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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**December 2008, London**
Project:	**IFRS for Private Entities (formerly IFRS for SMEs)**
Subject:	**Redeliberation of Approach for Financial Instruments (Section 11) Draft of Section 11A – Basic Financial Instruments (Attachment to Agenda Paper 5C)**

Section 11 (Part A)
Basic Financial Instruments

Overview

11.1 Section 11 is split into two parts, Section 11A and Section 11B. Section 11A (this part) applies to basic **financial instruments** and will be relevant to all entities. Section 11B applies to more complex financial instruments. If an entity enters into only basic financial instrument transactions then it will not need to apply Section 11B. However, even entities with only basic financial instruments shall consider the scope of Section 11B to ensure they are exempt.

11.2 To be considered a basic financial instrument within the scope of Section 11A, an instrument must satisfy the conditions in paragraph 11.6. Examples of financial instruments that are normally considered basic financial instruments include:

(a) cash;

(b) demand and fixed-term deposits;

(c) commercial paper and commercial bills;

(d) accounts, notes and loans receivable and payable;

(e) bonds and similar debt instruments;

(f) investments in non-convertible and non-puttable ordinary and preferred shares; and

(g) a commitment to make or receive a loan that cannot be net settled in cash.

11.3 Examples of financial instruments that would not normally satisfy the conditions in paragraph 11.6, and therefore will be in the scope of Section 11B, include:

(a) asset-backed securities such as collateralised mortgage obligations, repurchase agreements, and securitised packages of receivables;

(b) options, rights, warrants, futures contracts, forward contracts, and interest rate swaps that can be settled in cash or by exchanging another financial instrument; and

(c) financial instruments that are designated as hedging instruments under the requirements in Section 11B.

Scope

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

11.5 Section 11A applies to all financial instruments meeting the conditions of paragraph 11.6 except for the following:

(a) interests in **subsidiaries** (covered by Section 9 *Consolidated and Separate Financial Statements*), **associates** (see Section 13 *Investments in Associates*) and **joint ventures** (see Section 14 *Investments in Joint Ventures*);

(b) employers' rights and obligations under employee benefit plans (see Section 27 *Employee Benefits*);

(c) rights under insurance contracts (some rights under insurance contracts are within the scope of Section 11B *Additional financial Instrument Issues*);

(d) financial instruments that meet the definition of an entity's own equity (see Sections 21 *Equity* and 25 *Share-based Payment*);

(e) leases (see Section 19 *Leases*); and

(f) financial instruments designated as hedging instruments under Section 11B.

Basic financial instruments

11.6 An entity shall account for the following financial instruments as basic financial instruments under Section 11A:

(a) An instrument (such as a receivable, payable or loan) that meets the conditions in paragraph 11.7.

(b) A commitment to make or receive a loan that:

(i) cannot be settled net in cash, and

(ii) when executed, is expected to meet the conditions in paragraph 11.7.

(c) An investment in non-convertible and non-puttable ordinary shares or preference shares

11.7 A financial instrument that meets the following conditions shall be accounted for under Section 11A:

(a) It has a specified maturity date or is due on demand and, at or before the specified maturity date, it requires repayment of all or substantially all of the amount of consideration received or paid when it was issued.

(b) Returns to the holder are

(i) a fixed amount,

(ii) a fixed rate of return over the life of the instrument,

(iii) a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR) or

(iv) some combination of these fixed rate and variable rates (such as LIBOR plus 200 basis points). For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal outstanding during the period.

(c) There is no contractual provision that could result in the holder losing the principal amount and any interest attributable to the current period or prior periods.

(d) Contractual provisions that permit the issuer to prepay the debt or permit the holder to put it back to the issuer before maturity are not contingent on future events. The instrument may require the party exercising an early settlement right to make a penalty payment as long as the penalty is a fixed amount, a specified percentage of the invested amount or principal amount outstanding at the date of exercise, or an amount based on a change in an interest rate that reduces the benefit that otherwise would be obtained by the party exercising the settlement right.

(e) There are no conditional returns or repayment provisions except for the variable rate return described in (b) and prepayment provisions described in (d).

11.8 Examples of financial instruments that would typically satisfy the conditions in paragraph 11.7 are:

(a) normal trade accounts and notes receivable and payable and loans from banks or other third parties.

(b) accounts payable in a foreign currency, because the contractual cash flows typically satisfy the conditions in paragraph 11.7. However, any change in the account payable because of a change in the exchange rate is recognised in profit or loss as required by paragraph 30.10 of Section 30 *Foreign Currency Translation*.

(c) loans to or from subsidiaries or associates that are due on demand.

(d) a debt instrument that would become immediately receivable if the issuer defaults on an interest or principal payment (such a provision does not violate the conditions in paragraph 11.7).

11.9 Examples of financial instruments that do not satisfy the conditions in paragraph 11.7 include:

(a) investments in another entity's equity instruments (however, investments in ordinary shares and preference shares are included within paragraph 11.6(c))

(b) an interest rate swap that returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow, because such swaps and forwards do not meet the condition in paragraph 11.7(b).

(c) options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 11.7(b) is not met.

(d) investments in convertible debt, because the return to the holder can vary with the price of the debt issuer's equity shares rather than just with market interest rates.

(e) perpetual debt, because it does not have a maturity date as required by paragraph 11.7(a).

Initial recognition of financial assets and liabilities

11.10 An entity shall recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

Initial measurement

11.11 When a financial asset or financial liability is recognised initially, an entity shall measure it at cost (ie the fair value of the consideration given or received) as follows unless there is evidence to suggest that the transaction did not take place at arm's length between willing parties:

(a) When a financial asset is recognised initially, an entity shall measure it at the amount of any cash or cash equivalents paid plus the fair value of any other consideration given to acquire the asset at the time of its acquisition. If payment of the cash or other consideration is deferred, the entity shall measure the financial asset received at the **present value** of the consideration.

Examples

1. For a loan made to another entity, a receivable is recognised at the amount of cash given to that entity.
2. For goods sold to a customer on short-term credit, a receivable is recognised at the fair value of the goods sold, which is normally the invoice price.
3. For an item sold to a customer on two-year interest-free credit, a receivable is recognised at the fair value of the item sold, which is normally the invoice price discounted over two years.
4. For a purchase of another entity's ordinary shares for cash, the investment is recognised at the amount of cash paid to acquire the shares, which is normally the market value of the shares at that date.

(b) When a financial liability is recognised initially, an entity shall measure it at the amount of any cash or cash equivalents received plus the fair value of any other consideration received in exchange for the obligation at the time of its incurrence.

Examples

1. For a loan received from a bank, a payable is recognised at the amount of cash received from the bank.
2. For goods purchased from a supplier on short-term credit, a payable is recognised at the fair value of the goods received, which is normally the invoice price.

If there is evidence to suggest that the transaction did not take place at arm's length between willing parties, the entity shall record the transaction as if it had been undertaken on an arm's length basis. Any difference between the amount recognised for the financial asset (or liability) and the amount of consideration paid (or received) for that financial asset (or liability) should be recognised in profit or loss. Evidence that a transaction did not take place at arm's length may be, for example, an indication of a distress sale or indication that the transaction was influenced due to entities being under common control or common influence.

11.12 When assessing the amount to recognise initially for receivables and payables with no stated interest rate that are classified as current assets or current liabilities, the original invoice amount shall be used as the fair value of consideration paid/received.

Subsequent measurement

11.13 At each **reporting date**, an entity shall measure financial instruments as follows:

(a) A financial instrument under paragraph 11.6(a) shall be measured at amortised cost (using the **effective interest method**) less impairment. Paragraphs 11.14 to 20 provide guidance on determining amortised cost by applying the effective interest method.

(b) A commitment to make or receive a loan under paragraph 11.6(b) shall be measured at cost less impairment.

(c) An investment in non-convertible and non-puttable ordinary shares or preference shares under paragraph 11.6(c) shall be measured as follows (paragraphs 11.27 to 11.33 provide further guidance):

(i) if the market value of the shares can be measured reliably, the investment shall be measured at market value with changes in market value recognised in profit or loss

(ii) if the shares are not **publicly traded** and their market value cannot otherwise be measured reliably, the investment shall be measured at cost less impairment.

Paragraphs 11.21 to 11.26 provide guidance on assessing impairment of financial instruments in (a), (b) and (c)(ii) above.

Amortised cost

11.14 The amortised cost of a financial asset or financial liability is the net total of the following amounts:

(a) the amount at which the financial asset or financial liability is measured at initial recognition,

(b) minus any repayments of the principal amount,

(c) plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount,

(d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

11.15 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. The effective interest rate is determined based on the initial carrying amount of the financial asset or liability.

11.16 When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses (ie credit losses are considered and recognised as they are incurred, rather than when they are expected).

11.17 When applying the effective interest method, an entity generally amortises any related fees, finance charges 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.

11.18 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

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

Example of determining amortised cost for a 5-year loan using the effective interest method

On 1 January 20X0, an entity acquires a bond for consideration of CU$90, incurring transaction costs of CU5. Interest of CU4 is receivable annually over the next 5 years (31 December 20X0 to 31 December 20X4). The bond has a mandatory redemption of CU110 on 31 December 20X4.

Year	**Carrying amount at beginning of period**	**Interest income at 6.96%**	**Cash flow**	**Carrying amount at end of period**
20X0	95.00	6.61	(4.00)	97.61
20X1	97.61	6.79	(4.00)	100.40
20X2	100.40	6.99	(4.00)	103.39
20X3	103.39	7.19	(4.00)	106.58
20X4	106.58	7.42	(4.00)	110.00
			(110.00)	0

The effective interest rate of 6.96 per cent is the rate that discounts the expected cash flows on the bond to the initial carrying amount, i.e.:

$4/1.0696 + 4/1.0696^2 + 4/1.0696^3 + 4/1.0696^4 + 114/1.0696^5 = 95$

11.20 When determining amortised cost for receivables and payables with no stated interest rate that are classified as current assets or current liabilities, amortised cost is equal to the amount recognised at initial recognition minus any repayments of that amount and, in the case of receivables, minus any reduction for impairment or uncollectibility.

Impairment of financial instruments measured at cost or amortised cost

Recognition

11.21 At the end of each **reporting period**, an entity shall assess for impairment all financial assets that are measured at cost or amortised cost. If there is objective evidence of impairment, the entity shall recognise an **impairment loss** in profit or loss.

11.22 Objective evidence that a financial asset or group of assets is impaired includes observable data that come 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 creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider;

(d) it has become **probable** that the debtor will enter bankruptcy or other financial reorganisation;

(e) the disappearance of an active market for that financial asset because of the debtor's 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, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions.

11.23 Other factors may also be evidence of impairment, including significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates.

11.24 Financial assets that are individually significant, and all equity instruments regardless of significance, shall be assessed individually for impairment. Other financial assets shall be assessed for impairment either individually or grouped on the basis of similar credit risk characteristics.

Measurement

11.25 An entity shall measure an impairment loss on the following instruments measured at cost or amortised cost less impairment as follows:

(a) for an instrument that meets the conditions in paragraph 11.7 and is therefore measured at amortised cost, the impairment loss is the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate; and

(b) for an instrument measured at cost less impairment in accordance with paragraph 11.13(b) and 11.13(c)(ii) the impairment loss is the difference between the asset's carrying amount and the best estimate (which will necessarily be an approximation) of the amount (which might be zero) that the entity would receive for the asset if it were to be sold.

Reversal

11.26 If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the entity shall reverse the previously recognised impairment loss either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset (net of any allowance account) that exceeds what the carrying amount would have been had the impairment not previously been recognised. The entity shall recognise the amount of the reversal in profit or loss.

Market value

11.27 Paragraph 11.14(c)(i) requires an investment in ordinary shares or preference shares to be measured at market value if the market value of the shares can be measured reliably. An entity shall use the following hierarchy to estimate the market value of the shares:

(a) The best evidence of market value is a quoted price in an active market. This is usually the current bid price.

(b) When quoted prices are unavailable, the price of a recent transaction provides evidence of the current market value as long as there has not been a significant change in economic circumstances nor a significant lapse of time since the occurrence of the transaction. If the entity can demonstrate that the last transaction price is not a good estimate of market value (eg 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.

(c) If the market for the shares is not active and recent transactions on their own are not a good estimate of market value, an entity estimates the market value by using a valuation technique. The objective of using a valuation technique is to estimate what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations.

11.28 An entity shall not include transaction costs in the initial measurement of financial assets and liabilities measured at market value through profit or loss.

Valuation technique

11.29 If the market for a financial instrument is not active, an entity establishes market 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 market 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.

11.30 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 business considerations. Market 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 market 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.

No active market: equity instruments

11.31 The market value of investments in equity instruments that do not have a quoted market price in an active market is reliably measurable if (a) the variability in the range of reasonable market 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.

11.32 There are many situations in which the variability in the range of reasonable market value estimates of investments in equity instruments that do not have a quoted market price 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 market value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at market value.

11.33 If a reliable measure of market value is no longer available for an equity instrument measured at market value through profit or loss, its **carrying amount** at the date of the change becomes its new cost. The entity shall measure the instrument at this cost amount less impairment until a reliable measure of market value becomes available.

Derecognition of a financial asset

11.34 An entity shall **derecognise** a financial asset only when:

(a) the contractual rights to the cash flows from the financial asset expire or are settled, or

(b) the entity transfers to another party all of the significant risks and rewards relating to the financial asset; or

(c) the entity has retained some significant risks and rewards relating to the financial asset and the special conditions described in Section 11B are met. Such cases must be accounted for under Section 11B and will only result in derecognition if the special conditions in that section are met.

11.35 An entity shall account for a debt factoring or similar transaction in accordance with paragraphs 11.38 to 11.40. Under those paragraphs, in some cases the asset is derecognised and in other cases it is not derecognised. In some cases where the asset is not derecognised it is presented in a 'linked presentation' with the related liability.

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

11.37 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, the transferor shall reclassify that asset in its balance sheet (eg as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

(b) If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.

(c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.

(d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.

Debt factoring

11.38 Factoring is the sale of receivables to a bank or other party at a discount. Where the selling entity has transferred to the factor all significant benefits (ie the future cash flows from payment by the debtors) and all significant risks (ie slow payment risk and the risk of bad debts) relating to the debts, and has no obligation to repay the factor, the debts shall be removed from the entity's statement of financial position and no liability shall be shown in respect of the proceeds received from the factor. A profit or loss shall be recognised, calculated as the difference between the carrying amount of the debts and the proceeds received. Arrangements similar to factoring, such as invoice discounting (borrowing where the receivable is used as collateral), shall be accounted for in the same way as debt factoring.

11.39 Where the selling entity has retained significant benefits and risks relating to factored debts, and all the following conditions are met:

(a) there is absolutely no doubt that the entity's exposure to loss is limited to a fixed monetary amount (eg because there is no recourse or such recourse has a fixed monetary ceiling);
(b) amounts received from the factor are secured only on the debts factored;
(c) the debts factored are capable of separate identification;
(d) the debt factor has no recourse to other debts or assets;
(e) the entity has no right to reacquire the debts in the future;
(f) the factor has no right to return the debts even in the event of the cessation of the factoring agreement,

then the factored debts shall be shown gross (after providing for bad debts, credit protection charges and any accrued interest) separately on the face of the statement of financial position. Any amounts received from the factor in respect of those debts, to the extent that they are not returnable, shall be shown as deductions there from on the face of the statement of financial position (a 'linked presentation'). The financial statements shall include a note stating that the entity is not required to support bad debts in respect of factored debts and that the factors have stated in writing that they will not seek recourse other than out of factored debts. The interest element of the factor's charges shall be recognised as it accrues and included in the profit and loss account with other interest charges.

11.40 In all other cases the factored receivable shall not be derecognised. Therefore, the receivable shall be shown on the statement of financial position of the entity within assets and a corresponding liability in respect of the proceeds received from the factor shall be shown within liabilities. The interest element of the factor's charges and other factoring costs shall be recognised as they accrue and included in the profit and loss account with other interest charges.

Derecognition of a financial liability

11.41 An entity shall derecognise a financial liability (or a part of a financial liability) only when it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

11.42 If an existing borrower and lender exchange debt instruments with substantially different terms, the entities shall account for the transaction as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, an entity shall account for 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) as an extinguishment of the original financial liability and the recognition of a new financial liability. The entity shall recognise in profit or loss any 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.