ED NZ IAS-32

Entities should consider the following major points in relation to ED NZ IAS-32:

- a full inventory of financial instruments should be performed, with particular consideration given to:
 - convertible financial instruments such as resetting preference shares
 - puttable instruments such as units in unlisted unit trusts
 - any compound financial instruments issued prior to transition date where the liability component is still outstanding and has not been segregated
 - financial instruments with alternative settlement options
 - contingent settlement provisions
- consider whether any debt has been subject to an in-substance defeasance
- consider the impact of re-classification of financial instruments previously classified as equity as debt on loan covenants

ED NZ IAS-39

Entities should consider the need to address the following points in relation to ED NZ IAS-39:

Overview

- establish process to identify all financial instruments, including embedded derivatives
- consider classification of financial instruments and potential volatility in statements of financial performance and position.

Scope

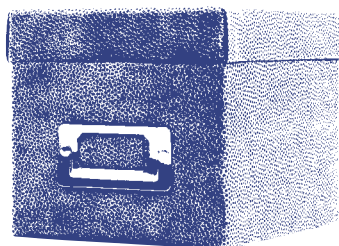
- consider which transactions are in or out of the scope of ED NZ IAS-39
- perform full inventory of all transactions and contracts
- insurance companies may need to classify contracts as financial instruments which were previously accounted for as insurance.

Initial recognition and classification

- consider whether the entity intends to voluntarily designate financial assets and financial liabilities on initial recognition as 'at fair value through profit or loss' or financial assets as available for sale. There is some flexibility on the classification of financial assets and financial liabilities and hence the associated accounting outcome. This may change however as noted under Proposed Amendments on page 1 above. Entities should carefully consider the classification of financial assets and financial liabilities.

Subsequent measurement

- consider whether the entity has a system to monitor the classification of financial assets and financial liabilities
- consider whether the entity has the resources and knowledge to calculate fair value of financial assets and financial liabilities.



Derecognition

- assess current derecognition policy for financial assets and liabilities
- consider whether the entity previously had an in-substance defeasance.

Special purpose entities

- consider the impact on current derivatives and structured finance products and whether they will still remain off- balance sheet under ED NZ IAS-39. Note, SIC-12 (an interpretation of IAS-27) may still require such structures to be consolidated.

Hedging

- assess the impact on the current hedging strategy. Formulate revised hedging and risk management strategy. Formally implement qualifying documentation and monitoring arrangements for hedges.
- consider necessary changes to information systems to address the hedge documentation requirements from transition date. Develop ongoing monitoring process.

Important Dates

The FRSB's timetable is aligned to that of the IASB. As the IASB issues standards, the FRSB will issue them as NZ IAS or NZ IFRS having made additions, where necessary, to ensure the standards are sector neutral. As a result the NZ agenda is subject to change as deliberations of the IASB proceed.

An up to date timetable is available at:
www.iasplus.com/agenda/timetabl.htm

Keep track of these important dates for responding on Exposure Drafts to the FRSB.

Comments Due April 2004:

- ED NZ IAS-12: *Income Taxes*
- ED NZ IAS-28: *Investments in Associates*
- ED NZ IAS-32: *Financial Instruments: Presentation and Disclosure*
- ED NZ IAS-39: *Financial Instruments: Recognition and Measurement*
- IFRIC Draft Interpretation D5: *Applying IAS-29: Financial Reporting in Hyperinflationary Economies for the First Time*

Comments Due May 2004:

- ED NZ IAS-24: *Related Party Disclosures*
- ED NZ IAS-41: *Agriculture*

All exposure drafts are available through the Institute's website: www.icanz.co.nz

New Zealand Directory

Auckland PO Box 33, Ph +64 (9) 309 4944, Fax +64 (9) 309 4947

Hamilton PO Box 17, Ph +64 (7) 838 4800, Fax +64 (7) 838 4810

Wellington PO Box 1990, Ph +64 (4) 472 1677, Fax +64 (4) 472 8023

Christchurch PO Box 248, Ph +64 (3) 379 7010, Fax +64 (3) 366 6539

Dunedin PO Box 1245, Ph +64 (3) 477 7042, Fax +64 (3) 477 9433

Independent Associate Firm

Hastings Dent Robertson & Partners, Ph +64 (6) 878 7004

Internet address <http://www.deloitte.co.nz>

Contact:

Denise Hodgkins

National Technical Director

Ph: +64 9 303 0918

Email: dhodgkins@deloitte.co.nz

Those wishing to receive this publication regularly are asked to communicate with:
The Editor, PO Box 33, Auckland.
Email: nzinfo@deloitte.co.nz
Ph +64 (9) 309 4944. Fax +64 (9) 309 4947.
© Deloitte 2004

This publication is of a general nature, intended as a background briefing only. It is not intended to be relied upon as, nor to be a substitute for, specific professional advice. Although this document is based on information from sources which are considered reliable, Deloitte, its directors, employees and consultants, do not represent, warrant or guarantee that the information contained in this document is complete or accurate.

No liability will be accepted for any loss occasioned to any party acting upon or refraining from acting in reliance on information contained in this publication, nor does Deloitte accept any responsibility to inform you of any matter that subsequently comes to its notice, which may affect any of the information contained in this document. This publication is intended for the use of clients and personnel of Deloitte. It is also made available to other selected recipients. Material from Accounting Alert may be reproduced with acknowledgement to Deloitte. As this document is prepared without consideration of any specific objectives, financial situation or needs, deals with aspects of the industry in question rather than its entirety and is time sensitive, a Deloitte partner should be consulted before any business decisions are made.

Deloitte is a member firm of Deloitte Touche Tohmatsu. Deloitte Touche Tohmatsu is a Swiss Verein (association), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other related names. The services described herein are provided by the member firms and not by the Deloitte Touche Tohmatsu Verein.

© Deloitte 2004.

AAA1322-04