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| FRD 114B |  |  | Financial instruments – general government entities and public  non‑financial corporations (June 2016) |
|  |  |  |  |
| Purpose |  |  | To prescribe to entities other than public financial corporations (PFCs) the criteria for the designation of financial assets and financial liabilities. |
| Application |  |  | Applies to all entities defined as either a public body or a department under section 3 of the *Financial Management Act 1994* except those entities which are not controlled by the State and whose financial position and result are thus not included in the Annual *Financial Report for the State of Victoria*. Application by those entities and by State owned companies is encouraged. |
|  |  |  | Excluded from the scope of this FRD are those public financial corporations to which FRD 116A applies. |
| Operative date |  |  | Annual reporting periods commencing on or after 1 July 2015. |
|  |  |  | FRD 114A *Financial instruments – general government entities and public non‑financial corporations* is withdrawn and superseded effective 1 July 2015. |
| Requirements |  |  | **Designation of Financial Assets and Financial Liabilities:**  Unless required to use some other basis by an Accounting Standard other than AASB 139, loans and receivables or financial liabilities are to be measure at amortised cost if the counter‑party to the transaction is another entity controlled by the State of Victoria. The Consolidated Analysis and Reporting team of the Department of Treasury and Finance (DTF) shall be informed if a basis other than amortised cost is used to measure such financial assets and financial liabilities. |
|  |  |  | Entities within the scope of this FRD shall not designate financial assets or financial liabilities as at fair value through profit and loss on their initial recognition, unless one of the following criteria is met:   1. the financial assets or financial liabilities are classified as 'held for trading' in accordance with AASB 139; or 2. the 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 (refer to AASB 139). |
|  |  |  | Other loans and receivables that are not quoted in an active market shall be measured at amortised cost. |
|  |  |  | In certain cases, there may be a preference for classifying certain financial assets as ‘held to maturity’. In such cases (because of the risk of tainting the class), entities shall seek prior written approval from DTF for nominated financial assets to be classified as ‘held‑to maturity’. As such they are measured at amortised cost, subject to reassessment at each balance date. Typically these would be term deposits where the intention and practice is to hold to maturity. |
|  |  |  | All derivatives (other than those designated as an accounting hedge) shall be recognised as a financial asset or financial liability at fair value through profit and loss. |
|  |  |  | Financial assets that are within the scope of AASB 139 and that support general insurance liabilities shall be reported at fair value through profit and loss. |
|  |  |  | All other financial assets shall be classified as ‘available for sale’. As such they shall be measured at fair value with movements (other than related to interest on any foreign exchange component of the fair value) reflected in equity until the asset is derecognised. Interest income for financial assets classified as ‘available for sale’ is recognised directly in profit and loss and based on amortised cost. |
|  |  |  | Financial liabilities that are not quoted in an active market shall bemeasured at amortised cost. |
|  |  |  | The following are excluded from the above requirements:   1. interests in subsidiaries, associates and joint ventures; employers’ rights and obligations under employee benefit plans, finance leases and liabilities under insurance contracts or other types of financial instruments excluded from the scope of AASB 132 and AASB 139; 2. financial instruments for which the Consolidated Analysis and Reporting team of DTF has given the entity prior written approval to treat in a particular way. |
|  |  |  | If formal hedge accounting compliant with AASB 132/139 is applied to an anticipated transaction related to non‑financial assets and liabilities (such as capital and inventory purchases) and subsequently results in the recognition of a non‑financial asset or a non‑financial liability, then an entity shall remove any associated gains and losses that were recognised directly in equity (hedging reserve) in accordance with the requirements for accounting for cash flow hedges contained within AASB 139, and include them in the initial cost or other carrying amount of the asset. |
|  |  |  | The matrix set out in Appendix A outlines these requirements. |
| Definitions |  |  | ***Embedded derivatives:*** 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.  ***Hedge accounting****:* the practice of identifying certain transactions as establishing a hedge against unwanted variations in other transactions and then accounting for these hedge transactions by valuing them at fair value and either recording movements immediately in profit and loss or where appropriate, deferring any gain or loss within equity until the transaction being hedged is complete and it is considered appropriate to transfer the movement to profit and loss (‘on balance sheet’ hedge accounting). AASB 132/139 allows these practices but with strict rules about designation, measurement and effectiveness. Another practice was referred to as ‘off balance sheet’ hedge accounting and involved ignoring movements in value until the hedged transaction was complete. This practice is disallowed under AASB 132/139.  ***Loans and receivables:*** non‑derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:  those that the entity intends to sell immediately or in the near term, which [consequently] are classified as ‘held for trading’, and those that the entity upon initial recognition designates as at fair value through profit or loss;  those that the entity upon initial recognition designates as ‘available for sale’; or  those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, and which are 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. |
| Guidance |  |  | **Designation and measurement:**  Subsequent to initial recognition, AASB 139 prohibits an entity from reclassifying a financial instrument into or out of fair value through profit or loss. |
|  |  |  | AASB 139requires the initial measurement of financial assets and financial liabilities at fair value. In the case of:   * + 1. a financial asset or financial liability classified at fair value through profit or loss, only the fair value is recorded; and     2. any other class of financial asset or financial liability, fair value plus transaction costs is recorded. |
|  |  |  | AASB 139 requires that, subsequent to initial recognition, all financial assets are to be remeasured to fair value, except for held‑to‑maturity investments and loans and receivables, which are carried at amortised cost using the effective interest method subject to a test for impairment. 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 linked derivatives) are measured at cost. |
|  |  |  | **Held to maturity:**  A decision to designate a financial asset as held‑to‑maturity is indicative that the investor is indifferent to future profit opportunities and therefore to the purchase prices offered by others over the investment’s term since the investor has the positive intent to hold the asset to maturity irrespective of market value fluctuations. AASB 139 requires an entity to assess its intent and ability to hold its held‑to‑maturity assets not only when those assets are initially acquired but also at each balance sheet date. |
|  |  |  | AASB 139 disallows an entity from classifying any financial assets as held to maturity if the entity has, during the current annual reporting period or during the two preceding annual reporting periods, 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:   * + 1. 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;     2. occur after the entity has collected substantially all of the financial asset’s original principal through scheduled payments or prepayments; or     3. 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. |
|  |  |  | This restriction applies on an economic entity basis (whole of government) as well as on an individual entity basis, so any disallowance affects the whole of government. |
|  |  |  | Request to nominate financial assets as ‘held to maturity’:  Requests to nominate financial assets as “held to maturity” shall be addressed to the Consolidated Analysis and Reporting team of DTF’s Budget & Finance Division, who will respond after consultation as required with the Accounting Policy team and Balance Sheet Management team. |
|  |  |  | Measurement subsequent to initial recognition:  AASB 139 requires that after acquisition, most financial liabilities are measured at original recorded amount less principal repayments and amortisation. Only derivatives and liabilities at fair value through profit or loss are remeasured to fair value.  An example of calculating the amortised cost for a financial liability is outlined in Appendix B. |
|  |  |  | 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 is recognised, as follows:   * + 1. A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss is recognised in profit or loss.     2. A gain or loss on an available‑for‑sale financial asset is recognised directly in equity (except for impairment losses and foreign exchange gains and losses, which are recognised in profit or loss) until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity (reserves) is recognised in profit or loss. However, interest calculated using the effective interest method is recognised in profit or loss. Dividends on an available‑for‑sale equity instrument are recognised in profit or loss when the entity’s right to receive payment is established. |
|  |  |  | For financial assets and financial liabilities carried at amortised cost, a gain or loss is recognised in profit or loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are designated as hedged items the accounting for the gain or loss shall follow the hedge accounting requirements of AASB 139. If an entity recognises financial assets using settlement date accounting required under AASB 139, any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised if the assets are carried at cost or amortised cost (other than impairment losses). If the assets are carried at fair value, the change in fair value is recognised in profit or loss or in equity as appropriate. |
|  |  |  | Hedge accounting restrictions:  Due to the complexities and difficulties in complying with AASB 132/139 for hedge accounting, it is strongly recommended that entities do not apply hedge accounting. This recommendation to avoid the use of formal hedge accounting should not discourage an entity from entering into derivative financial instruments to manage financial risks, such as its interest rate or currency risks inherent in its borrowing or asset management activities. There shall be consistency in the way that the derivatives and the underlying instruments concerned are recorded, measured and values adjusted. However if derivatives are designated as an accounting hedge, then the entity shall follow AASB 139 with regard to its application of hedge accounting. |
| Relevant pronouncements |  |  | AASB 7 *Financial Instruments: Disclosures* (December 2013)  AASB 101 *Presentation of Financial Statements* (December 2013)  AASB 132 *Financial Instruments: Presentation* (December 2013)  AASB 139 *Financial Instruments: Recognition and Measurement* (June 2014)  FRD 116A *Financial instruments – public financial corporations* (June 2016) |
| Background |  |  | AASB 2005‑4 amended AASB 139 to impose stringent criteria on the circumstances under which AASB 139 allows any financial asset or financial liability to be designated when initially recognised as a financial asset or financial liability at fair value through profit or loss. With some exceptions, this FRD requires all financial assets (and liabilities) that will be incorporated in the financial results and position of the whole of state to be classified as “available for sale” and so measured at fair value with movements in fair value to be recognised in equity, until the financial instrument is derecognised and the movements shall be recognised in the operating statement.  The ‘held to maturity’ financial asset designation allowed under AASB 139 requires DTF written approval before an entity can adopt these designations because harsh ramifications supplement the stringent tests in regard to ‘held‑to‑maturity’ asset designations. Sales or reclassifications of ‘held‑to‑maturity’ assets, other than the limited exceptions outlined in this FRD and AASB 139, result in any remaining ‘held‑to‑maturity’ assets being reclassified as ‘available‑for‑sale’ and recorded in the reporting period in which the sale or transfer occurred. Further, if an entity is not permitted to use the ‘held‑to‑maturity’ designation as a result of a sale or reclassification, the ‘held‑to‑maturity’ designation also shall not be used in the consolidated financial statements of the State of Victoria.  This FRD came into effect in the first annual reporting period beginning on or after 1 January 2005. Although AASB 1 requires prior period information to be restated, the State of Victoria elected to apply the exemption allowed under AASB 1 to not restate information required under AASB 132 and AASB 139.  If a hedge of a purchase or sale of a capital item or any other unrecognised firm commitment or highly probable forecast transaction subsequently results in the recognition of a non‑financial asset or non‑financial liability, then the standard allows an entity to either (a) reclassify hedging gains/losses into profit/loss in the same periods in which the asset or liability affects profit/loss; or (b) transfer the hedging gains/losses into the initial carrying amount of the asset/liability. This FRD limits the choice to Option (b) to ensure consistency and that the cost of the asset reflects any hedging performed.  Until the introduction of A‑IFRS, the market borrowings held by TCV were revised to amortised cost on consolidation in the *Financial Report for the State of Victoria*. Commencing with 2005‑06, there shall be no adjustment to these liabilities and consequently these borrowings shall be recorded at fair value in the *Financial Report for the State of Victoria*.  This FRD was revised in June 2016 to remove the first‑time adoption requirements as they are no longer required. References to comparative information were removed as it applies to transitional periods. The ‘Model for Disclosure within Financial Report’ section was also removed as this disclosure has been included in the *Model Report for Victorian Government Departments*. |

# Appendix A

## Financial instruments measurement and accounting matrix preferred designations

| **Financial instrument** |  | **Measured at** | | | |  | |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Designations requiring  DTF prior approval** | **Fair value** | |  | | **Subject to impairment** | |
| **Thru P&L** | **Thru equity** | **Amortised cost** | |
| Asset loans and receivables   * Term deposits not quoted in an active market * Receivables, including trade debtors and loans, that are not quoted in an active market and the entity has no intention to sell the assets |  |  |  | **√**  **√** | **√**  **√** | |
| Assets at fair value through profit or loss   * Receivables that are not designated as ‘loans and receivables’ nor ‘available for sale’ nor ‘held‑to‑maturity’ * Shares and other equity investments quoted in an active market or able to be reliably measured (see footnote\*) * Financial assets that back general insurance liabilities |  | **√**  **√**  **√** |  |  |  | |
| Assets available‑for‑sale   * Receivables that are not designated as ‘loans and receivables’ nor ‘assets at fair value through profit or loss’ nor ‘held‑to‑maturity’ * Term deposits that are not designated as ‘held‑to‑maturity’ nor ‘loans and receivables’ * Debt securities and other placements (assuming the securities may be sold before maturity) * Shares that are not designated as ‘at fair value through profit or loss’ |  |  | **√**  **√**  **√**  **√** |  | **√**  **√**  **√**  **√** | |
| Assets (quoted in an active market) held‑to‑maturity   * Receivables that are not designated as ‘assets at fair value through profit or loss’ nor ‘available‑for‑sale’ * Term deposits that are not designated as ‘available for sale’ nor ‘loans and receivables’ and where intention and practice is to hold to maturity * Debt securities and other placements that are not designated as ‘fair value through profit or loss’ nor ‘available for sale’ | **√**  **√    √** |  |  | **√**  **√    √** | **√**  **√    √** | |
| Liabilities at fair value through profit or loss (only those held for trading) or rarely meeting other conditions   * Interest bearing liabilities where there is a quoted market price in an active market |  | **√** |  |  |  | |
| Other Liabilities   * Interest bearing liabilities where market is inadequate (including borrowings from TCV) * Payables |  |  |  | **√**  **√** |  | |
| Derivatives   * Not designated as an accounting hedge * Designated as an accounting hedge – cashflow * Designated as an accounting hedge – fair value |  | **√**  **√** | **√** |  |  | |
| Embedded derivatives   * Embedded derivatives * Embedded derivatives where separation from the host contract is prohibited (see footnote #) |  | **√** | **√** | **√** | **√** | |

* Shares and other equity investments that cannot be reliably measured, are measured at cost (subject to impairment tests).
* Where the embedded derivatives are not separately accounted for from the host contract, it would be measured in accordance with the measurement requirements of the host contract.

# Appendix B

## Example – calculating amortised cost of a financial liability

The entity has interest bearing debt finance where there is no active market in existence.

The loan’s fair value at inception is $1 000 (including transaction costs), with a principal amount due of $1 250 after 5 years (i.e. premium of $250 attaches to loan).

A fixed rate of interest of 4.7% pa accrues on the principal and is paid annually.

In order to allocate interest payments and the initial premium over the term of the debt instrument at a constant rate on the carrying amount, interest shall be accrued at the rate of 10% annually (calculated as the internal rate of return on the expected cash inflows and outflows). The below table provides information about the amortised cost, interest expense and cash flows of the debt instrument in each reporting period.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **a** | **b** | **c** |  |
| **Year** | **Amortised cost  at beg of yr** | **Interest expense (a x 10%)** | **Cash outflow** | **Amortised cost  at end of yr (a + b – c)** |
| 0 | 1,000 | 100 | 59 | 1,041 |
| 1 | 1,041 | 104 | 59 | 1,086 |
| 2 | 1,086 | 109 | 59 | 1,136 |
| 3 | 1,136 | 113 | 59 | 1,190 |
| 4 | 1,190 | 119 | 59 + 1,250 | ‑ |
| **Total** |  | **545** | **1545** |  |