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# Section 11
## *Financial Assets and Financial Liabilities*

### Accounting policy choice

11.1 An entity shall choose to apply either:

(a) the provisions of this section, or

(b) IAS 39 *Financial Instruments: Recognition and Measurement*

in full to account for all of its financial instruments. An entity that chooses to apply IAS 39 shall make the disclosures required by IFRS 7 *Financial Instruments: Disclosures.* An entity's choice of (a) or (b) is an **accounting policy** choice. Paragraphs 10.6–10.12 of Section 10 *Accounting Policies, Estimates and Errors* contain requirements for determining when a change in accounting policy is appropriate, how such a change should be accounted for, and what information should be disclosed about the change in accounting policy.

### Scope

11.2 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. Common examples 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) ordinary and preferred shares and similar equity instruments;

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

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


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11.3 This section applies to all financial instruments except 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 unless the insurance contract could result in a loss to either party as a result of contractual terms that are unrelated to:

(i) changes in the insured risk,

(ii) changes in foreign exchange rates, or

(iii) a default by one of the counterparties;

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

(e) leases (see Section 19 *Leases*) unless the lease could result in a loss to the lessor or the lessee as a result of contractual terms that are unrelated to:

(i) changes in the price of the leased asset,

(ii) changes in foreign exchange rates, or

(iii) a default by one of the counterparties.

11.4 Most contracts to buy or sell a non-financial item such as a commodity, inventory, property, plant or equipment are excluded from this section because they are not financial instruments. However, this section applies to all contracts that could result in a loss to the buyer or seller as a result of contractual terms that are unrelated to changes in the price of the non-financial item, changes in foreign exchange rates, or a default by one of the counterparties.

11.5 In addition to the contracts described in paragraph 11.4, this section applies to contracts to buy or sell non-financial items if the contract can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the following exception: contracts that were entered into and

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continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are not financial instruments for the purposes of this section.

## Initial recognition of financial assets and liabilities

11.6 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.

## Measurement

11.7 At each **reporting date**, an entity shall measure the following financial instruments at cost or amortised cost less impairment, as indicated:

(a) an instrument (such as a receivable, payable, or loan) that meets the conditions of paragraph 11.9, and that the entity designates at initial **recognition** to be measured at amortised cost (using the **effective interest method**) less impairment. Appendix A to this section provides guidance on applying the effective interest method.

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

(i) cannot be settled net in cash,

(ii) when executed, is expected to meet the conditions for recognition at cost or amortised cost less impairment, and

(iii) the entity designates at initial recognition to be measured at cost less impairment.

(c) equity instruments that are not **publicly traded** and whose **fair value** cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, which shall be measured at cost less impairment.

11.8 With the exception of those financial instruments measured at cost or amortised cost less impairment in accordance with paragraph 11.7, at each reporting date an entity shall measure all financial instruments at fair value, without any deduction for transaction costs it may incur on sale or other disposal, and recognise changes in fair value recognised in profit or loss.


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11.9 An entity may designate an instrument for measurement at amortised cost, in accordance with paragraph 11.7(a), only if it meets all of the following conditions:

(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).

For the purpose of applying these conditions to the debt component of a **compound financial instrument**, an entity first separates the equity component as required by paragraph 21.7 of Section 21 *Equity*.

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11.10 Examples of financial instruments that would be, or could be designated to be, measured at cost or amortised cost less impairment are:

(a) normal trade accounts and notes receivable and payable and loans from banks or other third parties, because these typically satisfy the conditions in paragraph 11.9.

(b) investments in non-convertible debt instruments, because these typically satisfy the conditions in paragraph 11.9.

(c) a contract or right (option) to buy an equity instrument whose fair value cannot be reliably measured if the contract or right will result in the delivery of the equity instrument, because that equity instrument is measured at cost less impairment in accordance with paragraph 11.7(c).

(d) accounts payable in a foreign currency, because the contractual cash flows typically satisfy the conditions in paragraph 11.9. 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*.

(e) loans to or from subsidiaries or associates that are due on demand, because they typically satisfy the conditions in paragraph 11.9.

(f) 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 11.9).

11.11 Examples of financial instruments that are not measured at cost or amortised cost less impairment are as follows. They are measured at fair value through profit or loss (see paragraph 11.8):

(a) investments in equity instruments with published price quotations, because paragraph 11.7(c) allows measurement at cost less impairment only for equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably.

(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 11.9(b).

(c) options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 11.9(b) is not met.

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(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 11.9(a).

11.12 An entity shall not change its policy for the subsequent measurement of a financial asset or liability into or out of the fair value through profit or loss category while it is held or issued.

11.13 If a reliable measure of fair value is no longer available for an equity instrument measured at fair value through profit or loss, its fair value **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 fair value becomes available.

## Fair value

11.14 Paragraph 11.8 requires some financial instruments to be measured at fair value. The best evidence of fair value is a quoted price in an active market. If the market for a financial instrument is not active, an entity estimates fair 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.

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

11.16 An entity shall not include transaction costs in the initial measurement of financial assets and liabilities measured at fair value through profit or loss. If payment for the asset is deferred or is financed at a rate of interest that is not a market rate, the entity shall measure cost at the **present value** of the future payments discounted at a market rate of interest.

11.17 An entity shall apply the additional guidance on estimating the fair value of a financial asset or a financial liability that is provided in Appendix B to this section.

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## Impairment of financial instruments measured at cost or amortised cost

### Recognition

11.18 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. Financial instruments measured at fair value through profit or loss are not specially assessed for impairment because the fair valuation process automatically recognises any impairment.

11.19 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.

11.20 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.



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11.21 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

11.22 An entity shall measure an impairment loss as follows:

(a) for an instrument measured at amortised cost less impairment in accordance with paragraph 11.7(a), 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 11.7(b) and (c), the impairment loss is the difference between the asset's carrying amount and the asset's fair value.

### Reversal

11.23 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.

## Derecognition of a financial asset

11.24 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;

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

(c) the entity, despite having retained some significant risks and rewards relating to the financial asset, has transferred control of the asset to another party and the other party has the practical

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ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer. In this case, the entity shall:

(i) derecognise the asset, and

(ii) recognise separately any rights and obligations created or retained in the transfer.

The carrying amount of the transferred asset shall be allocated between the rights or obligations retained and those transferred based on their relative fair values at the transfer date. Newly created rights and obligations shall be measured at their fair values at that date. Any difference between the consideration received and the amounts recognised and derecognised in accordance with this paragraph shall be recognised in profit or loss in the period of the transfer.

11.25 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.

11.26 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


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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.

## Derecognition of a financial liability

11.27 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.

11.28 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.

## Hedge accounting

11.29 An entity may designate a hedging relationship between a **hedging instrument** and a **hedged item** in such a way as to qualify for hedge accounting. If specified criteria are met, hedge accounting permits the gain or loss on the hedging instrument and on the hedged item to be recognised in profit or loss at the same time.

11.30 To qualify for hedge accounting, an entity shall comply with all of the following conditions:

(a) the entity designates and documents the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified and the risk in the hedged item is the risk being hedged with the hedging instrument.

(b) the hedged risk is one of the risks specified in paragraph 11.31.

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(c) the hedging instrument is as specified in paragraph 11.32.

(d) the entity expects the hedging instrument to be highly effective in offsetting the designated hedged risk. The **effectiveness of a hedge** is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

11.31 This [draft] standard permits hedge accounting only for:

(a) interest rate risk of a debt instrument measured at amortised cost;

(b) foreign exchange or interest rate risk in a firm commitment or a **highly probable forecast transaction**;

(c) price risk of a commodity that it holds or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity; or

(d) foreign exchange risk in a net investment in a foreign operation.

11.32 This [draft] standard permits hedge accounting only if the hedging instrument has all of following terms and conditions:

(a) it is an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract or a commodity forward exchange contract that is expected to be highly effective in offsetting a risk identified in paragraph 11.31 that is designated as being the hedged risk.

(b) it involves a party external to the reporting entity (ie external to the group, segment or individual entity being reported on).

(c) its **notional amount** is equal to the designated amount of the principal or notional amount of the hedged item.

(d) it has a specified maturity date not later than

(i) the maturity of the financial instrument being hedged,

(ii) the expected settlement of the commodity purchase commitment, or

(iii) the occurrence of the highly probable forecast foreign currency or commodity transaction being hedged.

(e) it has no prepayment, early termination or extension features.

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## Hedge of fixed interest rate risk of a recognised financial instrument or commodity price risk of a commodity held

11.33 If the conditions in paragraph 11.30 are met and the hedged risk is the exposure to a fixed interest rate risk of a debt instrument measured at amortised cost or the commodity price risk of a commodity that it holds, the entity shall:

(a) recognise the hedging instrument as an asset or liability and the change in the fair value of the hedging instrument in profit or loss; and

(b) recognise the change in the fair value of the hedged item related to the hedged risk in profit or loss and as an adjustment to the carrying amount of the hedged item.

11.34 If the hedged risk is the fixed interest rate risk of a debt instrument measured at amortised cost, the entity shall recognise the periodic net cash settlements on the interest rate swap that is the hedging instrument in profit or loss in the period in which the net settlements accrue.

11.35 The entity shall discontinue the hedge accounting specified in paragraph 11.33 if:

(a) the hedging instrument expires or is sold or terminated;

(b) the hedge no longer meets the conditions for hedge accounting specified in paragraph 11.30; or

(c) the entity revokes the designation.

11.36 If hedge accounting is discontinued and the hedged item is an asset or liability carried at amortised cost that has not been derecognised, any gains or losses recognised as adjustments to the carrying amount of the hedged item are amortised into profit or loss using the effective interest method over the remaining life of the hedged instrument.

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## Hedge of variable interest rate risk of a recognised financial instrument, foreign exchange risk or commodity price risk in a firm commitment or highly probable forecast transaction, or a net investment in a foreign operation

11.37 If the conditions in paragraph 11.30 are met and the hedged risk is

(a) the variable interest rate risk in a debt instrument measured at amortised cost,

(b) the foreign exchange risk in a **firm commitment** or a highly probable forecast transaction,

(c) the commodity price risk in a firm commitment or highly probable forecast transaction, or

(d) the foreign exchange risk in a net investment in a foreign operation,

the entity shall recognise directly in equity the portion of the change in the fair value of the hedging instrument that was effective in offsetting the change in the fair value or expected cash flows of the hedged item. The entity shall recognise any excess of the fair value of the hedging instrument over the change in the fair value of the expected cash flows in profit or loss. The hedging relationship ends for (a), (b) and (c) when the hedged transaction occurs and for (d) when the net investment in the foreign operation is sold. The hedging gain or loss recognised in equity shall be reclassified to profit and loss when the hedged item is recognised in profit and loss.

11.38 If the hedged risk is the variable interest rate risk in a debt instrument measured at amortised cost, the entity shall subsequently recognise the periodic net cash settlements from the interest rate swap that is the hedging instrument in profit or loss in the period in which the net settlements accrue.

11.39 The entity shall discontinue the hedge accounting specified in paragraph 11.37 or 11.38 if:

(a) the hedging instrument expires or is sold or terminated;

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 11.30;



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(c) in a hedge of a forecast transaction, the forecast transaction is no longer highly probable; or

(d) the entity revokes the designation.

If the forecast transaction is no longer expected to take place or if the hedged debt instrument measured at amortised cost is derecognised, any gain or loss on the hedging instrument that was recognised directly in equity shall be removed from equity and recognised in profit or loss.

## Disclosure

### Disclosure of accounting policies for financial instruments

11.40 In accordance with paragraph 8.5 of Section 8 *Notes to the Financial Statements*, an entity shall disclose, in the summary of significant accounting policies, the measurement basis (or bases) used for financial instruments and the other accounting policies used for financial instruments that are relevant to an understanding of the financial statements.

### Balance sheet—categories of financial assets and financial liabilities

11.41 An entity shall disclose the carrying amounts of each of the following categories of financial assets and financial liabilities, in total and by each significant type of financial asset or financial liability within each category, either on the face of the balance sheet or in the notes:

(a) financial assets measured at fair value through profit or loss (paragraph 11.8);

(b) financial assets measured at amortised cost less impairment (paragraph 11.7(a));

(c) equity instruments measured at cost (paragraph 11.7(c));

(d) loan commitments measured at cost less impairment (paragraph 11.7(b));

(e) financial liabilities measured at fair value through profit or loss (paragraph 11.8); and

(f) financial liabilities measured at amortised cost (paragraph 11.7(a)).

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11.42 For all financial assets and financial liabilities measured at fair value, the entity shall disclose the basis for determining fair value, eg quoted market price in an active market or a valuation technique. When a valuation technique is used, the entity shall disclose the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates.

11.43 If a reliable measure of fair value is no longer available for an equity instrument measured at fair value through profit or loss, the entity shall disclose that fact.

## Derecognition

11.44 If an entity has transferred financial assets to another party in a transaction that does not qualify for derecognition (see paragraphs 11.24–11.26), the entity shall disclose for each class of such financial assets:

(a) the nature of the assets;

(b) the nature of the risks and rewards of ownership to which the entity remains exposed; and

(c) the carrying amounts of the assets and of any associated liabilities that the entity continues to recognise.

## Collateral

11.45 When an entity has pledged financial assets as collateral for liabilities or contingent liabilities, it shall disclose:

(a) the carrying amount of the financial assets pledged as collateral; and

(b) the terms and conditions relating to its pledge.

## Defaults and breaches on loans payable

11.46 For loans payable recognised at the reporting date, an entity shall disclose:

(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable that permit the lender to demand repayment at the reporting date;


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(b) the carrying amount of the loans payable in default at the reporting date; and

(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

11.47 If, during the period, there were breaches of loan agreement terms other than those described in paragraph 11.46, an entity shall disclose the same information as is required by paragraph 11.46 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

## Income statement and equity—items of income, expense, gains or losses

11.48 An entity shall disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

(a) net gains or net losses recognised on:

(i) financial assets measured at fair value through profit or loss;

(ii) financial liabilities measured at fair value through profit or loss;

(iii) financial assets measured at amortised cost less impairment; and

(iv) financial liabilities measured at amortised cost;

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss; and

(c) the amount of any impairment loss for each class of financial asset.

## Hedge accounting

11.49 An entity shall disclose the following separately for hedges of each of the four types of risks described in paragraph 11.31:

(a) a description of the hedge;

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(b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and

(c) the nature of the risks being hedged, including a description of the hedged item.

11.50 For a hedge of fixed interest rate risk or commodity price risk of a commodity held (paragraphs 11.33–11.36) the entity shall disclose:

(a) the amount of the change in fair value of the hedging instrument recognised in profit or loss and

(b) the amount of the change in fair value of the hedged item recognised in profit or loss.

11.51 For a hedge of variable interest rate risk, foreign exchange risk, commodity price risk in a firm commitment or highly probable forecast transaction, or a net investment in a foreign operation (paragraphs 11.37–11.39) the entity shall disclose:

(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;

(b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;

(c) the amount of the change in fair value of the hedging instrument that was recognised in equity during the period (paragraph 11.37);

(d) the amount that was removed from equity and recognised in profit or loss for the period, showing the amount included in each line item in the income statement (paragraphs 11.38 and 11.39).

## Risks relating to financial instruments measured at cost or amortised cost

11.52 For financial assets measured at amortised cost less impairment, the entity shall disclose the significant terms and conditions that may affect the amount, timing and certainty of future cash flows, including interest rate risk, foreign exchange rate risk and credit risk.



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# Appendix A to Section 11
# Effective interest rate

*This Appendix accompanies, but is not part of, Section 11. It provides guidance for applying the effective interest method in accordance with paragraph 11.7.*

11A.1 In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

11A.2 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

11A.3 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.

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11A.4 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.

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# Appendix B to Section 11
# Fair value measurement considerations

*This Appendix is an integral part of Section 11.*

11B.1 Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

## Active market: quoted price

11B.2 A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the reporting date in that instrument (ie without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

11B.3 The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the

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time of the transaction. If conditions have changed since the time of the transaction (eg a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (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. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

11B.4 If a rate (rather than a price) is quoted in an active market, the entity uses that market quoted rate as an input into a valuation technique to determine fair value. If the market quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

## No active market: valuation technique

11B.5 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

11B.6 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. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects

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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.

11B.7 Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or on the basis of any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or is based on a valuation technique whose variables include only data from observable markets.

11B.8 The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this [draft] standard. The application of paragraph 11B.7 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, this section requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

11B.9 The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (ie similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument,

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holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

11B.10 The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

11B.11 In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

## No active market: equity instruments

11B.12 The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives (options, forward and futures contracts, swaps etc) that are linked to and must be settled by delivery of such an unquoted equity instrument is reliably measurable if


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(a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

11B.13 There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

## Inputs to valuation techniques

11B.14 An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

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

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(b) *Credit risk*. The effect on fair value of credit risk (ie the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.

(c) *Foreign currency exchange prices*. Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.

(d) *Commodity prices*. There are observable market prices for many commodities.

(e) *Equity prices*. Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.

(f) *Volatility (ie magnitude of future changes in price of the financial instrument or other item)*. Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.

(g) *Prepayment risk and surrender risk*. Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount.)

(h) *Servicing costs for a financial asset or a financial liability*. Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.


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