

### 3.4.2 Securitised loans

A purchased interest in a pool of assets that are themselves loans and receivables can be classified as loans and receivables if it meets the criteria for such classification. If an entity acquires a beneficial interest in a securitised pool of loans and receivables, this would not meet the definition of loans and receivables if the beneficial interest is quoted in an active market.

### 3.5 Available-for-sale financial assets (AFS)

AFS financial assets are those non-derivative financial assets that are designated as AFS, or that are not classified as loans and receivables or HTM investments, are not held for trading and are not designated as at FVTPL on initial recognition.

AFS financial assets are measured at fair value with fair value gains or losses recognised in other comprehensive income. On sale or impairment of the asset, the cumulative gain or loss previously recognised in other comprehensive income is reclassified to profit or loss as a reclassification adjustment.

However, interest calculated using the effective interest method on interest-bearing AFS financial assets, impairment losses and foreign exchange gains and losses on monetary AFS financial assets are recognised in profit or loss (see **chapter C6**).

Dividends are recognised in profit or loss only when:

- the entity's right to receive payment of the dividend is established;
- it is probable that the economic benefits associated with the dividend will flow to the entity; and
- the amount of the dividend can be measured reliably.

Examples of AFS financial assets are equity investments that are not designated on initial recognition as at FVTPL, debt securities that are quoted in an active market (which may or may not have put features that would also prohibit them from being classified as HTM) and other financial assets held for liquidity purposes.

#### Example 3.5

##### Held for trading versus available-for-sale

[IAS 39:IG.B.12]

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 per cent of total portfolio

value. The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments. Is Entity A permitted to classify the instruments as available for sale?

It depends on Entity A's intentions and past practice. If the portfolio manager is authorised to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available-for-sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

In July 2014, the IFRS Interpretations Committee issued an agenda decision on IAS 39 titled *Classification of a hybrid financial instrument by the holder*. The Committee was asked to clarify the classification by the holder of a hybrid financial instrument with a revolving maturity option, an early settlement option and a suspension of interest payments option (all at the option of the issuer). Specifically, the submitter raised the question of whether the host of such a financial instrument should be classified by the holder as equity or as a debt instrument under IAS 39.

On the basis of the responses to the outreach request, the Interpretations Committee observed that the issue is not widespread. The Interpretations Committee also noted that the financial instrument described in the submission is specific and it would not be appropriate to provide guidance on this particular issue.

The Interpretations Committee considered that its agenda criteria are not met. Consequently, the Interpretations Committee decided not to add this issue to its agenda.

## 4 Reclassifications

IAS 39 permits limited reclassifications of certain financial assets subject to meeting specified criteria. Reclassifications are not permitted for financial liabilities, derivatives or financial assets for which the fair value option has been selected.

### 4.1 Into FVTPL

IAS 39:50 prohibits any reclassification of a financial instrument into the FVTPL category after initial recognition.

Although IAS 39:50 is categorical that reclassifications into FVTPL are prohibited, there does appear to be one exception to this prohibition, which is described in IAS 39:12. If an entity is not able to measure an embedded derivative separately at a financial reporting date

subsequent to acquisition, the entity is required to designate the entire hybrid (combined) contract as at FVTPL. Because embedded derivatives are only required to be separated from contracts that are not measured at FVTPL, the situation described in IAS 39:12 would appear to be a reclassification from a measurement category other than FVTPL to FVTPL.

## 4.2 Out of FVTPL

As described in 3.1, financial assets may be classified at initial recognition as at FVTPL if specified conditions are met. In some cases, this classification is mandatory (e.g. in the case of derivatives that are not designated as effective hedging instruments or non-derivative financial assets that are deemed held for trading). In other cases, the classification is by election (e.g. when an entity applies the fair value option). IAS 39 only permits reclassification out of FVTPL, subject to specified criteria, for non-derivative financial assets that were originally classified as at FVTPL because they met the definition of held for trading. Financial assets that are classified as at FVTPL because they are derivatives or because they are designated as at FVTPL under the fair value option cannot be reclassified under any circumstances.

Loan commitments that are within the scope of IAS 39 and recognised and measured as at FVTPL cannot be reclassified because they meet the definition of derivatives and derivatives cannot be reclassified. In addition, a financial asset cannot be reclassified if it is designated as at FVTPL under the fair value option which would also prohibit reclassification of loan commitments designated as at FVTPL in accordance with IAS 39:4(a). Also, in the case of written loan commitments, they are financial liabilities and financial liabilities cannot be reclassified.

The first condition to be met in order to reclassify a financial asset from FVTPL is that the financial asset is no longer held for the purpose of selling or repurchasing it in the near term. [IAS 39:50(c)] This criterion applies irrespective of whether the asset was initially classified as held for trading because (i) it was acquired principally for the purpose of selling in the near term or (ii) because it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

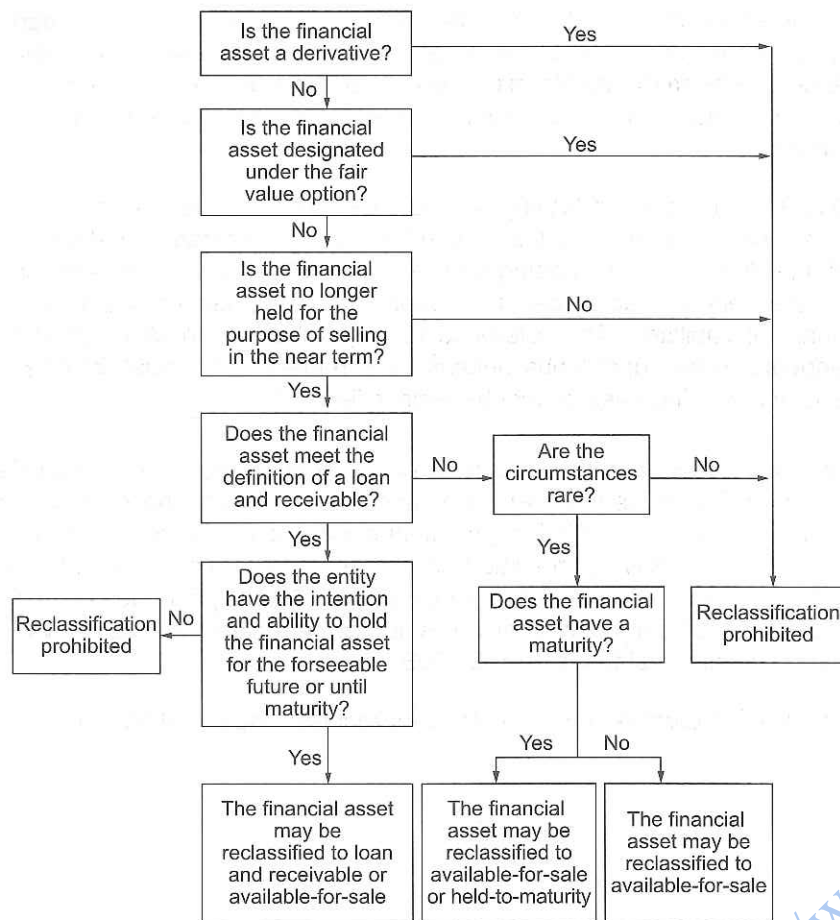
If an entity wishes to reclassify a financial asset that was classified as held for trading because it was part of a portfolio of identified financial instruments that are managed together and for which there was evidence of a recent actual pattern of short-term profit-taking, the entity must demonstrate that the specific asset subject to reclassification is

not intended to be sold in the near term. For an asset that forms part of a portfolio of assets, this may be difficult to demonstrate unless the asset has been isolated from the portfolio or the mandate of the portfolio has changed such that there is no longer evidence of short-term profit-taking.

IAS 39:50(c) refers to "selling or repurchasing it in the near term" which is the same terminology that is used in the held for trading definition. Both selling *and* repurchasing is relevant in the held for trading definition as the held for trading definition applies to both financial assets and financial liabilities. The reference to "repurchasing" in IAS 39:50(c) appears to be superfluous because this relates to financial liabilities and financial liabilities cannot be reclassified.

The second condition to be considered in order to reclassify a financial asset from FVTPL is whether the financial asset meets the definition of loans and receivables. If it does, the financial asset may be reclassified out of FVTPL if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity. [IAS 39:50D] If it does not meet the definition of loans and receivables, it may be reclassified out of FVTPL only in rare circumstances. [IAS 39:50B]

The following summarises the criteria for reclassifying out of FVTPL.



IAS 39 does not state explicitly at what date an entity should determine whether the financial asset meets the definition of loans and receivables when assessing whether the financial asset can be reclassified. Two interpretations are acceptable:

- (i) assess the definition of loans and receivables at the date of initial recognition of the financial asset; or
- (ii) assess the definition of loans and receivables at the date of reclassification of the financial asset. This is particularly relevant for financial assets that would not have met the definition of loans and receivables at initial recognition (e.g. because the instrument was traded in an active market), but that meet the definition at the date of reclassification.

An entity should decide on the appropriate interpretation and apply it consistently as an accounting policy choice to all reclassification assessments that require the entity to apply the definition of loans and receivables. If the accounting policy is considered relevant for the

understanding of the financial statements, it should be disclosed in accordance with IAS 1:117.

The financial asset reclassified from FVTPL should be reclassified at its fair value on the date of reclassification. Any gain or loss recognised in profit or loss up until the date of reclassification should not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost (in the case of equity instruments) or amortised cost (in the case of debt instruments). [IAS 39:50C]

For financial assets reclassified out of FVTPL, the entity will start to apply the impairment guidance described in IAS 39:58 - 70 for that asset. Prior to the date of reclassification, an assessment of impairment was not required because the asset was measured at FVTPL. Because the instrument's fair value at the date of reclassification becomes its new deemed cost or deemed amortised cost, impairment losses recognised after the reclassification date may differ from the impairment losses that would have been recognised had the instrument never been previously measured at FVTPL (see 5.4.3 in **chapter C6** for more detail).

A financial asset reclassified out of FVTPL is subject to extensive disclosure requirements (see 4.1.4 in **chapter C12**).

#### 4.2.1 Rare circumstances

IAS 39 does not provide any specific guidance as to how an entity should determine whether the circumstances under which reclassification is being contemplated are 'rare'. However, the Board expressed in IAS 39:BC104D that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term. In a press release that accompanied the issuance of the amendment to IAS 39, *Reclassification of Financial Assets*, in October 2008 the IASB stated that "the deterioration of the world's financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments".

In order for circumstances to be considered rare, there should be cause and effect between those circumstances and the financial assets held that are subject to reclassification. In the second half of 2008, some markets for asset-backed securities became in effect closed because of the stark reduction in new instruments being issued and very low trading volumes for existing instruments, partly due to a lack of price transparency and lack of investor appetite. An entity with investments in asset-backed securities in those markets, which had originally been classified as held for trading, may have ceased to intend to hold the investments for trading purposes and, due to the rare circumstances in those markets, been unable to sell the assets. Depending on the specific facts and circumstances reclassification may be acceptable. The mere reduction in the price of assets is generally not evidence of

rare circumstances because falling prices, even in a stock market crash, are not in themselves rare. In addition, the reduction in the value of an asset (e.g. an investment in an equity security) does not necessarily have an effect on the intentions or investment strategy of the holder of the instrument. Often the only effect is the fair value loss that would be realised if the entity disposed of the asset, and the realisation of a fair value loss is not in itself rare.

#### 4.2.2 Foreseeable future

IAS 39 does not provide guidance on how an entity should assess whether it intends to hold the financial asset for the foreseeable future.

'Foreseeable future' is not a new term introduced in the IAS 39 amendment because it is a term used in other IFRSs. IAS 21:15 permits the foreign exchange gains/losses on a monetary item that is a receivable from or a payable to a foreign operation to be recognised in other comprehensive income if settlement is neither planned nor likely to occur in the foreseeable future. Paragraph 39 of IAS 12 *Income Taxes* allows an exemption from recognising certain 'controllable' deferred tax liabilities in circumstances where it is probable that temporary differences will not reverse in the foreseeable future.

What is regarded as the 'foreseeable future' will depend on the facts and circumstances and intentions of the entity and the specific asset that is being assessed for reclassification. If an entity is actively marketing the asset in an attempt to sell it, this activity would be inconsistent with the assertion that the entity does not intend to sell the asset in the foreseeable future. An entity may at the date of reclassification have the intention to retain the asset for the foreseeable future, but later it may receive an unsolicited offer and choose to sell the asset. An entity determines the foreseeable future at the date of reclassification and it does not need to revisit this assessment. However, to the extent that an entity sells reclassified assets shortly after the reclassification date, this would call into question the entity's assertion that it has the intention to hold other assets that it wishes to reclassify until the foreseeable future.

#### 4.2.3 Assessing embedded derivatives

Hybrid contracts that are financial instruments may contain embedded derivatives which were not separately accounted for because these hybrid contracts are measured at FVTPL (see **section 3 in chapter C5**) may be reclassified out of FVTPL subject to meeting specific criteria. As the embedded derivative was not separated out at initial recognition a question arises whether IFRSs require or prohibit an entity from assessing the separation of the embedded derivative at the date the financial asset is reclassified.

In March 2009, the IASB issued amendments to IAS 39 and IFRIC 9 titled *Embedded Derivatives*. The amendments state that, upon reclassification of a financial asset out of FVTPL, an entity is required to assess whether embedded derivatives should be separated from the host financial contract. In addition, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the FVTPL category, that reclassification is prohibited. In such circumstances, the hybrid (combined) contract remains classified as at FVTPL in its entirety. The Board noted that when IFRIC 9 was issued, reclassifications out of the FVTPL category were prohibited and, therefore, IFRIC 9 did not consider the possibility of such reclassifications. The Board believed it was appropriate that embedded derivatives should be assessed at the date of reclassification. Not to require this would allow an entity to circumvent the requirement to assess embedded derivatives by classifying a financial asset initially as at FVTPL and subsequently reclassifying the asset.

The amendments also state that when assessing for embedded derivatives at the date of reclassification, the assessment should be made on the basis of the circumstances that existed at the later of when the entity first became a party to the contract and the date of change in the terms of the contract that significantly modifies the cash flows that otherwise would have been required under the contract. The Board considered that looking to circumstances when the entity became party to the contract was consistent with one of the stated purposes of embedded derivative accounting which is to prevent circumvention of the recognition and measurement requirements for derivatives and provide some degree of comparability. Furthermore, because the terms of the embedded features in the hybrid (combined) financial instrument have not changed, the Board did not see a reason for arriving at an answer on separation different from what would have been the case at initial recognition of the hybrid (combined) contract.

The Board's decision to look to circumstances when an entity became party to the contract when determining whether an embedded derivative is closely related to the host financial contract will be most relevant when determining whether put options, call options, or other prepayment options in debt instruments are closely related. IAS 39 deems such options to be non-closely related if the conditions in IAS 39:AG30(g) are not met. The condition in IAS 39:AG30(g)(i) requires the option's exercise price to be approximately equal to the amortised cost of the host debt instrument. At the date of reclassification, an entity will be required to make the embedded derivative assessment it would have made had the debt instrument not been initially classified as at FVTPL, i.e. the entity will need to determine the instrument's amortised cost for all dates when the instrument may be put, called, or prepaid and compare the amortised cost with the exercise price of the option on those dates.

### 4.3 Into AFS investments

A debt or equity instrument may be reclassified out of held for trading (part of the FVTPL category) into AFS in accordance with IAS 39:50 (see 4.2). Because the instrument is measured at fair value both before and after reclassification, there is no gain/loss on reclassification and all amounts previously recognised in profit or loss prior to the date of reclassification are retained in profit or loss.

An entity must reclassify a debt instrument from HTM to AFS if there is no longer the intention and ability to hold the debt instrument to maturity. Also, all debt instruments must be reclassified out of HTM into AFS when there are sales or reclassifications of more than an insignificant amount of HTM investments that do not meet any of the conditions in IAS 39:9 (see 4.6). At the date of reclassification, the difference between the carrying amount of such investments and their fair value should be recognised in other comprehensive income. [IAS 39:52]

If the fair value of an investment in an unquoted equity instrument becomes sufficiently reliable following a period during which the investment was measured at cost in accordance with IAS 39:53, resulting in the measurement of that investment at fair value, this is not a reclassification between financial asset categories. Investments in equity instruments can only ever be classified in either FVTPL or AFS (both of which are required to be measured at fair value) and IAS 39 does not have a fifth classification category. Therefore, although IAS 39:53 refers to financial assets that became reliably measurable when the measure was not previously available and this paragraph is included in the section titled 'Reclassifications', it is not apparent what category such assets could be reclassified to. It is reasonable to consider such assets as continuing to belong to the same classification category to which they were originally classified, but that their basis of measurement has been changed to fair value. The difference between cost and fair value at the date the fair value becomes reliably measurable should be recognised in other comprehensive income if the asset is classified as an AFS asset (see 4.10 and 4.11).

### 4.4 Out of AFS investments

Investments in debt instruments may be reclassified out of AFS. Investments in equity instruments classified as AFS cannot be reclassified.

If the fair value of an investment in an unquoted equity instrument classified as an AFS asset becomes unreliable and, therefore, an entity ceases to measure this investment at fair value and begins to measure it at cost in accordance with IAS 39:54, this is not a reclassification between financial asset categories. Investments in equity instruments can only ever be classified in either FVTPL or AFS (both of which require

measurement at fair value) and IAS 39 does not have a fifth classification category. Therefore, although IAS 39:54 refers to examples where the fair value of an investment in an unquoted equity instrument becomes unreliable, and this paragraph is included in the section of the Standard titled 'Reclassifications', it is not apparent what category such assets could be reclassified to. It is reasonable to consider such assets as continuing to belong to the same classification category to which they were originally classified, but that their basis of measurement has been changed to cost (see 4.10 and 4.11).

A financial asset classified as AFS may be reclassified to HTM if the entity has the intent and ability to hold the asset to maturity. The asset may be reclassified during the instrument's life except during the two-year tainting period (see 3.3) if the entity has disposed of more than an insignificant amount of held-to-maturity assets.

A financial asset classified as AFS may be reclassified out of the AFS category to the loans and receivables category if it meets the definition of loans and receivables and the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

As described in 4.2, an entity should determine an accounting policy with respect to the date it determines whether a reclassified AFS debt instrument meets the definition of loans and receivables. Two interpretations are acceptable:

- (i) assess the definition of loans and receivables at the date of initial recognition of the financial asset; or
- (ii) assess the definition of loans and receivables at the date of reclassification of the financial asset.

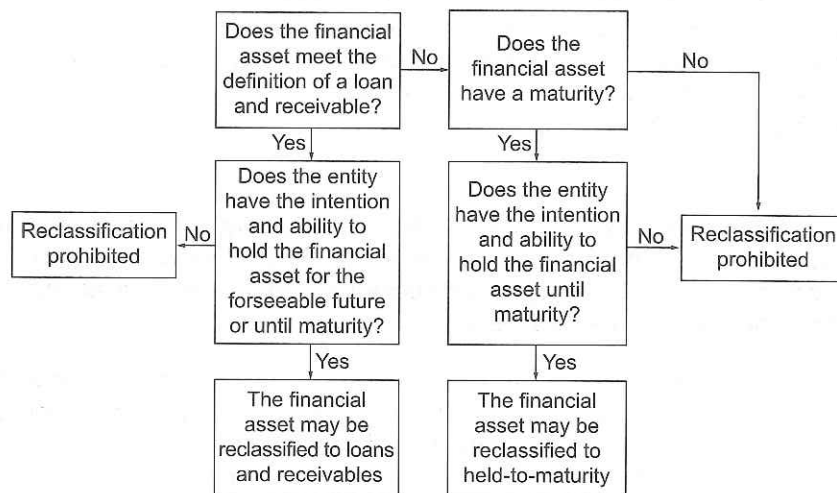
An entity should decide on an appropriate interpretation and apply it consistently as an accounting policy choice to all reclassification assessments that require the entity to apply the definition for loans and receivables. If the accounting policy is considered relevant for the understanding of the financial statements, it should be disclosed in accordance with IAS 1:117.

If an entity's accounting policy is to assess the definition of loans and receivables at the date of initial recognition, then the entity will not be able to reclassify an AFS debt instrument where that AFS debt instrument was classified as such because it did not meet the definition of loans and receivables at initial recognition due to the fact that it was traded in an active market.

If an entity's accounting policy is to assess the definition of loans and receivables at the date of reclassification, then the debt instrument may no longer be traded in an active market and so the entity may be able

to reclassify the AFS debt instrument even though it did not meet the definition of loans and receivables at initial recognition.

The following summarises the criteria for reclassifying out of AFS.



A financial asset reclassified from AFS should be reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in profit or loss should not be reversed. The fair value of the financial asset on the date of reclassification becomes its new amortised cost.

Any previous gain or loss on an AFS asset that has been recognised in other comprehensive income should be amortised to profit or loss over the remaining life of the investment using the effective interest method in the case of an instrument with a fixed maturity. Any difference between the new amortised cost (being the asset's fair value at the date of reclassification) and its maturity amount should also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium or a discount. In the case of a financial asset that does not have a fixed maturity (e.g. a perpetual debt instrument reclassified from AFS to loans and receivables), the gain or loss should be recognised in profit or loss when the financial asset is sold or otherwise disposed of or impaired. If the reclassified financial asset is subsequently impaired, any previous gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss irrespective of whether or not the asset has a fixed maturity. [IAS 39:54]

A financial asset reclassified out of AFS to loans and receivables is subject to extensive disclosure requirements (see 4.1.4 in chapter C12).

#### 4.5 Into HTM investments

A financial asset classified as at FVTPL may be reclassified to HTM if the financial asset is no longer held for the purpose of selling or repurchasing it in the near term [IAS 39:50(c)] and it meets the definition of a HTM investment. The criteria for reclassification are described in 4.2.

A financial asset classified as AFS may be reclassified to HTM if the entity has the intent and ability to hold the asset to maturity. The asset may be reclassified during the instrument's life except during the two-year tainting period if the entity has disposed of more than an insignificant amount of HTM assets. When the two-year period subsequent to the period in which tainting occurred has passed, the entity is allowed to reclassify the assets back into HTM provided that it intends and is able to hold these assets to maturity. On the date of reclassification, an asset's carrying amount (i.e. its fair value at the date of reclassification) becomes the asset's new amortised cost. [IAS 39:54] Any previous fair value gain or loss on the asset that has been accumulated in equity is amortised to profit or loss over the remaining life of the financial asset using the effective interest method.

#### 4.6 Out of HTM investments

When, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as HTM, it is reclassified to AFS and remeasured at fair value. [IAS 39:51] The 'tainting' provisions of IAS 39 (see 3.3) apply not only to sales but also to reclassifications of HTM investments. Therefore, reclassifications of more than an insignificant amount of HTM investments, which do not meet any of the conditions for permitted sales, taint the HTM portfolio and all remaining HTM investments must be reclassified into AFS.

On reclassification out of HTM into the AFS category, as a consequence of tainting, any difference between an asset's carrying amount and its fair value is recognised in other comprehensive income. [IAS 39:51 and IAS 39:55(b)] This difference must be disclosed in addition to the reason for reclassification. [IFRS 7:12]

When an entity taints its HTM portfolio in the current reporting period, and is required to reclassify all of its HTM investments into the AFS category, it does not restate its comparatives for the reporting period to reflect this change of classification, because this would conceal the impact of 'tainting' the portfolio.

#### 4.7 Into loans and receivables

Reclassifications of financial assets classified either as at FVTPL or as AFS to the loans and receivables category are permitted in certain circumstances. The criteria for reclassifying out of these categories are described in 4.2 and 4.4.

#### 4.8 Out of loans and receivables

Although IAS 39 provides explicit guidance on reclassifications into loans and receivables, it is silent as to whether and when reclassifications out of loans and receivables are permitted or required. As the loan and receivable definition requires that the instrument is not quoted in an active market the Standard is not clear whether reclassification is permitted or required if the instrument becomes quoted in an active market after it is classified as a loan and receivable. Reclassification would only be permitted to an available-for-sale financial asset as reclassifications into the fair value through profit or loss category are expressly forbidden by IAS 39:50.

Due to the lack of specific guidance in IAS 39 an entity should determine an accounting policy whether financial assets should be reclassified from loans and receivables to available-for-sale financial assets in the case where the loans and receivables definition is no longer met. This policy should be applied consistently for similar events and circumstances for all loans and receivables. If an entity chooses reclassification as its accounting policy, it will need to reclassify as available-for-sale all items classified as loans and receivables that become quoted in an active market; it would not be appropriate for an entity to reclassify only some of its loans and receivables that become quoted in an active market. The date of reclassification should be the date when the market for the financial asset becomes active.

#### 4.9 Summary of reclassifications

The summary of reclassifications below excludes investments in equity instruments (or derivatives linked to them and settled by delivery of an unquoted equity instrument) for which fair value is unreliable (see 4.10 and 4.11).

Out of	Into	Criteria	Example
FVTPL	L&R	<p><i>Debt instrument meets the definition of L&amp;R</i></p> <p>The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset for the foreseeable future.</p>	A trade receivable that at initial recognition was intended to be sold when that intent no longer applies.

Out of	Into	Criteria	Example
FVTPL	HTM	<p><i>Debt instrument does not meet the definition of loans and receivables (if the instrument met the definition of L&amp;R it could not be reclassified to HTM because the HTM definition specifically excludes L&amp;R)</i></p> <p>The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset until maturity (this requirement applies for all HTM assets) and the circumstances are rare.</p>	A debt security that at initial recognition was intended to be sold in the near term and is a security that is traded in an active market (e.g. corporate debt, government bond) and where the entity now considers it has the intent and ability to hold to maturity. The circumstances for the reclassification are deemed rare.
FVTPL	AFS	<p><i>Debt instrument meets the definition of L&amp;R</i></p> <p>The asset is no longer held for the purpose of selling in the near term and the entity has the intention and ability to hold the financial asset for the foreseeable future.</p>	A trade receivable that at initial recognition was intended to be sold where the intent no longer applies.
FVTPL	AFS	<p><i>Equity instrument or debt instrument does not meet the definition of L&amp;R</i></p> <p>The asset is no longer held for the purpose of selling in the near term and the circumstances are rare.</p>	A debt security that at initial recognition was intended to be sold and is a security that is traded in an active market (e.g. corporate debt, government bond). The circumstances for the reclassification are deemed rare.
AFS	L&R	<p><i>Debt instrument meets the definition of L&amp;R</i></p> <p>The entity has the intention and ability to hold the financial asset for the foreseeable future.</p>	A trade receivable that at initial recognition was designated as AFS.

[IFRS 13:72]

- Level 1 inputs comprise unadjusted quoted prices in active markets for identical assets and liabilities that the entity can access at the measurement date (see 10.2.1);
- Level 2 inputs comprise other observable inputs not included within Level 1 of the fair value hierarchy (see 10.2.2); and
- Level 3 inputs comprise unobservable inputs (including the entity's own data, which are adjusted, if necessary, to reflect the assumptions market participants would use in the circumstances) (see 10.2.3).

Observable inputs are defined as "[i]nputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability". [IFRS 13:Appendix A]

Unobservable inputs are defined as "[i]nputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability". [IFRS 13:Appendix A]

The fair value hierarchy gives the highest priority to Level 1 inputs and the lowest priority to Level 3 inputs. [IFRS 13:72]

For example, if a fair value measurement for an asset is based on an unadjusted quoted price in an active market for an identical asset that the entity can access at the measurement date, this is categorised within Level 1 of the fair value hierarchy. In contrast, a valuation based on unobservable inputs would be categorised within Level 3. [IFRS 13:72]

When an entity approaches the measurement of an asset, or a liability, or an entity's own equity instrument, at fair value, it looks at the available valuation techniques and at the inputs available for those techniques. When selecting the techniques and inputs to be used, the entity is required to maximise the use of observable inputs and minimise the use of unobservable inputs (see section 8). Once the selection has been made, each of the inputs is categorised within the fair value hierarchy outlined above; 10.2 summarises IFRS 13's requirements regarding the categorisation of inputs.

When an entity has determined the appropriate categorisation of the inputs into a fair value measurement, and has arrived at a measure of fair value using those inputs, it is then necessary to determine the appropriate categorisation of the fair value measurement in its entirety; this topic is discussed in 10.3.

## 10.2 Categorisation of inputs to valuation techniques within the fair value hierarchy

### 10.2.1 Level 1 inputs

#### 10.2.1.1 Level 1 inputs – general

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date. [IFRS 13:76 & Appendix A]

A quoted price for an identical asset or liability in an active market provides the most reliable evidence of fair value and should be used without adjustment to measure fair value whenever available, except in any of the circumstances described in IFRS 13:79 (see below). [IFRS 13:77]

An active market is defined as "[a] market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis". [IFRS 13:Appendix A]

Determining whether a market is active focuses on the trading activity for the individual asset or liability being measured and not on the general levels of activity in the market in which the asset or liability is traded. For example, a security listed on the FTSE in London or HKEx in Hong Kong could be considered to be traded in an inactive market if the security itself is traded infrequently.

IFRS 13:B37 sets out a list of factors that may indicate that there has been a significant decrease in the volume or level of activity for an asset or a liability relative to normal market activity for that asset or liability (or similar assets or liabilities) (see 9.5). The presence of one or more of the factors listed in IFRS 13:B37 alone is not sufficient to conclude that a market is not active. An entity should evaluate the relevance and significance of these factors to the individual asset or liability measured at fair value in order to determine whether the market for that asset or liability is inactive. A market is not deemed inactive simply because of insufficient trading volume relative to the size of an entity's position.

The characterisation of a market as 'active' or 'inactive' may change as market conditions change. However, a decline in the volume of transactions for a particular asset or liability does not automatically mean that the market has become inactive. A market would still be considered active as long as the frequency and volume of relevant transactions are sufficient to provide ongoing pricing information.

Further, quoted prices from a market affected by a decline in the volume or level of activity should not be ignored unless the price is associated with a transaction that is not orderly. It is not appropriate to conclude automatically that all transactions occurring in a market

exhibiting a significant decline in volume or level of activity are not orderly. IFRS 13:B43 sets out a list of factors that may indicate that a transaction is not orderly (see 9.6). Very little weight should be given to prices observed for a transaction that is not orderly; more weight may be given to a price observed for an orderly transaction. However, the entity should evaluate carefully whether an adjustment may be needed to that price to ensure the fair value measurement is consistent with the objectives in IFRS 13.

When a financial asset or financial liability is exchanged in multiple active markets (e.g. on different exchanges), the entity will need to consider which market is the most relevant for measuring fair value. IFRS 13 states explicitly that the emphasis within Level 1 is on determining both of the following:

[IFRS 13:78]

- the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability (see 3.3); and
- whether the entity can enter into a transaction for the asset or liability at the price in that market at the measurement date.

When a quoted price in an active market is available, it should not be adjusted except in the circumstances listed below.

[IFRS 13:79]

- When an entity holds a large number of similar (but not identical) assets or liabilities (e.g. debt securities) that are measured at fair value and a quoted price in an active market is available but not readily accessible for each of those assets or liabilities individually (i.e. given the large number of similar assets or liabilities held by the entity, it would be difficult to obtain pricing information for each individual asset or liability at the measurement date). In such circumstances, as a practical expedient, an entity may measure fair value using an alternative pricing method that does not rely exclusively on quoted prices (e.g. matrix pricing – see 8.4). However, the use of an alternative pricing method results in a fair value measurement categorised within a lower level of the fair value hierarchy.
- When a quoted price in an active market does not represent fair value at the measurement date. That might be the case if, for example, significant events (such as transactions in a principal-to-principal market, trades in a brokered market or announcements) take place after the close of a market but before the measurement date. An entity shall establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for

new information, the adjustment results in a fair value measurement categorised within a lower level of the fair value hierarchy.

- When measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in an active market and that price needs to be adjusted for factors specific to the item or the asset (see 5.1.2). If no adjustment to the quoted price of the asset is required, the result is a fair value measurement categorised within Level 1 of the fair value hierarchy. However, any adjustment to the quoted price of the asset results in a fair value measurement categorised within a lower level of the fair value hierarchy.

If an entity holds a position in a single asset or liability (including a position comprising a large number of identical assets or liabilities, such as a holding of financial instruments) and the asset or liability is traded in an active market, the fair value of the asset or liability should be measured within Level 1 as the product of the quoted price for the individual asset or liability and the quantity held by the entity. That is the case even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price. [IFRS 13:80]

#### 10.2.1.2 Published net asset values for open-ended investment funds as Level 1 inputs

Some open-ended investments funds not listed on a stock exchange may publish daily quotations of their net asset values (NAVs) at which redemptions or purchases of units occur without any adjustments to the published NAV. The redemptions and unit purchases may take place regularly at the quoted NAVs and there is no secondary market for the units because they are not transferrable (i.e. the sole transactions are issuances and redemptions of the units by the fund). These quoted NAVs may meet the definition of a Level 1 input provided that all of the elements of the definition in IFRS 13:76 (see 10.2.1.1) are met.

Consequently, the following criteria must be satisfied:

- the price must be quoted in an active market (see 10.2.1.1);
- the price must be unadjusted;
- the price must be for an asset or a liability that is identical to the asset or liability being measured; and
- the entity must have access to the price at the measurement date.

For the price to be classified as a Level 1 input, it is not required that there be an active market between the holders of the financial instrument and other potential holders that are not the issuer of the financial instrument; it is possible that the financial instrument does not

have an active market other than between the holders of the financial instrument and the issuer of the financial instrument.

Careful analysis is required when assessing whether such prices meet the definition of a Level 1 input. In particular, the assessment should include: (1) whether quoted prices are readily and regularly available; (2) whether transactions occur regularly; and (3) whether the regularly occurring transactions take place at the quoted (unadjusted price) on an arm's length basis.

### 10.2.2 Level 2 inputs

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. [IFRS 13:81 & Appendix A]

Level 2 inputs include the following:

[IFRS 13:82]

- quoted prices for similar assets or liabilities in active markets;
- quoted prices for identical or similar assets or liabilities in markets that are not active;
- inputs other than quoted prices that are observable for the asset or liability, for example:
  - interest rates and yield curves observable at commonly quoted intervals;
  - implied volatilities; and
  - credit spreads; and
- inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

Under IFRS 13:82 (see above), when an entity measures the fair value of an asset or a liability and no Level 1 inputs are available, it may use quoted prices for 'similar' assets or liabilities in active markets as a Level 2 input. Equally, under IFRS 13:79(a) (see 10.2.1), entities holding a large number of 'similar' assets or liabilities for which a quoted price is not accessible for all of the assets and liabilities being measured, may measure fair value using alternative pricing (e.g. matrix pricing) as a practical expedient.

IFRS 13 does not provide any specific guidance as to what is meant by 'similar' in this context. The identification of a similar asset or liability involves the exercise of judgement and requires both:

- an understanding of the terms and other factors that affect the fair values of the asset or liability being measured and the asset or liability for which the quoted price exists; and
- an identification and assessment of any differences in the terms and other factors that affect the fair values of these assets or liabilities.

In October 2008, the IASB's Expert Advisory Panel issued a report *Measuring and Disclosing the Fair Value of Financial Instruments in Markets That Are No Longer Active* which describes practices entities use when measuring financial instruments at fair value. Paragraph 32 of the report (quoted below) provides examples of the basic terms of a financial instrument with contractual cash flows. Entities may consider these terms, and any associated differences, when assessing whether the instrument for which a quoted price exists is 'similar' to the instrument being measured.

"The basic terms of a financial instrument include, for example:

- (a) **the timing of the cash flows:** when the entity expects to realise the cash flows related to the instrument.
- (b) **the calculation of the cash flows:** for example, for a debt instrument the interest rate that applies (i.e. the coupon), or for a derivative instrument how the cash flows are calculated in relation to the underlying instrument or index (or indices).
- (c) **the timing and conditions for any options in the contract:** for example:
  - (i) prepayment options (one or both parties can demand or make an early payment).
  - (ii) extension options (one or both parties can extend the period of the instrument).
  - (iii) conversion options (one or both parties can convert the instrument into another instrument).
  - (iv) put or call options (one or both parties can exchange the instrument for a defined amount of cash or other assets or liabilities).
- (d) **protection of the rights of the parties to the instrument:** for example:
  - (i) terms relating to credit risk in debt instruments, such as collateral, event of default and margin call triggers.
  - (ii) subordination of the instrument, for example the priority of the instruments in the event of a winding up.
  - (iii) the legal enforceability of the cash flows."

Further, paragraph 33 of the report notes that "to measure the fair value of an instrument it is necessary to assess the return that market participants would require on the instrument to compensate for" certain risks. This principle is largely consistent with the fair value measurement

principles in IFRS 13. Accordingly, any differences between the compensation that market participants would require for the risk associated with the instrument being measured and the compensation required for the instrument for which a quoted price exists should be considered in determining whether the instruments are similar and whether an adjustment to the quoted price is necessary.

If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. [IFRS 13:82]

#### Example 10.2.2

##### Determining how an input is classified when the item being measured has a specified contractual term

Company X enters into a fixed-price six-year agreement to sell 50 megawatts (MW) of on-peak electricity for delivery at location ABC beginning on 1 January 20X1 and continuing through to 31 December 20X6. On 31 March 20X1, Company X is measuring the fair value of the fixed-price agreement. Active market quotes are available for forward contracts to sell electricity at location ABC for two years (31 March 20X1 to 31 March 20X3). Accordingly, Company X will use the two years of observable forward pricing data and develop an expectation for the remaining 3 years and nine months (i.e. 1 April 20X3 to 31 December 20X6) using a model that relies on pricing data and weather patterns from the previous four years. The model also incorporates all relevant physical constraints (capacity of existing power plants and power plants expected to be completed near location ABC, projected supply and demand etc.).

In the circumstances described, the five-year and nine-month forward price curve represents a Level 3, rather than a Level 2, input.

An input for an item with a specified contractual term falls within Level 2 of the hierarchy only if it meets both of the following criteria:

- as required by IFRS 13:82 (see above), the input must be observable for substantially the full term of the asset or liability (see above); and
- the impact of the unobservable period must not be significant to the fair value of the asset or liability. The guidance set out in **10.3.3.2** should be applied when evaluating whether the effect of the unobservable period is significant.

IFRS 13:B35(b) cites as an example an interest rate swap with a term of 10 years and for which the fair value is determined using a swap rate based on a yield curve that is observable at commonly quoted intervals for nine years. The swap rate input is a Level 2 input provided that any reasonable extrapolation of the yield curve for Year 10 would not be significant to the fair value measurement of the swap in its entirety.

In contrast, in the circumstances described, Company X can observe forward prices for only 24 months of the remaining 69-month term of the agreement (i.e. 35 per cent of the term). Because this does not represent substantially the

full term, the first criterion above is not met. An analysis of the second criterion is unnecessary; the forward price curve is considered a Level 3 input. However, if the forward price curve had been observable for substantially the full term, Company X would need to consider the second criterion (i.e. whether the effect of the unobservable term is significant to the fair value of the agreement) to determine whether the forward price curve is a Level 2 or Level 3 input.

Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the following:

[IFRS 13:83]

- the condition or location of the asset;
- the extent to which inputs relate to items that are comparable to the asset or liability (including those factors described in IFRS 13:39 – see **5.1.2**); and
- the volume or level of activity in the markets within which the inputs are observed.

An entity should consider whether adjustments to the quoted price for a similar asset or liability are necessary to reflect differences between the terms of the items being compared and other factors that may affect the fair values of those items. For example, the entity may need to make adjustments to reflect differences in the condition, location or risks (including non-performance risk and liquidity risk) of the items being compared.

Under IFRS 13:37, when a quoted price for the transfer of an identical or similar liability is not available and the identical item is held by another party as an asset, the fair value of the liability is measured from the perspective of a market participant that holds the identical item as an asset at the measurement date. The value should only be adjusted for factors specific to the asset that are not applicable to the fair value measurement of the liability. IFRS 13:39 provides a number of examples of such factors (see **5.1.2**).

In addition, if an entity uses a quoted price for a similar item in its valuation technique, the entity may need to make adjustments to reflect differences in risk, including liquidity differences. For example, the item being measured may be in shorter supply (relative to demand) than the similar item for which a quoted price exists. In this situation, a liquidity risk premium exists for the item being measured that should be factored into the fair value measurement as an adjustment to the quoted price of the similar item.

An adjustment to a Level 2 input that is significant to the entire measurement might result in a fair value measurement categorised within Level 3 of the

fair value hierarchy, if the adjustment uses significant unobservable inputs. [IFRS 13:84] See 10.3.3.2 for further discussion.

IFRS 13 provides the following examples of Level 2 inputs for particular assets and liabilities.

[IFRS 13:B35]

- **Receive-fixed, pay-variable interest rate swap based on the London Interbank Offered Rate (LIBOR) swap rate** A Level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap.
- **Receive-fixed, pay-variable interest rate swap based on a yield curve denominated in a foreign currency** A Level 2 input would be the swap rate based on a yield curve denominated in a foreign currency that is observable at commonly quoted intervals for substantially the full term of the swap. That would be the case if the term of the swap is 10 years and that rate is observable at commonly quoted intervals for nine years, provided that any reasonable extrapolation of the yield curve for Year 10 would not be significant to the fair value measurement of the swap in its entirety (see **example 10.2.2** for circumstances when observable data is not available for substantially the full term of the agreement).
- **Receive-fixed, pay-variable interest rate swap based on a specific bank's prime rate** A Level 2 input would be the bank's prime rate derived through extrapolation if the extrapolated values are corroborated by observable market data, for example, by correlation with an interest rate that is observable over substantially the full term of the swap.
- **Three-year option on exchange-traded shares** A Level 2 input would be the implied volatility for the shares derived through extrapolation to Year 3 if both of the following conditions exist:
  - (i) prices for one-year and two-year options on the shares are observable; and
  - (ii) the extrapolated implied volatility of a three-year option is corroborated by observable market data for substantially the full term of the option.

In that case, the implied volatility could be derived by extrapolating from the implied volatility of the one-year and two-year options on the shares and corroborated by the implied volatility for three-year options on comparable entities' shares, provided that correlation with the one-year and two-year implied volatilities is established. [IFRS 13:B35]

### 10.2.3 Level 3 inputs

Level 3 inputs are unobservable inputs for the asset or liability. [IFRS 13:86 & Appendix A]

Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available (e.g. when there is little, if any, market activity for the asset or liability at the measurement date). However unobservable inputs should reflect the assumptions that market participants would use when pricing the asset or liability, so as to achieve the general fair value measurement objective (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). [IFRS 13:87]

Unobservable inputs should reflect, among others, assumptions that market participants would make about risk. Assumptions about risk include the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model) and the risk inherent in the inputs to the valuation technique. A measurement that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one when pricing the asset or liability. For example, it might be necessary to include a risk adjustment when there is significant measurement uncertainty (e.g. when there has been a significant decrease in the volume or level of activity when compared with normal market activity for the asset or liability (or similar assets or liabilities) and the entity has determined that the transaction price or quoted price does not represent fair value – see 9.5 to 9.7). [IFRS 13:88]

Unobservable inputs should be developed using the best information available in the circumstances, which might include an entity's own data. In developing unobservable inputs, an entity's own data, should be adjusted if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (e.g. an entity-specific synergy). IFRS 13 does not require an entity to undertake exhaustive efforts to obtain information about market participant assumptions. However, the entity is required to take into account all information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement. [IFRS 13:89]

IFRS 13 provides the following examples of Level 3 inputs for particular assets and liabilities.

[IFRS 13:B36]

- **Long-dated currency swap** A Level 3 input would be an interest rate in a specified currency that is not observable and cannot be corroborated by observable market data at commonly quoted intervals or otherwise for substantially the full term of the currency swap. The interest rates in a currency swap are the swap rates calculated from the respective countries' yield curves.
- **Three-year option on exchange-traded shares** A Level 3 input would be historical volatility, i.e. the volatility for the shares derived from the

shares' historical prices. Historical volatility typically does not represent current market participant expectations about future volatility, even if it is the only information available to price an option.

- **Interest rate swap** A Level 3 input would be an adjustment to a mid-market consensus (non-binding) price for the swap developed using data that are not directly observable and cannot otherwise be corroborated by observable market data.

#### 10.2.4 Determining the level within the fair value hierarchy when broker or pricing service quotes are used

IFRS 13 allows the use of quoted prices provided by brokers or pricing services if the entity has determined that the quoted prices provided by a broker or pricing service are developed in accordance with IFRS 13. See 9.7 for more detailed guidance regarding when a quoted price provided by a broker or pricing service can be considered to be determinative of fair value.

When quoted prices are provided by a broker or pricing service, and are used by an entity in measuring the fair value of an asset or a liability, the following considerations are relevant for the entity's assessment of the level within the fair value hierarchy in which the quoted prices fall.

##### Level 1 inputs

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities. If the quote provided by a broker or pricing service relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date, the quoted price should be used to measure the fair value of the asset or liability without adjustment, subject to limited exceptions as discussed in IFRS 13:79 (see 10.2.1.1).

If an adjustment is necessary in accordance with IFRS 13:79, or if the quoted price originates from a market that is not active, the broker or pricing service quote does not represent a Level 1 input.

##### Level 2 inputs

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Observable inputs are defined in IFRS 13:Appendix A as "[i]nputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability [or own equity instrument]".

If a quote from a broker or pricing service meets any of the following criteria, it represents a Level 2 input.

- The entity can determine that the broker or pricing service quote itself represents a quoted price for similar assets or liabilities in active markets.
- The entity can determine that the quote is based on quoted prices for identical or similar assets or liabilities in markets that are not active, from transactions that are orderly and for which adjustments are based only on information that is (1) observable, or (2) market-corroborated, or (3) unobservable, but insignificant to the measurement.
- The entity can determine that the quote was established using a valuation technique and that the inputs the broker or pricing service used to arrive at the quoted price are observable or market-corroborated and any unobservable inputs do not have a significant effect on the measurement.
- The entity can corroborate the broker or pricing service quote or inputs using prices (1) from orderly transactions in an active market or (2) from orderly transactions in an inactive market for which any adjustment needed to ensure the price is representative of fair value is insignificant to the measurement.

In some circumstances, adjustments to the Level 2 inputs may be necessary, for example if the quoted price is based on a similar (but not identical) asset or liability. If an adjustment is required, an entity should determine whether the adjustment is significant to the entire measurement and whether it is based on unobservable inputs (see 10.3.3.2). If this is the case, the entire measurement will be categorised within Level 3.

##### Level 3 inputs

Level 3 inputs are unobservable inputs for the asset or liability. Broker or pricing service quotes meeting any of the following criteria are categorised in Level 3 of the fair value hierarchy.

- The entity can determine that the quote is based on a Level 1 or Level 2 input but an adjustment is required that is significant to the measurement and based on unobservable inputs.
- The entity can determine that the quote is based on unobservable inputs with a significant effect.

Regardless of whether the entity determines that the broker or pricing service quote is based on observable or unobservable inputs, it is not appropriate for an entity to accept, without further analysis, that the inputs used are appropriate in the circumstances. The entity must gain sufficient understanding of the inputs to be able to conclude that they reflect assumptions market participants would use, including assumptions about risks inherent in a particular valuation technique