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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:**        **January 2009, London**

**Project:**                **IFRS for Private Entities (formerly IFRS for SMEs)**

**Subject:**                **Draft of Section 11A – Basic Financial Instruments (Attachment A to Agenda Paper 12A)**

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## **Section 11A**

### ***Basic Financial Instruments***

#### **Overview**

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- 11A.1 Section 11 has 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 other, more complex financial instruments. If an entity enters into only basic financial instrument transactions then Section 11B will not be applicable. However, even entities with only basic financial instruments shall consider the scope of Section 11B to ensure they are exempt.
- 11A.2 Basic financial instruments within the scope of Section 11A must satisfy the conditions in paragraph 11A.6. Examples of financial instruments that normally satisfy those conditions include:
- (a) cash;
  - (b) demand and fixed-term deposits where the entity is the depositor, eg bank accounts;

- (c) commercial paper and commercial bills held;
  - (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) commitments to make or receive a loan that cannot be net settled in cash.
- 11A.3 Examples of financial instruments that do not normally satisfy the conditions in paragraph 11A.6, and therefore are 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 qualify to be hedging instruments in accordance with the requirements in Section 11B.

### **Scope**

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- 11A.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.
- 11A.5 Section 11A applies to all financial instruments meeting the conditions of paragraph 11A.6 except for the following:
- (a) interests in **subsidiaries** (see 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) financial instruments that meet the definition of an entity's own equity (see Sections 21 *Equity* and 25 *Share-based Payment*); and
  - (c) leases (see Section 19 *Leases*).

### **Basic financial instruments**

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- 11A.6 An entity shall account for the following financial instruments as basic financial instruments in accordance with Section 11A:
- (a) Cash.
  - (b) A debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11A.7.
  - (c) 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 11A.7.
  - (d) An investment in non-convertible and non-puttable ordinary shares or preference shares.

11A.7 A debt instrument that satisfies all of the conditions in (a) through (e) below shall be accounted for in accordance with Section 11A:

- (a) 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), provided that both the fixed and variable rates are positive (eg, an interest rate swap with a positive fixed rate and negative variable rate would not meet this criteria). 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.
- (b) 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.
- (c) Contractual provisions that permit the issuer to prepay a debt instrument 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.
- (d) There are no conditional returns or repayment provisions except for the variable rate return described in (a) and repayment provisions described in (c).

11A.8 Examples of financial instruments that would typically satisfy the conditions in paragraph 11A.7 are:

- (a) trade accounts and notes receivable and payable, and loans from banks or other third parties.
- (b) accounts payable in a foreign currency. 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 11A.7).

11A.9 Examples of financial instruments that do not satisfy the conditions in paragraph 11A.7 include:

- (a) an investment in another entity's equity instruments other than non-convertible and non-puttable ordinary shares and preference shares. (see paragraph 11A.6(d))
- (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 11A.7(a).
- (c) options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 11A.7(a) is not met.
- (d) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates.
- (e) a loan receivable from a third party that gives the third party the right or obligation to prepay if the applicable taxation or accounting requirements change because such a loan does not meet the condition in paragraph 11A.7(c)

### **Initial recognition of financial assets and liabilities**

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11A.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**

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11A.11 When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price. 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 the asset or liability at the present value of the future payments discounted at a market rate of interest.

#### **Examples – financial assets**

1. For a long-term loan made to another entity, a receivable is recognised at the **present value** of cash receivable (eg including interest payments and repayment of principal) from that entity.
2. For goods sold to a customer on short-term credit, a receivable is recognised at undiscounted cash receivable from that entity, 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 current cash sale price for that item. If the current cash sale price is not known, it may be estimated at the present value of the cash receivable discounted using the prevailing market rate(s) of interest for a similar receivable.
4. For a cash purchase of another entity's ordinary shares, the investment is recognised at the amount of cash paid to acquire the shares.

### Examples – financial liabilities

1. For a loan received from a bank, a payable is recognised initially at the present value of cash payable to the bank (eg including interest payments and repayment of principal).
2. For goods purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier, which is normally the invoice price

### Subsequent measurement

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11A.12 At each **reporting date**, an entity shall measure financial instruments as follows:

- (a) Debt instruments that meet the conditions in paragraph 11A.6(b) shall be measured at amortised cost (using the **effective interest method**) less impairment. Paragraphs 11A.13 to 18 provide guidance on determining amortised cost by applying the effective interest method. Financial instruments that have no stated interest rate and that are classified as current assets or current liabilities shall be measured at the undiscounted amount of the cash or other consideration expected to be paid or received.
- (b) Commitments to make or receive a loan that meet the conditions in paragraph 11A.6(c) shall be measured at cost less impairment.
- (c) Investments in non-convertible and non-puttable ordinary shares or preference shares that meet the conditions in paragraph 11A.6(d) shall be measured as follows (paragraphs 11A.25 to 11A.31 provide further guidance):
  - (i) if the fair value of the shares can be measured reliably, the investment shall be measured at fair value with changes in fair value recognised in profit or loss
  - (ii) if the shares are not **publicly traded** and their fair value cannot otherwise be measured reliably, the investment shall be measured at cost less impairment.

Paragraphs 11A.19 to 11A.24 provide guidance on assessing impairment of financial instruments in (a), (b) and (c)(ii) above.

### Amortised cost

11A.13 The amortised cost of a financial asset or financial liability at each reporting date is the net 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,
- (c) plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition 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.

Financial assets and financial liabilities that have no stated interest rate and that are classified as current assets or current liabilities are initially measured at undiscounted amount under 11A.12, and so (c) does not apply to them.

- 11A.14 The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period, to the carrying amount of the financial asset or financial liability. The effective interest rate is determined based on the carrying amount of the financial asset or liability at initial recognition. Under the effective interest method:
- (a) The amortised cost of a financial asset (liability) is the present value of future cash receipts (payments) discounted at the effective interest rate.
  - (b) The interest expense (income) in a period equals the carrying amount of the financial liability (asset) at the beginning of the reporting period multiplied by the effective interest rate.
- 11A.15 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 it shall not consider future credit losses (ie credit losses are considered and recognised as they are incurred, rather than when they are expected).
- 11A.16 When calculating the effective interest method, an entity shall amortise any related fees, finance charges paid or received, transaction costs and other premiums or discounts over the expected life of the instrument, except as follows: The entity shall use a shorter period if that is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate.
- 11A.17 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect changes 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 at maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.
- 11A.18 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 on the date of the revision.

**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 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.:

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

**Impairment of financial instruments measured at cost or amortised cost***Recognition*

11A.19 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 immediately.

11A.20 Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

- (a) significant financial difficulty of the issuer or obligor;
- (b) a breach of contract, such as a default or delinquency in interest or principal payments;
- (c) the 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.

11A.21 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.

11A.22 An entity shall assess the following financial assets individually for impairment:

- (a) all equity instruments regardless of significance; and
- (b) other financial assets that are individually significant.

An entity shall assess other financial assets for impairment either individually or grouped on the basis of similar credit risk characteristics.

#### *Measurement*

11A.23 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 11A.7 and, therefore, is 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 asset's original effective interest rate; and
- (b) for an instrument measured at cost less impairment in accordance with paragraph 11A.12(b) and 11A.12(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 at the reporting date.

#### *Reversal*

11A.24 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 immediately.

#### **Fair value**

11A.25 Paragraph 11A.12(c)(i) requires an investment in ordinary shares or preference shares to be measured at fair value if the fair value of the shares can be measured reliably. An entity shall use the following hierarchy to estimate the fair value of the shares:

- (a) The best evidence of fair value is a quoted price for an identical asset in an active market. This is usually the current bid price.
- (b) When quoted prices are unavailable, the price of a recent transaction for an identical asset provides evidence of the current fair value as long as there has not been a significant change in economic circumstances or 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 fair value (eg because it reflects 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 of an identical asset on their own are not a good estimate of fair value, an entity estimates the 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.

11A.26 An entity shall not include transaction costs in the initial measurement of financial assets and liabilities measured at fair value through profit or loss.

*Valuation technique*

11A.27 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 for an identical asset between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same as the financial instrument being measured, 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.

11A.28 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 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*

11A.29 The fair 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 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.

11A.30 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 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.

11A.31 If a reliable measure of fair value is no longer available for an equity instrument measured at fair value through profit or loss, its **carrying amount** at the last date the instrument was reliably measurable 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.

### **Derecognition of a financial asset**

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11A.32 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, 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 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.

11A.33 An entity shall account for a factoring of receivables or similar transactions in accordance with paragraphs 11A.36 and 11A.37.

11A.34 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.

11A.35 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 statement of financial position (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.

### **Factoring of receivables**

11A.36 Factoring is the sale of receivables to a bank or other party at less than their face amount. The general derecognition principles in paragraphs 11A.32 to 11A.35 apply. Therefore, where the selling entity has transferred to the factor all significant benefits (eg the future cash flows from payment by the debtors) and all significant risks (eg slow payment risk and the risk of bad debts) relating to the debts, and has no obligation to repay the factor, the receivables shall be removed from the entity's statement of financial position (ie derecognised) and no liability shall be shown in respect of the proceeds received from the factor. A gain or loss shall be recognised, calculated as the difference between the carrying amount of the receivables and the proceeds received.

11A.37 When the selling entity retains any of the significant benefits and risks relating to factored receivables, the entity shall follow the derecognition requirements in Section 11A.32(c).

### **Derecognition of a financial liability**

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11A.39 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.

11A.40 If an existing borrower and lender exchange financial 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.